HEARINGS BEFORE THE

COMMITTEE ON WAYS AND MEANS
(Volume 1 of 5)

104th Congress
1995-1996

HEARINGS BEFORE THE

COMMITTEE ON WAYS AND MEANS
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COMMITTEE ON WAYS AND MEANS
(Volume 4 of 5)

104th Congress
1995-1996

HEARINGS AND WRITTEN COMMENTS BEFORE THE

COMMITTEE ON WAYS AND MEANS
(Volume 5 of 5)

104th Congress
1995-1996

MISCELLANEOUS TAX REFORMS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JULY 11 AND 12, 1995

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[1] Appointed July 10, 1995.

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TUESDAY, JULY 11, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10:02 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearings follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225-2743
June 30, 1995
No. FC-8

Archer Announces Hearing on Miscellaneous Tax Reforms

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a series of hearings on miscellaneous tax reforms. **The hearings will take place on Tuesday, July 11, Wednesday, July 12, and Thursday, July 13, 1995, in the main Committee Hearing Room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

This hearing will cover various revenue issues which have been brought to the attention of the Committee as well as tax simplification legislation which was most recently before the Committee on Ways and Means as part of H.R. 3419 in the 103rd Congress.

Because of the large number of items described below which are within the scope of the hearing, it will not be possible for the Committee to hear oral testimony on all of the issues. Written submissions are strongly encouraged in lieu of appearances before the Committee. Requests to appear are strongly discouraged with respect to issues that have previously been the subject of a hearing before the Committee (including simplification items from H.R. 3419 which are not proposed below to be modified).

In announcing the hearing, Chairman Archer stated: "The purpose of the hearing is to allow the Committee on Ways and Means to consider various relatively minor ways to simplify and improve the current tax laws while the Committee continues its longer range project of fundamental reform of our nation's tax system. Because of the large number of proposals, it will obviously not be possible for the Committee to take action on all of them. As the Committee moves forward, I intend to oppose any proposals which are targeted tax relief or which have significant cost. In addition, any proposals which are adopted will be accompanied by a sufficient offset to avoid increasing the deficit."

The proposals below, which are the subjects of the hearings, will be more fully described in a pamphlet to be issued by the Joint Committee on Taxation prior to the hearing.

MISCELLANEOUS TAX PROPOSALS

Accounting

1. Expense certain costs associated with natural disasters
2. Allow installment method of reporting income from sale of certain residential real property to first-time homebuyers
3. Eliminate "look-back method" for nonresidential construction contractors
4. Repeal 1986 provision requiring contributions in aid of construction to be included in gross income
5. Allow trading partnerships and corporations to use a mark-to-market method of accounting for securities
6. Allow partnerships and S corporations to use fiscal year by paying estimated tax on behalf of their owners
7. Allow deduction for intrastate operating rights of motor carriers

8. Permit taxpayers to estimate shrinkage for inventory accounting
9. Provide exclusion for certain amounts received by a utility with respect to nuclear decommissioning costs
10. Repeal Treasury ruling requirement for nuclear decommissioning costs
11. Treatment of certain compensation payable by certain personal service corporations using an accrual method of accounting
12. Treatment of livestock sold on account of weather-related conditions
13. Treatment of certain crop insurance proceeds and disaster assistance payments
14. Clarify availability of cash accounting method for construction contractors

Business expenses

1. Any period during which a Federal employee is certified by the Attorney General to be participating in a Federal criminal investigation not included in computation of one-year limitation with respect to deductibility of travel expenses while temporarily away from home
2. Deduction for regularly scheduled air transportation limited to normal tourist class fare
3. Increase deductibility of business meal expenses for individuals subject to Federal hours of service limitations

Business tax credits

1. Credit for rehabilitation of certain historic homes
2. Tax credit for electric vehicles
3. Tax credit and tax-exempt financing for environmental remediation expenses

Capital gains

1. 10-percent alternative tax on gains from assets held 5 years or more
2. One-time exclusion of the sale of a principal residence by an individual who has attained age 55
   a. Allow multiple exclusions where two otherwise eligible taxpayers marry
   b. Allow multiple exclusions in certain cases
   c. Allow multiple exclusions in the case of certain unemployed persons
   d. Treat certain disabled persons as satisfying the age 55 requirement
3. Revise targeted capital gains exclusion for small business
4. Restore exception to market discount rules for tax-exempt bonds

Charitable deduction

1. Deduction for commemorative coins purchased from U.S. Mint
2. Charitable deduction for non-itemizers
3. Remove charitable deductions from overall limitation on itemized deductions
4. Repeal charitable substantiation rule for contributions of $250 or more
5. Allocation of basis to sale portion of bargain sales of real estate interests to charities or governments
6. Enhanced deduction for corporate contributions of scientific equipment for design research

Child Care Credit -- Extend dependent care credit and dependent assistance programs to certain overnight camp expenses

Compliance

1. Allow offset of State tax liability with overpayments of Federal tax
2. Repeal reporting requirement for real estate brokers
3. Extend IRS offset authority for undercover operations
4. Modify tip income reporting rules

Corporate

1. Provide that Alaska Native Corporation distributions of the proceeds from sale of ANCSA resources not be treated as taxable dividends until shareholders have received a return of capital on the resources sold
2. Lengthen corporate capital loss carryover from 5 to 15 years
3. Eliminate rule that accumulated earnings tax applies without regard to number of

shareholders
4. Provide exception to large corporate interest underpayment rules

Depreciation and amortization
1. Normalization of consolidated tax adjustments of a non-regulated subsidiary of a regulated public utility
2. Establish 15-year recovery period for small retail motor fuel outlet stores
3. Establish 3-year recovery period for semiconductor manufacturing equipment
4. Establish 3-year recovery period for property subject to certain rental purchase agreements
5. Establish 10-year recovery period for "qualified commercial improvement property"
6. Establish 10-year recovery period for leasehold improvements
7. Treatment of intermodal cargo containers
8. Exempt acquisition of software and software services businesses from 15-year intangibles amortization

EITC -- Allow State agencies to administer an advanced EITC payment

Education
1. Exclusion for income earned on State prepaid tuition plans
2. Adopt education savings accounts
3. Expand section 108(f) to provide that cancellation of certain private college student loans not taxable income

Employment taxes
1. Tax status of certain fishermen
2. FICA exemption for certain seasonal children camp employees
3. Extend FICA tip credit with respect to tips received by all persons who receive tips in connection with the provisions of food or beverages
4. Effective date of FICA tip credit
5. Repeal presumption that bakery distributors are employees for employment tax purposes
6. FUTA exemption for certain religious schools
7. FICA tax on health professionals' corporation paid by two or more entities under single employment contract
8. Repeal section 1706 of the 1986 Tax Reform Act

Empowerment zones
1. Expand number of community development corporations (from 20 to 40) eligible for tax credit and increase aggregate amount of contributions eligible for the credit
2. Tax incentives for economic recovery in designated areas with employment loss in financial and real estate businesses
3. Allow 20-percent tax credit for commercial revitalization costs in empowerment zones and other specially designated areas

Energy
1. Amend the section 29 credit for fuels derived from nonconventional sources
   a. Allow the credit to be claimed against the alternative minimum tax
   b. Repeal the requirement that fuel be sold to an unrelated party in certain cases
   c. Expand the definition of a qualifying facility in the case of fuel derived from an underground coal gasification process
   d. Redefine "tar sands" as a qualifying source and extend the period during which recovery of fuel from tar sands may commence (and credit-eligible fuel may be produced)
2. Increase the permitted refining activity in which an independent producer may engage while still qualifying for tax benefits not available to integrated producers
3. Allow independent producers to engage in retail sales through regulated utility affiliates while still qualifying for tax benefits not available to integrated producers
4. Allow a tax credit for lubricating oil produced for discarded motor oil
5. Allow oil and gas producers to expense geological and geophysical expenses in the year incurred

6. Extend the tax credit for electricity derived by wind and closed-loop biomass processes to electricity from certain gas-powered fuel cells

Estate and gift tax

1. Exemption for historic properties
2. Exempt certain land subject to permanent land conservation easement from estate tax
3. Estate tax marital credit for certain employees of international organizations
4. Relief from retroactive gift tax regulation on disclaimers
5. Extend the "predeceased parent exception" to collateral heirs and to taxable terminations and distributions
6. Increase special use valuation limit to $1.5 million
7. Credit for fair market value of inherited conservation property donated to Federal Government against estate tax
8. Package of proposals to simplify and improve estate and gift taxation
9. Require notification to charitable beneficiaries of charitable remainder trusts

Excise taxes

1. Modify the diesel motor fuel excise tax collection rules, including refund procedures, collection of tax on recreational boat diesel fuel, penalty for use of dyed fuel for taxable purposes, and exemption for a State exempt from Clean Air Act dyeing requirements
2. Treat kerosene as diesel motor fuel for excise tax purposes
3. Equalize the rail diesel motor fuel excise tax rate to that imposed on competing transportation modes
4. Exempt AMTRAK from the excise tax on rail diesel motor fuel
5. Exempt from excise tax motor fuels used in highway engines to power non-highway equipment mounted on trucks
6. Modify the gasoline excise tax refund procedure for gasoline sold to States and local governments
7. Reduce the excise tax rates on propane, CNG, LNG, and methanol to reflect their BTU equivalence to gasoline
8. Move the point of collection of the heavy truck excise tax from retail sale to manufacture, and clarify activities which constitute taxable remanufacture of existing trucks
9. Consolidate the current two-tier aviation gasoline excise tax at the terminal rack
10. Exempt fixed-wing air ambulances from the aviation excise taxes
11. Reduce the harbor maintenance excise tax if the unobligated balance of the accompanying Trust Fund program exceeds $100 million at the end of any year
12. Reduce current ethanol fuels tax subsidies if carbon dioxide produced as a by-product is marketed by the producer
13. Reduce the excise tax rate on hard apple cider to the rate of tax imposed on beer
14. Expand the tax credit for alcohol derived from fruit that is blended into distilled spirits to include alcohol from other agricultural products (e.g. whey)
15. Modify or phaseout the excise tax on luxury automobiles
16. Modify the excise tax on ozone-depleting chemicals to (a) exempt certain imported, recycled chemicals and (b) chemicals used in metered-dose inhalers (for 5 years)
17. Exempt stretch limousines from the gas-guzzler excise tax
18. Allow in-bond transfers of bottled distilled spirits among commonly owned distilled spirits plants
19. Drawback of distilled spirits tax on spirits used in nonbeverage products

Exempt organizations

1. Treatment of certain costs of private foundation in removing hazardous substances
2. Prevent reclassification as UBIT of certain dues paid to agricultural or horticultural organizations
3. Private foundations
   a. modify rules for private foundation grants to foreign organizations
   b. extend due date for first quarter estimated tax by private foundations
4. Common investment fund for private foundations
5. Exclusion from UBIT for corporate sponsorship payments received by tax-exempt organizations in connection with public events

6. Repeal 1986 extension of UBIT to games of chance
7. Clarify UBIT treatment of licensing of Olympic trademarks
8. Exception from debt-financed rules (sec. 514(c)(9)) for private foundation debt to improve real property
9. Permit tax-free liquidation of certain closely held corporations whose stock is given to charity and exempt certain assets from section 514(c)(2) debt financed rules
10. Allow conversion of scholarship funding corporation to taxable corporation
11. Treatment of certain amounts received by telephone cooperatives
12. Clarify that parent holding companies for hospitals may qualify as public charities rather than private foundations
13. Income of a rural electric cooperative for allocable shares of maintenance, etc. expenses to power a nonmember's electric co. takes from a separately owned and jointly operated electric generating facility is not included in 85-percent member income test
14. Codify IRS directive governing calculation of UBIT liability from charitable gaming
15. Extend private inurement rule to section 501(c)(4) organizations
16. Permit certain corporate conversions to tax-exempt title holding company without asset appreciation tax where corporation is wholly owned by tax-exempt entity that received stock as a gift or bequest

Financial institutions

1. Delete 1993 Act retroactive denial of losses reimbursed by FSLIC assistance for failed thrifts
2. Treat small commercial finance companies as small banks for bad debt reserve deduction

Foreign

1. Increase in section 911 exclusion from $70,000 to $100,000 with indexing
2. Repeal of limitation on foreign sales corporation exemption for military property
3. Inclusion of computer software as foreign sales corporation export property
4. Recharacterization of overall domestic loss for foreign tax credit purposes
5. Election to use earnings and profits basis for allocation of interest expense for foreign tax credit limitation purposes
6. Extension and modification of special allocation of research and experimental expenditures to U.S. source income for foreign tax credit limitation purposes
7. Repeal foreign tax credit basket for "10/50" noncontrolled corporations
8. Extension of period to which excess foreign tax credit may be carried
9. Extend deemed paid foreign tax credit to dividends from, or Subpart F income of, CFCs below third tier
10. Translation of foreign taxes into U.S. dollar amounts using average exchange rate during taxable year
11. Expansion of de minimis exception to Subpart F income treatment
12. Treatment of foreign base company sales and services income of controlled foreign corporations in the European Community
13. Exclusion of foreign base company shipping income from Subpart F income for certain controlled foreign corporations
14. Exempt controlled foreign corporations from uniform capitalization rules
15. Reporting of foreign corporation earnings and profits on a U.S. GAAP basis
16. Permit shareholder of a "10/50" corporation to elect to treat it as a CFC for foreign tax credit and Subpart F purposes
17. Increase in reporting threshold for stock ownership of a foreign corporation
18. Modification of excess passive assets provision for corporations with active financing income
19. Exception from foreign personal holding company income and foreign base company services income for active financing income
20. Repeal of excess passive asset provision and modification of passive foreign investment company provisions
21. Exemption of U.S. shareholders of controlled foreign corporations from passive foreign investment company provisions
22. Valuation of assets of a controlled foreign corporation under the passive foreign investment company and excess passive assets provisions

23. Exempt certain income derived by insurance brokers or agents from PFIC rules
24. Prizes and awards received from a foreign payor by a nonresident alien relating to competitions held in the United States are not treated as U.S. source income
25. Exempt service income of a nonresident alien earned on international ships or aircraft from U.S. tax
26. Repeal portfolio interest exemption
27. Exempt certain short-term OID obligations held by a non-resident alien from U.S. estate tax
28. Carryover of excess possession tax credit
29. Pass-through treatment for investments in U.S. mutual funds by foreigners
30. Consolidate income and loss of same country foreign corporations that elect to be taxed as domestic insurance companies

Housing cooperatives
1. Tax relief for housing coops on interest on reasonable reserves and income from laundries and parking; for limited equity coops, tax relief for commercial rentals
2. Treatment of coops owning only land

Insurance
1. Treatment of salvage and subrogation of property and casualty insurance companies
2. Health insurance organizations eligible for benefits of section 833
3. Treatment of certain gains and losses of life insurance companies under section 818(b)
4. Treatment of certain charitable risk pools
5. Small property and casualty insurance company deduction
6. Treatment of deposits under certain perpetual insurance policies
7. Extend section 130 exclusion to structured settlements for workmen's compensation payments
8. Treatment of certain small property and casualty insurance companies under AMT
9. Tax treatment of consolidations of life insurance departments of mutual savings banks
10. Extend section 832(e) to financial guarantee insurance
11. Increase dollar limits for burial insurance
12. Foreign companies carrying on insurance business

Low-income housing
1. Provide 15-year depreciation and other tax incentives to encourage the preservation of low-income housing
2. Allow HOME funds to be used with 91-percent credit
3. Expand community service area costs eligible for credit
4. Change state credit authority limitation stacking rule
5. Expand credit to lead paint removal
6. Expand credit to certain cooperative housing

Minimum tax
1. Allow deduction of partnership investment expenses under AMT
2. Allow energy tax credits against AMT

Partnerships -- Permanent extension of publicly traded partnership grandfather rule

Passive losses
1. Modify the application of passive loss rules to timber activities
2. Modify the application of the passive loss rules to farming activities

Pass-through entities
1. Subchapter S reform proposals to expand availability of Subchapter S and improve its operation
2. Subchapter S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers
3. Establish financial asset securitization investment trusts (FASITS)
4. Establish tax-exempt municipal investment trusts (TEMICs)
5. Package of proposals to simplify and improve REIT provisions

6. Allow bank common trust funds to be transferred to more than one mutual fund without taxing trust beneficiaries

Peace Tax Fund -- establish U.S. Peace Tax Fund to receive conscientious objectors' income, estate or gift tax payments to be used only for WIC, Head Start, U.S. Institute of Peace, and Peace Corps

Pensions and employee benefits

A. Pensions
  1. Nondiscrimination rules
     a. Repeal special nondiscrimination tests for qualified cash or deferred arrangements
     b. Modify definition of highly compensated employee to eliminate 1-officer rule
     c. Repeal top-heavy rules (sec. 416)
     d. Modify separate line of business rules
     e. Modify safe harbor rule for leased employees
     f. Exempt state judicial plans from nondiscrimination requirements
     g. Repeal OBRA '93 provision limiting compensation taken into account to $150,000
     h. Repeal for pilots OBRA '93 provision limiting compensation taken into account to $150,000
     i. Repeal minimum participation rule (sec. 401(a)(26))
  2. Distribution rules
     a. Repeal 15-percent excise tax on excess distributions
     b. Provide that pension distributions are taxed as capital gains
     c. Reinstate 10-year forward averaging
     d. Permit penalty-free withdrawals for unemployed individuals
  3. Limits on contributions and benefits (sec. 415)
     a. Modification of interest rate provisions enacted in General Agreement on Tariffs and Trade (GATT)
     b. Eliminate combined limitation for participants in both a defined contribution plan and a defined benefit plan (sec. 415(e))
  4. Employee stock ownership plans
     a. Modify rules relating to deferral of gain on certain sales of stock to an ESOP (sec. 1042)
     b. Permit ESOP to be beneficiary of charitable remainder trust
     c. Treatment of certain securities transferred to ESOP from terminated defined benefit plan
     d. Permit closely-held corporation to pay estate tax if stock transferred to an ESOP
  5. Permit permanently disabled persons to contribute to section 401(k) plans
  6. Modify sanctions for failure to comply with qualification requirements
  7. Allow prenuptial waiver of spousal annuity benefits
  8. Deny Federal tax information to States imposing a pension source tax
  9. Unfunded deferred compensation plans of tax-exempt and governmental organizations (sec. 457)
     a. Exempt deferred compensation plans for volunteer firefighters
     b. Increase deferred compensation limit for group medical practices
     c. Require individual ownership of plan assets
  10. Provisions relating to individual retirement arrangements (IRAs)
     a. Permit tax-free rollover of certain severance payments
     b. H.R. 682 ("Savings and Investment Incentive Act of 1995")
  11. Treatment of Indian tribal governments under section 403(b)
  12. Special rules for church pension plans

B. Employee Benefits
  1. Tax treatment of certain disability benefits for police and firefighters
  2. Exclude from income retirement benefits that an employee elects to use to purchase employer-provided accident or health care
  3. Modify restrictions on golden parachute payments
  4. Provide that academic health center employee housing may be excludable from income

Tax-exempt bonds

1. Expansion of arbitrage rebate exception for certain bonds
2. Bonds for certain governmental output facilities
3. Bonds for emergency response vehicles of certain volunteer fire departments
4. Space port exempt-facility bonds
5. Bonds for solar energy facility
6. Bonds for the sale of the Alaska Power Administration facility
7. Bonds for the United Nations
8. Bonds for certain pre-1990 issues in the State of Connecticut
9. Bonds related to the transfer of Port Everglades, Florida
10. Qualified mortgage bonds - home improvement loans
11. Qualified veterans' mortgage bonds
12. Modification of exception to bank interest deduction disallowance for qualified 501(c)(3) bonds
13. Expansion and indexing of the $10 million capital expenditure limitation for qualified small-issue bonds
14. Repeal special exception for Student Loan Marketing Association allowing deduction for interest expense attributable to investment in tax-exempt bonds

Tax return checkoff

1. Permit individual tax return checkoff for U.S. Olympic Trust Fund
2. Permit individual tax return checkoff for deficit reduction

Trusts and estates

1. Reduce tax rate increase for trusts for disabled individuals
2. Apply same income tax rates to trusts and estates as for married individuals filing separate returns

Other

1. Allow nonprofit educational foundations to sell U.S. savings bonds

POSSIBLE MODIFICATIONS TO SIMPLIFICATION PROVISIONS CONTAINED IN H.R. 3419 (103rd Congress)

Provisions Relating to Individuals

1. Permit payment of taxes by credit card (section 112 of the bill)

Consideration is being given to clarifying that the fees that may be imposed for using a credit card to pay Federal taxes could not be borne by the Federal government.

2. Election by parent to claim unearned income of certain children on parent's return (section 113 of the bill)

Consideration is being given to deleting the provision contained in H.R. 3419, because it is included in the technical corrections provisions contained in H.R. 1215, as passed by the House of Representatives on April 5, 1995.

3. Expanded access to simplified income tax returns (section 116 of the bill)

Consideration is being given to deleting the provision in H.R. 3419 directing the Internal Revenue Service to study whether the ability of taxpayers to file simplified Federal income tax returns should be expanded because the Committee understands that such a study is ongoing.

Pension Simplification

1. Tax-exempt organizations eligible under section 401(k) (section 212 of the bill)

H.R. 3419 would permit nongovernmental tax-exempt organizations to maintain

qualified cash or deferred arrangements (i.e., 401(k) plans) for their employees. Consideration is being given to providing that a tax-exempt employer that elects to establish a 401(k) plan for its employees would not also be permitted to provide for the deferral of compensation pursuant to section 457.

2. Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions (sec. 223 of the bill)

H.R. 3419 provides a design-based safe harbor that employers can utilize to satisfy the nondiscrimination requirements for qualified cash or deferred arrangements. Consideration is being given to extending this design-based safe harbor to simplified employee pensions ("SEPs").

3. Full-funding limitation of multiemployer plans (section 235 of the bill)

H.R. 3419 would repeal the 150-percent of current liability full-funding limit for multiemployer pension plans. Consideration is being given to deleting this provision of the bill.

4. Alternative full-funding limitation (section 236 of the bill)

H.R. 3419 would provide that the 150 percent of current liability full-funding limit would be increased for certain employers and that the Treasury Department would adjust the full-funding limit for all other employers so as to ensure that the provision is approximately revenue neutral. Consideration is being given to deleting this provision of the bill.

5. Special rules for plans covering pilots (section 242 of the bill)

Under present law, a special provision permits plans covering airline pilots covered under a collective bargaining agreement to be tested separately for nondiscrimination purposes. H.R. 3419 would extend this special provision to all airline pilots without regard to whether they are covered under a collective bargaining agreement. Consideration is being given to deleting this provision of the bill.

6. Treatment of employer reversions required by contract to be paid to the United States (section 244 of the bill)

H.R. 3419 would provide an exception to the excise tax on reversions in the case of a reversion of excess pension plan assets that is required, by Federal law or regulation, to be paid to the Federal government. Consideration is being given to deleting this provision of the bill.

7. Continuation health coverage for employees of failed financial institutions (section 245 of the bill)

H.R. 3419 would provide that the Resolution Trust Corporation would be required to provide continuation health coverage to certain employees of failed financial institutions. Consideration is being given to deleting this provision of the bill.

8. Clarify relationship between community property rights and retirement benefits

Consideration is being given to including a provision that would clarify the relationship between community property rights and retirement benefits (e.g., the interaction of qualified plan requirements with state community property laws).

<u>Treatment of Large Partnerships</u>

1. Simplified flow through for large partnerships (section 301 of the bill)

H.R. 3419 would modify the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners)

and its partners. The bill reduces the number of possible items that must be separately reported to partners. Consideration is being given to deleting this provision.

2. Simplified audit procedures for large partnerships (section 302 of the bill)

H.R. 3419 would create a new audit system for large partnerships (in addition to the present-law system of partnership audit rules enacted in TEFRA). The bill would define "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners). Under the bill, partnership adjustments generally would flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits would be adjusted to reflect partnership-level adjustments that take effect in that year. The adjustments generally would not affect prior-year returns of any partners. Consideration is being given to deleting this provision.

3. Partnership returns on magnetic media (section 304 of the bill)

H.R. 3419 would authorize the Internal Revenue Service ("IRS") to require large partnerships and other partnerships with 250 or more partners to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the IRS on magnetic media. Consideration is being given to requiring that magnetic media filing of partnership tax returns (Form 1065) and copies of schedules sent to each partner (Form K-1) be made mandatory, effective for partnership taxable years beginning after December 31, 1995 (in lieu of authorizing the IRS to require magnetic media filing).

Foreign Provisions

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (sections 401 - 404 of the bill)

H.R. 3419 would provide some coordination among the various anti-deferral regimes applicable to U.S. persons who hold stock in foreign corporations. Consideration is being given to the possibility of applying subpart F to U.S. persons who hold stock in foreign corporations without regard to the level of U.S. ownership in such corporations.

Provisions Relating to Regulated Investment Companies

1. Require brokers and mutual funds to report basis to customers (section 522 of the bill)

Consideration is being given to deleting the mandatory information reporting requirement in H.R. 3419 because it is understood that much of the industry is voluntarily reporting basis to shareholders.

Tax-Exempt Bond Provisions

1. Clarification of definition of "investment-type property" (section 535 of the bill)

The provision contained in H.R. 3419 would be deleted because it was clarified by a recent Treasury regulation (Treas. reg. section 1.148-1(b)).

Administrative Provisions

1. Administrative practice and procedural simplification (sections 831-839 of the bill)

H.R. 3419 would make nine modifications related to administrative practice and procedure. Because these provisions have generally been included in bills relating to taxpayer bill of rights, which are likely to be considered separately by the Committee, consideration is being given to dropping these provisions from H.R. 3419.

Estate and Gift Tax Provisions

1. Statute of limitations applicable to valuation of gifts

Consideration is being given to adding a new provision providing that a gift for which the limitations period has passed cannot be revalued for estate tax purposes, e.g., for purposes of determining the applicable estate tax bracket and available unified credit. The provision would apply to decedents dying after the date of enactment.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to the Committee's tax staff at (202) 225-2743 no later than the close of business, Friday, July 7, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee's tax staff, room 1135 Longworth House Office Building, no later than 12:00 noon on Monday, July 10, 1995.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business on Thursday, July 27, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee's tax staff, room 1135 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all

clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

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Chairman ARCHER. The Committee will come to order.

Before we commence the official agenda of the Committee this morning, I would like to officially welcome our new Member, Congressman Greg Laughlin from Texas. We are happy to have you on board, and I know that you will make an excellent contribution to the Committee, as every Member of the Committee does. We are glad to have you here as we begin to consider the hearing subject matter today, which is a result of many bipartisan requests that I have received from many House Members seeking consideration of various tax legislation. Although we have a very busy agenda this summer, I have agreed to honor the request for a hearing, and I am interested in learning about the various bills that have been proposed.

The purpose of this hearing is to allow our Committee to consider relatively minor ways to change the current Income Tax Code while the Committee continues its longer range project of fundamental reform of our Nation's tax system. Because of the large number of proposals, it will obviously not be possible for the Committee to take action on all of them, and I can't promise Members that we will be able to take action on any of them. That will depend upon how this process unfolds.

As the Committee moves forward, I intend to oppose any proposals which are rifle-shot targeted tax relief or proposals which have any significant cost. Let me stress that we are here to clean up the Code and fix some of its counterproductive and complicated provisions. We are not here to create loopholes in the Code.

In addition, any package or proposals which may be marked up as a result of the hearing won't be reported out unless accompanied by offsets that guarantee no increase in the deficit.

Now, having said that, I do look forward to hearing the testimony today; and I now recognize my friend, the Ranking Minority Leader of the Committee, Sam Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman. I concur in what you have to say, and I would only make the suggestion that if we get far enough along in this to do revenue offsets, I would hope that we would have some kind of public airing of those offsets. It seems to me that past experience has shown me that we have taken too many shots in the dark on offsets and come up with some unfortunate results, but that is the only thing I have to add and look forward to working with you.

Chairman ARCHER. That is a constructive comment; and, time permitting, we certainly do want to know what we are doing when we entertain any offsets.

Now before us in our first panel today we have Hon. Barbara Kennelly from Connecticut, Hon. Sander Levin from Michigan, and Hon. Amo Houghton from New York. In my part of the country we have the saying, "ladies first," so, Barbara, would you like to start off?

STATEMENT OF HON. BARBARA B. KENNELLY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CONNECTICUT

Mrs. KENNELLY. Thank you, Mr. Chairman.

Chairman Archer, I appreciate your having this hearing, and I appreciate your letting me testify. First, I would like to say I will

cut my testimony short because I know how many witnesses you have and ask that my whole testimony be placed in the record.

I am going to discuss two issues. The first is number two under empowerment zones, tax incentives for economic recovery; and the second is number one under employee benefits, tax treatment of certain disability benefits for police and firefighters.

My first proposal would create three additional empowerment zones geared to the financial services, banking and real estate or "FIRE" industries, as categorized by the Federal Reserve.

Mr. Chairman, Mr. Rangel, and a former Member of this House, Mr. Kemp, worked very closely on enterprise zones and that concept has become a success. This is an extension of that very concept. But as excellent as the present enterprise zone concept is, it will not work for every community, particularly for those with economies based on services.

I will use my town as an example—but I heard what you said about rifle shots, Chairman Archer, and I know that has always been a tradition of this Committee, and so I have written the legislation so it has a very definite national impact. But let me use Hartford, my town, as an example.

Hartford has long been known as the insurance capital of the world and as a center for financial services. But the banking industry in New England is consolidating. The real estate market collapsed not too long ago and has not yet recovered. An unprecedented change is sweeping the insurance industry. As I said, Hartford is not alone.

In the past decade, the entire country has had banking and S&L problems. We have seen Bermuda, to name just one of our international competitors, attract $4 billion in insurance capital. Later this year, we will debate allowing banking and other service industries, including securities and insurance, to affiliate. Even with every merger and spinoff, every mayor, every city council, and thousands of employees across this country ask, What does this mean for jobs? How will this affect the property tax base and the real estate in my city, town, or State?

My proposal would create three additional enterprise zones with modified tax incentives targeted to services. These FIRE zones, which could include central business districts and encompass entire cities, would be created in areas where at least 12 percent of FIRE employment, or 5,000 jobs, have been lost.

New or existing businesses would receive a range of tax incentives, including a wage credit, unlimited expensing on FIRE buildouts and computer equipment, as well as elimination of passive loss restrictions on historical rehabilitation. As you know, Chairman Archer, and Mr. Gibbons knows so well, there really has just been historical rehabilitation since that change—the proposal also includes reduced capital gains rates for zone properties held 5 years—10 percent for individuals, 17 percent for corporations, and double deductions for security expenses within the zone.

The second issue that I come before this Committee for is something that is very, very important to me, something I have worked on for years and yet almost get there and then don't.

Connecticut is one of several States where an error in State law has caused benefits intended as Workman's Comp. to be brought

into income on audit. In our case, the State law providing benefits for police and firefighters included an irrebuttable presumption that heart and hypertension conditions were the result of hazardous work conditions.

Connecticut has now corrected the law to satisfy the IRS by permitting the State or municipality to require medical proof that the conditions were the result of hazardous work, but the IRS has said that those who received the benefits must pay 3 years back taxes plus interest and penalties, even though paying interest and penalties is quite beyond the means of most of these families, where the primary breadwinner is disabled.

This legislation would recognize that the individual towns and cities were acting in good faith. This provision was reported by the Committee in 1992, passed the House on the suspension calendar, and ultimately was vetoed by the President. This provision enjoys strong bipartisan support. I hope the Committee would see fit to provide families with the tax relief they need most.

Chairman Archer, I will just end by saying, can you imagine if you were a fireman or policeman, had a heart attack, was disabled, was told that you would collect that disability, some people even died, and then they get a letter from the IRS saying, Sorry, we have changed our minds, and you have got to pay back taxes when you are just trying to keep yourself together?

Thank you, Chairman Archer.

[The prepared statement follows:]

The Honorable Barbara B. Kennelly
Testimony before the
Committee on Ways and Means
Miscellaneous Tax Reforms Hearing
July 11, 1995

Mr. Chairman, thank you for the opportunity to address the Committee today. I will be brief but want to take the opportunity to discuss two important issues. The first is number two under empowerment zones--tax incentives for economic recovery in designated areas with employment loss in financial and real estate businesses. The second is number one under Employee benefits--tax treatment of certain disability benefits for police and firefighters.

My first proposal is to create 3 additional empowerment zones geared to the financial services, banking and real estate or "FIRE" industries as categorized by the Federal Reserve. Charlie (Rangel), you worked on empowerment or enterprise zones on a bipartisan basis for years with Jack Kemp and others. I salute you for it. I supported you in your efforts and I think the competition for both the zone and community designation provides ample evidence of the broad support for these efforts.

My City of Hartford applied for designation as an enterprise community but was denied. But when I started looking at the details, it was clear to me that while empowerment zones/enterprise communities are excellent economic development tools, they just don't quite fit many areas.

As this Committee well knows, the tax incentives in empowerment zones include a wage credit, expensing of up to $75,000 and a loosening of restrictions on tax-exempt bonds--all incentives seemingly geared to manufacturing. Hartford and a number of other cities around the nation, however, are different--our base is services and we would frankly benefit from a different mixture of tax incentives.

Let me talk about Hartford for a moment though. Hartford has long been known as the insurance capital of the world. Mr. Christensen, I know you are aware of this. We have also traditionally been a center for financial services. However, any reader of the Wall Street Journal is aware of the consolidation in the banking industry in New England and the collapse of the real estate market. On top of this, we are in the midst of unprecedented change in the insurance industry. In just one ten day period recently, a number of announcements were made in Hartford: Connecticut Mutual Life Insurance was be acquired by Mass Mutual, the Travelers was selling its stake in Metrahealth--the last vestige of its health business, ITT would spin off its ITT/Hartford insurance division effective January 1st and <u>Business Week</u> listed Security-Connecticut as one of the hottest take-over targets in the insurance business.

But enough about Hartford because this proposal isn't just about Hartford. In the past decade, we have seen unprecedented change in our financial services industries. We have had banking and S&L problems, face increasing competition in the global marketplace, and later in the year will debate allowing banking, and other service industries including securities and insurance to affiliate. In addition, we have seen Bermuda attract over $4 billion in insurance capital in the past few years. It is certainly a beautiful place, but most importantly, it's also a tax haven.

And while change can certainly be good, it does creates a tremendous amount of uncertainty. With each and every merger or spin-off, every mayor and every city council, not mention the thousands of effected employees ask the same two questions: what does this mean for jobs; and what impact will this have on the property tax base and real estate values?

That is why I am asking the Committee modify the traditional notion of enterprise zone to include services. My proposal would create 3 additional zones with tax incentives targeted to services.

Specifically, these FIRE zones would be patterned after existing enterprise zones, but could encompass an entire city or municipality, and more important, could include central business districts. Eligibility would be the same as for existing enterprise zones, with an additional requirement that an eligible city would have to have experienced the loss of at least 12 percent of FIRE industry employment, or alternatively, 5000 jobs.

In lieu of traditional enterprise zone tax incentives, new or existing businesses in FIRE zones would receive a range of tax incentives.

First, to deal with jobs, there would be a wage credit for the creation of new jobs within the zone. This would encourage businesses to hire displaced and underemployed insurance, real estate and banking workers as well as create entry level jobs for clerks, and janitors.

Second, to deal with the high commercial vacancy rate problem that plagues many cities, there would be unlimited expensing on FIRE buildouts and computer equipment. The proposal would also remove the passive loss restrictions on historic rehabilitation.

Next, to provide an incentive for investors, the proposal would provide for a reduction in the individual capital gains rate for zone property held for 5 years to 10 percent. In addition, capital gains on zone property would not be considered a preference item for individual alternative minimum tax purposes. The corporate capital gains tax rate would also be reduced, to 17 percent.

Finally, many big cities aren't always as safe as we would like. Therefore, the proposal would provide for a double deduction for security expense within the zone. This should give employers an added stake in the safety of our cities.

I hope that the Committee will look favorably on this important issue and look forward to working with you on the details.

While the second issue is one the Committee has previously considered and indeed acted upon, this is the single most important tax issue bar none to roughly 1100 families in Connecticut as well as one of my top priorities this session. I wanted to address it to for the benefit of the many new members of the Committee.

I have introduced legislation in this area, H.R. 98. It would simply clear up a situation where erroneous state law has caused benefits that were intended to be treated as workmen's compensation to be brought into income on audit. In several states, including Connecticut, the state law providing these benefits for police and fire fighters included an irrebuttable presumption that heart and hypertension conditions were the result of hazardous work conditions.

In Connecticut, at least, the state law has been corrected so that while there is a presumption that such conditions are the result of hazardous work, the state or municipality involved could require medical proof. This change satisfies the IRS definition of workmen's compensation. Therefore, all this legislation would do is exempt from income those payments received by these individuals as a result of faulty state law but only for the past three years--1989, 1990 and 1991. From January 1, 1992 forward those already receiving these benefits would have to meet the standard IRS test.

The importance of this legislation is that these individuals believed that they followed state law. The cities and towns involved believed that they followed state law and therefore all parties involved believed that these benefits were not subject to tax. However, the IRS currently has an audit project ongoing in CT and has deemed these benefits taxable. All this legislation says is that all parties involved made a good faith effort to comply with what they thought the law was. The state was in error. That error has been rectified but those individuals on disability should not required to pay 3 years back taxes plus interest and penalties. I don't have to tell you that the interest and penalties on this tax continue to increase each day and are quite beyond the means of most of these families where the primary breadwinner is disabled.

This provision was reported by this Committee in 1992, passed the House on the suspension calendar, included in H.R. 11 and ultimately vetoed by the President. This provision enjoys the bipartisan support of the entire Connecticut Congressional delegation. I hope that the Committee would see fit to provide these Connecticut families with the tax relief they need most.

Thank you.

Chairman ARCHER. Thank you, Ms. Kennelly.

Hon. Sander Levin. Sandy.

STATEMENT OF HON. SANDER LEVIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. LEVIN. Thank you, Mr. Chairman and Mr. Gibbons and my colleagues—our colleagues.

I am so glad to be here today with my colleague and friend, Representative Houghton, to talk just briefly about our proposal, H.R. 1690. I believe you have a copy of my testimony, and under our rules it will be entered into the record so I won't bother to read it all.

I know that you, Mr. Chairman, and you, Mr. Gibbons, have been interested in this area for a number of years. This is a matter that very much relates to the competitiveness of American business. Last year, we spent a lot of time crafting a historic piece of legislation implementing the Uruguay round, and I think that was a step to help competitive American businesses compete overseas. I also think our recent efforts on a bipartisan basis relating to United States-Japan is also relevant to that.

But no matter how effective our trade policy may be, often it is frustrated by our tax policy, and this is an effort to simplify what is a very complex area of the law. Representative Houghton and I have a friendly race to see who can understand this piece of our Tax Code first, and we are both losing because, while we have tried to begin to delve into this and don't, at least on my part, claim anything close to expertise, it is unusually complicated. What this bill tries to do is to move toward simplification and rationalization. H.R. 1690 is just a first downpayment, we hope a substantial one, toward simplification and rationalization.

Simplifying, for example, in especially the foreign tax credit and antideferral mechanisms. They are going to have to be there, I think, no matter what is the reform of our Tax Code, but they have to be far, far less complex. Also, to encourage exports and to provide incentives for R&D in the United States and overall to enhance the competitiveness of the United States.

We have made a lot of progress in competitiveness. We now have the most competitive, productive business sector in the world. There has been very substantial improvement in recent years, but our tax laws, if they don't strangle, do thwart.

Mr. Chairman, this isn't a new problem. Your predecessor, Chairman Rostenkowski, and Bill Gradison introduced H.R. 5270 3 years ago, and this legislation is modeled after that. There is no claim here for originality. I think there is a hope for perseverance.

The bill has strong support in the business community, and the reason is these companies in this instance aren't looking for a tax break. They are really looking for understandability, for intelligibility. I believe each of you has a copy of the "Dear Colleague" from Mr. Houghton and myself that spells out some of the basic provisions.

Could I just close by emphasizing this point? This is only a first step. We don't claim this bill is a finished product. We want everybody's input, including our colleagues', and further input from

not only the business community but others who have an interest in this area.

We are attempting to remember fiscal constraint. We don't have a bottom line figure on this bill. The bill doesn't cover all of the problems in part because of the need to take into account fiscal restraints. But, again, this is a first step. It is preliminary. We hope it is a move in the right direction, and we hope that this product could be in a position in the next period of time so that if there is action on miscellaneous tax reforms or if it might be possible to insert these provisions or modifications thereof into a reconciliation bill, Mr. Chairman, we would be ready. This is clearly an important area of the law that badly needs reform.

Thank you very much.

[The prepared statement and attachment follow:]

STATEMENT OF

CONGRESSMAN SANDER LEVIN

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

HEARING ON MISCELLANEOUS TAX REFORMS

JULY 11, 1995

Thank you, Mr. Chairman, for the opportunity to testify with my friend and colleague, Congressman Amo Houghton, on H.R. 1690, the International Tax Simplification and Reform Act of 1995.

Last year, this Committee helped craft historic trade legislation implementing the GATT Uruguay Round agreements that passed Congress with strong bipartisan support.

But our trade policy too often is frustrated by our tax policy.

Our trade policy seeks the mutual benefits of open trade, and in particular the benefits of opening foreign markets for U.S. exports so that America can take advantage of its superior competitiveness to create good jobs here at home. But our tax policy often dictates that our largest companies move those jobs overseas, or that our smallest companies are prevented from ever getting into the game.

Now is the time -- as the historic Uruguay Round trade agreements begin to take effect -- to reform the international tax provisions in a comprehensive manner so that they are more in line with our trade policy.

The first step toward bringing our tax policy in line with our trade policy must be simplification. The international provisions are among the most complicated and impenetrable in the Internal Revenue Code. And as we simplify, we must try to accommodate other important trade policy objectives.

H.R. 1690, represents a substantial down payment in the effort to rationalize the international area. In general, the bill seeks in modest but important ways to: (1) simplify this overly complex area, especially the foreign tax credit and the various antideferral mechanisms; (2) encourage exports; (3) provide incentives for performance of R&D in the U.S.; and (4) enhance U.S. competitiveness in other industrialized countries.

And it seeks to achieve these objectives in a revenue-conscious manner.

This bill has a solid foundation in previous efforts. Ten days of hearings before this Committee in 1991 gave rise to the introduction of a similar bipartisan bill, H.R. 5270, by Congressmen Dan Rostenkowski and Bill Gradison in 1992. And in January 1993, the Bush Administration Treasury Department issued its report on possible reform along these lines.

The bill has strong support in the business community, including the National Association of Manufacturers, the Emergency Committee for American Trade, the National Foreign Trade Council, the U.S. Council for International Business, and the American Petroleum Institute. In addition, over twenty of this nation's largest employers have expressed their individual support for this legislation.

One of those employers, the Mobil Corporation, testified at last month's hearings on overhauling the tax system that a disproportionate amount of its annual 76-pound federal income tax return was attributable to two areas -- the international provisions, and the interaction of the alternative minimum tax with the depreciation provisions. I am happy to report that Mobil's Senior Tax Counsel, Bill Dakin, recently wrote that H.R. 1690 "would reduce the cost of preparing Mobil's federal income tax return, with little or no impact on the amount of the tax due."

If the same is true for other employers -- and I suspect it is -- then this confirms that H.R. 1690 will achieve its intended objectives.

The bottom line is clear: If the United States is to continue to be the preeminent economic force in the world and if our economy is to continue to create good jobs, we must ensure at the very least that the international provisions of U.S. tax law do not continue to stand in the way.

Current law tends to frustrate the legitimate goals and objectives of American business. It erects artificial, unnecessary barriers to U.S. competitiveness. These issues cannot be swept under the rug by throwing out the current system and replacing it, for example, with a "flat" tax, because any system must face the thorny problem of properly taxing income earned across borders.

H.R. 1690 will not solve all of the problems, but we believe it is an important step in the right direction, at the right time. We urge you to support this bipartisan effort by including H.R. 1690's comprehensive international tax reform as part of this year's tax legislation.

Congress of the United States
House of Representatives
Washington, DC 20515

June 7, 1995

Dear Colleague:

We are writing to urge you to cosponsor H.R. 1690, the International Tax Simplification and Reform Act of 1995.

The international tax provisions are among the most complicated and impenetrable in the Internal Revenue Code. In many instances they lead to results that are fundamentally at odds with this nation's trade policy. Comprehensive reform of these provisions is long overdue and is relevant even under a "flat" or "flatter" tax system.

H.R. 1690 represents a substantial down payment in the effort to rationalize the international area. In general, the bill seeks in modest but important ways to: (1) simplify this overly complex area, especially the foreign tax credit and the various antideferral mechanisms; (2) encourage exports; (3) provide incentives for performance of R&D in the U.S.; and (4) enhance U.S. competitiveness in other industrialized countries.

And it seeks to achieve these objectives in a revenue-conscious manner.

If the United States is to continue to be the preeminent economic force in the world and if our economy is to continue to create good jobs, we ought to ensure that the international provisions of U.S. tax law do not stand in the way. Current law tends to frustrate the legitimate goals and objectives of American business. It erects artificial, unnecessary barriers to U.S. competitiveness.

Clearly, H.R. 1690 is not going to solve all of the problems, but we believe it is an important bipartisan step in the right direction. Please join us in cosponsoring H.R. 1690 by calling Hugh Hatcher (5-3161) or Craig Kramer (5-4961). A summary of the bill is attached.

Many thanks,

Amo Houghton

Sander Levin

H.R. 1690

INTERNATIONAL TAX SIMPLIFICATION AND REFORM ACT

Simplify and Reform the Foreign Tax Credit ("FTC")

1. Repeal basket for noncontrolled "10/50" corporations.
2. Extend carryback and carryover rules to 3 and 15 years.
3. Compute FTCs using average exchange rate.
4. Extend indirect FTC from the third to the sixth tier.

Simplify and Reform the Anti-deferral Regimes

1. Treat the EU as one country under the subpart F rules.
2. Restore the active business exception for financial services income.
3. Increase the de minimis exception to subpart F to less than 10 percent of gross income.
4. Exempt controlled foreign corporations ("CFCs") from the passive foreign investment company ("PFIC") rules.

Other Simplification Proposals

1. Exempt CFCs from the uniform capitalization rules.
2. Permit U.S. GAAP reporting of foreign subsidiary E&P.
3. Raise the § 6046(a) reporting threshold to 10 percent.

Other Reform Proposals

1. Allow election to use E&P basis for purposes of allocating interest expense.
2. Permit domestic losses to be resourced.
3. Make permanent the 64-percent allocation to U.S. source of research and development performed in the U.S.

Chairman ARCHER. The gentleman, in my opinion, is correct. It desperately needs reform.

The gentleman from New York, Mr. Houghton.

STATEMENT OF HON. AMO HOUGHTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. HOUGHTON. Thank you, Mr. Chairman. Mr. Gibbons, good to be with you and my associates here today.

I am not going to try to duplicate some of the statements which Mr. Levin, my associate, has spoken of. What I thought I would do is wind my way through certain things that I happen to think are important.

Also, I would like to feel that we could submit our testimony, which I will not be reading, and also a variety of other different letters. We have letters from the National Foreign Trade Council, National Association of Manufacturers, and a whole variety of other people who agree with this general thrust.

Mr. Chairman, if I had my druthers, we would be doing much more. In 1991–93 there were various stabs at changing the international tax provisions. This I think probably started with Bill Frenzel, and then he left and then Bill Gradison. The scope of the suggestions that both of them made was far greater than anything which we propose here, but here is an attempt to start down the road of correcting abuses which really prevent American job creation because of the complexity of the Tax Code, rather than trying to correct them.

There are 14 individual items in this bill. Six of them cost absolutely nothing. The other eight I am not sure what they are going to cost because we do not have a costing out of these, but I can't imagine they would cost very much. But even if you did only the six which cost nothing, it would be a start here.

There are a variety of things which are important here, but basically what they do is cut through redtape, make it possible for American companies to trade in this market, which we are encouraging through either regional or totally global constructs such as NAFTA or GATT, and try to make it possible for Americans to create jobs, either to invest or to export abroad.

A few weeks ago, there was testimony here by Mobil, and you probably remember some of the statistics. I mean, the 1993 tax returns consisted of 6,300 pages, 4 feet high, and weighed 76 pounds. I think those were roughly the numbers, and I don't know how many millions it costs Mobil, but lots. They have 745 companies, and when each of those companies operating outside received a package of instructions, they were inundated which took away from their ability to do the thing which we want to encourage, which is competing. Paperwork simplicity is very, very important.

Another suggestion here would be that you could only claim a tax credit for taxes paid by someone else if you own 10 percent or more of the company. Yet the Tax Code requires that for informational purposes alone, if you own 5 percent of that company, you have to develop reams and reams of pages justifying what you are doing and spelling out and breaking down the various different business units. Doesn't make any sense at all.

Another rather simple approach is to take an average annual exchange rate computation rather than having to go into a spot market any time you do a transaction and do numerous specific calculations—and these are by the hundreds—you could do an average over the year.

I will not go into some of the other more technical details because I don't think it is appropriate now. I do think we are on the road to doing something which is extremely important, hopefully that we can get back to where we were in terms of the pre-1986 act, which had a couple of baskets—an active operating basket and an inactive passive basket—where we can do very simple calculations and put the emphasis, rather than on the Tax Code, on building the businesses.

So, I thank you very much for hearing us out, and we would like to submit our testimony.

[The prepared statement and attachments follow:]

STATEMENT OF THE HONORABLE AMO HOUGHTON

BEFORE THE

COMMITTEE ON WAYS AND MEANS

JULY 11, 1995

Mr. Chairman, and fellow members of the Committee, thank you for the opportunity to appear before you, with our colleague Sandy Levin. We wish to discuss a bill, H.R.1690, that we introduced on May 24, 1995. The title of the bill is "International Tax Simplification and Reform Act of 1995". The fourteen provisions of the bill are included in the Advisory, No. FC-8, June 30, 1995, issued by the Chairman under the heading "Foreign" on page 5. The subject of the three days of hearings is the list of miscellaneous tax reforms included in the Advisory.

The subject of these hearings -- miscellaneous tax reforms -- is timely, and much on point with the simplification and reform measures proposed in our bill. I won't go into the details of those provisions. What I'd like to do is provide a bit of perspective on why we are proposing the changes, then ask for your support.

Let me say that we have the support of such organizations as: The National Foreign Trade Council, The American Petroleum Institute, The U.S. Council for International Business, ECAT (Emergency Committee for American Trade), and NAM (National Association of Manufacturers). They represent many of the major multinational companies in the United States.

Would these provisions, if enacted, benefit many of these companies? The answer is yes, but many of the provisions, such as average exchange rates and the relaxation of reporting requirements, provide a benefit in the right direction -- reducing the regulatory and paperwork burden on multinational companies. This is a burden that many of their foreign competitors do not have. It is one which also is questionable from a cost-benefit standpoint. Trade policy has advanced, but our international tax laws have not kept up with the changes in the trade laws, and have become a detriment to carrying out that policy.

For some period of time, the Committee on Ways and Means has been considering issues relating to international competitiveness and proper taxation of U.S.-based multinational corporations. In 1991, the Committee held 10 days of public hearings on the issues: international competitiveness including tax, trade, education, technology and other important issues affecting the nation's ability to compete internationally.

In 1992, two former members of this Committee, Messrs. Rostenkowski and Gradison, introduced H.R. 5270. It attempted to address many of the same issues included in our bill. More recently, in January of 1993, the Department of the Treasury issued a study entitled "International Tax Reform: An Interim Report."

Now as we begin the process of re-examining in fundamental ways our income tax system, we believe it imperative to address the area of international taxation. In an Internal Revenue Code stuffed with eye-glazing complexity, there is probably no area that contains as many difficult and complicated rules as international taxation.

Neither one of us is under any illusion that the measure which we introduced removes all complexity or breaks bold new conceptual ground. For example, other areas of concern include section 956A and the sheer number of foreign tax credit "baskets". We believe, however, that the enactment of H.R.1690 would be a significant step in the right direction. The enactment of this measure would enhance the ability of American business in its efforts to compete abroad. It would also be a major step in the long overdue process of simplifying the international taxes. Why not then move toward creating a set of international tax rules which taxpayers can understand, and the government can administer?

H.R. 1690 focuses on changes in three broad areas. One category involves changes to the foreign tax credit. Foreign tax credits ought to operate fairly and with a reasonable measure of administrative simplicity to avoid the burden of double taxation. We believe that the measures outlined in H.R. 1690 go a long way toward making a foreign tax credit system fairer and simpler.

A second category relates to the so-called antideferral mechanisms set forth in the Internal Revenue Code. Though the United States has had the general policy of not taxing income of foreign subsidiaries earned abroad until that income is brought back into the United States, the anti-abuse rules (began with the enactment of Subpart F in 1962) have now reached the point at which the exceptions have virtually swallowed the rule.

A bewildering array of antideferral rules (under Subpart F, the foreign personal holding company rules and the passive foreign investment company rules) has created serious complexity. American business finds it hobbling to compete abroad if it must comply with rules which at best frustrate legitimate business activity and at worst create an administrative nightmare. Neither corporate taxpayers nor the Internal Revenue Service can understand them. We do not suggest that anti-tax havens and anti-abuse rules are not appropriate. But it is clear that the balance has moved too far in the direction of excessive restrictions and overwhelming complexity. The measures set forth in H.R. 1690 are a significant and important step in correcting this imbalance.

Finally, H.R. 1690 incorporates several significant changes in allocation and accounting rules. These changes are required to better ensure that the foreign tax credit rules operate properly, i.e. provide for greater taxpayer compliance by eliminating unnecessary complexity, also to make U.S. companies more competitive abroad and by creating a more equitable and administrable means of making certain allocations.

In summary, therefore the proposed changes we believe represent a creditable package and a "down payment" on further reform in the international tax area. We ask you to join us, in this bipartisan effort, by supporting these changes as part of this year's tax legislation. Thank you.

NATIONAL FOREIGN TRADE COUNCIL, INC.

1625 K STREET, N.W., WASHINGTON, DC 20006-1604

Tel: (202) 887-0278 FAX: (202) 452-8160

Contact Person:
Robert H. Green

May 24, 1995

PRESS RELEASE

NFTC Offers Support for Houghton/Levin Legislation

The National Foreign Trade Council, Inc. (NFTC) wishes to offer praise and support for the legislation (H.R. 1690) introduced today by Representatives Amo Houghton (R-NY) and Sander Levin (D-MI). As prominent members of the Tax-Writing House Ways and Means Committee, Representatives Houghton and Levin are to be saluted for showing extraordinary bipartisan leadership in tackling one of the most difficult and complex areas of the U.S. federal income tax system, namely, the U.S. international tax regime.

The current U.S. international tax rules were developed in a much different era when U.S. companies were dominant, and competition from foreign companies was virtually nonexistent. The global economy of the contemporary era demands that the U.S. rules be modernized to reflect current competitive realities.

The proposals contained in the Houghton/Levin legislation reflect an attempt by the authors to achieve certain objectives for the U.S. business community operating abroad without completely overhauling the U.S. international tax regime. The NFTC strongly supports pursuit of these objectives, which include:

- Allowing U.S. companies to compete on a more equal footing for market share against their foreign counterparts;

- Reducing the incidence of double taxation on U.S. companies operating abroad;

- Mitigating the inordinate compliance costs to U.S. companies operating in foreign jurisdictions without causing a serious revenue loss to the Treasury;

- Supporting proposals that are generic in nature and apply to a broad spectrum of U.S. industry conducting business abroad; and

- Encouraging manufacturing and the performance in the U.S. of research and development, which will lead to the licensing and sale of U.S. products in foreign markets.

In particular, the NFTC would like to express its support for the following provisions in the legislation:

- Apply the Look-Through Rule to 10/50 Corporations. The provision would apply the look-through rule to noncontrolled foreign corporations and would repeal the separate foreign tax credit limitation for the noncontrolled so-called 10/50 corporations/i.e./ corporations in which the U.S. taxpayers own at least a 10 percent, but not more than a 50 percent voting interest. The proposal would relieve the incidence of double taxation that quite often is imposed on U.S. companies that acquire a minority interest in joint ventures with foreign concerns to develop or market a product line in a particular jurisdiction or region. Foreign companies are not forced to comply with similar restrictions under the tax laws of their own countries.

- Exempt Controlled Foreign Corporations (CFCs) from the PFIC Rules. Both the Subpart F provisions and the PFIC rules were intended to require current taxation of the earnings of foreign companies in which U.S. taxpayers either earn a controlling interest or are investors. The Subpart F rules tax the U.S. shareholder on the current earnings of a CFC where the earnings are derived principally from passive income or active income generated in tax haven jurisdictions. The PFIC rules were intended to tax U.S. investors currently on earnings from certain mutual funds abroad even where the investors do not own a controlling interest. The proposal would eliminate the duplication between the two anti-deferral regimes that cause unintended adverse results to U.S. companies, while dramatically reducing the compliance costs associated with the Subpart F and PFIC rules.

- Extend the Foreign Tax Credit Carryback and Carryover Rules. The legislation would extend the carryback and carryover rules for excess foreign tax credits to three years for carrybacks and 15 years for carryovers of excess foreign tax credits. Due to restrictive foreign tax credit rules and the lower corporate rate adopted in the 1986 Tax Reform Act, many U.S. companies have excess foreign tax credits, which are about to expire. If the current limits are not extended, U.S. companies will face double taxation on income earned abroad.

- Provisions to Expand Export Sales. The NFTC support the following provisions in the legislation which will boost U.S. exports and promote the sales of U.S. products through CFCs: increase the deminimis exception from Subpart F to less than 10 percent of gross income; treat the European Union as one country under the Subpart F rule; and allow resourcing of domestic losses to parallel current rules regarding resourcing of foreign losses.

- Restore Deferral for Active Financing Income. The legislation would help to place the U.S. financial service industry on a more equal footing with its foreign counterparts by restoring deferral for most active financing income.

Simplification Provisions. The legislation also contains a number of needed simplification provisions, several of which are incorporated from the foreign simplification package in H.R. 3419, which was not enacted last year. These include: extension of the indirect foreign tax credit from the third to the sixth tiers; permit use of the average foreign exchange rate in computing foreign tax credits; raise the reporting threshold under Section 6046(a) to 10 percent; and exempt CFCs from the uniform capitalization rules under Section 263A.

The impact of these provisions, if enacted, would improve the position of U.S. companies in the international arena in a number of important respects: it would allow them to compete on a more level playing field for tax purposes against their foreign counterparts; it would encourage the performance of manufacturing and R&D in this country which will lead to licensing and sales abroad; it would reduce the incidence of double taxation on the global income of U.S. companies; and it would drastically reduce the inordinate compliance costs that U.S. companies face in reporting their multinational income for tax purposes.

The NFTC congratulates Representatives Houghton and Levin and their staffs in devising a well balanced, constructive approach to addressing the competitive problems that U.S. companies face under current U.S. tax rules in the global marketplace. We look forward to working with their offices to enact this legislation. We would urge prompt public hearings on this legislation, and expeditious consideration by the Congress.

NAM National Association of Manufacturers

Gil Thurm
Vice President
Taxation & Economic Policy

July 10, 1995

The Honorable Amo Houghton
United States House of Representatives
1110 Longworth House Office Building
Washington, DC 20515

Dear Representative Houghton:

We are writing to express NAM's strong support of H.R. 1690, the International Tax Simplification and Reform Act of 1995, and to commend you and Representative Levin for your leadership on this bill.

The international provisions of the Internal Revenue Code are hopelessly complicated. They impose an enormous compliance burden on U.S. taxpayers, and often needlessly restrict the ability of American companies to engage in international transactions and to compete effectively in the world market. Comprehensive reform of these provisions to make them consistent with U.S. economic and trade policy is critical to providing U.S. jobs and growth.

The NAM believes that H.R. 1690 is a good beginning on such reform, at a minimal revenue cost. We are particularly pleased that the bill would repeal the "10/50" basket for foreign tax credits, and reduce double taxation by (1) extending the number of years to which foreign tax credits can be carried forward and back, and (2) extending the number of tiers from which indirect foreign tax credits can be claimed. Recognition of the European Union as a single country, and elimination of the overlap of the CFC and PFIC rules are important steps in the simplification and rationalization of the Subpart F provisions. Finally, the NAM believes that making the "64% R&D allocation" permanent and allowing the election to use E&P basis for allocating interest expense is an important step in encouraging U.S. research and eliminating controversy and inequities in the allocation provisions.

The NAM strongly supports this bill.

Sincerely,

TO: Committee on Industry Statements
Foreign Source Income Committee

American Petroleum Institute
1220 L Street, Northwest
Washington, D.C. 20005
(202) 682-8100

FROM: Barbara Bush

Sent: June 21, 1995

cc: WGD
6/21/95

Charles J. DiBona
President

June 19, 1995

The Honorable
Bill Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
Longworth Office Building
Washington, DC 20515-6348

Dear Mr. Chairman:

The American Petroleum Institute (API) would like to express its support for H.R. 1690, The International Tax Simplification and Reform Act of 1995, introduced by Congressmen Levin and Houghton on May 24. For many of API's members with international operations the proposed simplifications would substantially alleviate current tax compliance burdens within the complex system of U.S. taxation of foreign operations.

In comments to the tax writing committees in past years API has identified the issues in the taxation of foreign operations which are of concern to our members. While H.R. 1690 does not address all of these issues, it does include many of them. At the present, of specific interest are Bill Sec. 4 (exception from UNICAP rules), Sec. 6 (extension of foreign tax credit carryover rules), Sec. 7 (extended look-through with respect to income from noncontrolled section 902 companies), Sec. 9 (exclusion of CFC shareholders from PFIC regime), and Sec. 11 (recapture of overall domestic loss).

In view of the continuing growth of the global market with a more complex international involvement of U.S. companies, any step toward simplification like H.R. 1690, particularly in the area of tax compliance and administration, is needed and should be promoted.

Sincerely,

Charles J DiBona

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Emergency Committee for American Trade 1211 Connecticut Ave. N.W. Washington, D.C. 20036 (202) 659-5147

July 10, 1995

The Honorable Amo Houghton
United States House of Representatives
1110 Longworth House Office Building
Washington, D.C. 20515-3231

Dear Congressman Houghton:

I am writing to express the strong support of the members of the Emergency Committee for American Trade (ECAT) for H.R.1690, the "International Tax Simplification and Reform Act of 1995," introduced by yourself and Congressman Sander Levin. We have long advocated and supported many of the provisions of the bill, and we commend you for your initiative in introducing it. All provisions of H.R. 1690 represent sound tax policy.

Without attempting to catalog ECAT positions on each of the bill's provisions, let me simply note that enactment of H.R.1690 would temper some of the excesses in the taxation of foreign source income included in the 1986 tax reform bill and in other pieces of legislation. By simplifying several complex areas of the tax code concerning foreign source income, the provisions of H.R.1690 would reduce the administrative burden and costs of compliance. We particularly welcome the provisions concerning the allocation of R & D and interest expenses and those simplifying and reforming the foreign source income "deferral" provisions..

H.R.1690 is of more than academic interest to the members of ECAT. Enactment of the bill would assist their competitiveness at home and abroad. The approximately 60 members of ECAT are all U.S. headquartered firms with extensive international business interests. Their annual worldwide sales are over $1 trillion. They employ about five million workers, and they account for a substantial portion of total U.S. exports. ECAT member firms operate facilities in every state and in nearly all 435 congressional districts.

Again, thanks for your initiative in introducing H.R. 1690.

Sincerely,

Bob McNeill

Robert L. McNeill
Executive Vice Chairman

1212 Avenue of the Americas New York, New York 10036-1689
Telephone: 212.354.4480 FAX: 212.575.0327

United States Council for International Business

Serving American Business as U.S. Affiliate of:

The International Chamber of Commerce
The International Organization of Employers
The Business and Industry Advisory Committee to the OECD
The ATA Carnet System

June 2, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
United States House of Representatives
Longworth House Office Building
Washington, DC 20515-6348

Dear Mr. Chairman:

The United States Council for International Business wishes to express its support for H.R. 1690, the International Tax Simplification and Reform Act of 1995, which was introduced last week by Congressmen Houghton and Levin. The provisions of this bill, if adopted, would substantially alleviate the burden of tax code complexity which U.S. corporations now face with regard to the international area, and thus enhance their international competitiveness vis-a-vis their foreign competitors.

We are pleased to note that this bill contains many of the changes which we recommended in our letter to you of March 8, 1995, wherein we expressed our support for simplification in the foreign area and for your efforts in this regard. Specifically, the allowance of look-through treatment for non-controlled Section 902 company dividends and the repeal of the separate basket approach for these companies would allow cross crediting of foreign taxes, and level the playing field between U.S. companies and foreign companies which are not subject to additional home country taxation. The exemption of U.S. controlled foreign corporations (as defined in Subpart F) from the passive foreign investment company rules would correct an inadvertent overlapping of the PFIC and Subpart F rules, and thus greatly reduce complexity in the case of such companies. The extension of the foreign tax credit beyond the third tier and the extension of foreign tax credit carryovers would also significantly reduce complexity and would help reduce the double taxation of foreign source income which impedes U.S. competitiveness abroad.

The bill also contains many helpful provisions which we have not mentioned heretofore, such as the exclusion of CFCs from uniform capitalization rules, making permanent the 64% allocation of U.S. R&D expenses to U.S. source, the recapture of domestic losses as foreign sourced income, increasing the de minimis exception to Subpart F treatment to less than 10% of gross income, and the use of the average rate of exchange in translating foreign taxes.

We regret that the bill does not address the problems created by the excess passive assets rule (Section 956A). We hope that this issue may be addressed as your Committee further considers H.R. 1690. We will, of course, be prepared to work with your staff on the repeal of Section 956A which, we believe, will result in little or no revenue cost because of the interaction between 956A and Subpart F.

In sum, this bill makes great strides toward simplifying the international provisions of the U.S. Internal Revenue Code. We therefore strongly urge that this bill be acted upon, with the incorporation of our suggestion as noted above, as soon as possible, with a view to incorporating it into this year's budget reconciliation bill.

Sincerely,

Robert T. Scott
Chairman, Committee on Taxation

Richard M. Hammer
International Tax Counsel

Chairman ARCHER. I want to thank all three of you for very thoughtful input to the Committee, and now I recognize Mr. Gibbons for inquiry.

Mr. GIBBONS. Mr. Levin, Mr. Houghton, I wish you well in your crusade to straighten out the foreign tax problems that we have. It is my estimation that we spend more money trying to collect these foreign taxes than we actually collect in taxes. If you go around the world, you will find a U.S. representative of the Internal Revenue Service in about every major city on Earth and sometimes numerous members of the IRS in those places.

Eventually, we are going to have to go to a consumption-based tax which every industrialized country except the United States and Australia have gone to, and nobody makes the effort to reach out and tax their businesses and their citizens to the extent that we do. Our foreign tax provisions are absolutely unproductive, all because we got mad at a few Hollywood starlets who moved their tax status to Mexico to get out of paying U.S. income taxes.

There are better ways of doing it. A value-added tax is probably the easiest and fairest and fits in with the international picture better than anything else. But good luck. Appreciate your trying.

Mr. Houghton, I hope you are able to pass that little bill that Barber Conable originated and passed on to me and you cosponsored this time. We certainly need to do that. We have unfairly treated surviving spouses of international civil servants who are assigned to this country by the way we tax them on their estates, and it ought to be corrected.

Mr. HOUGHTON. Thank you.

Chairman ARCHER. Are there any other Members who wish to inquire? If not, thank you very much.

Mrs. KENNELLY. Thank you, Chairman Archer.

Chairman ARCHER. Our next panel is Hon. William Goodling, Hon. Barney Frank, Hon. Tim Johnson, Hon. Peter Blute, and Hon. Peter Torkildsen. Will you please come and take seats at the witness table.

Gentlemen, we are happy to have you before the Committee today and pleased to entertain your suggestions for changes in the Code and particularly want to welcome the Chairman of the Economic and Educational Opportunities Committee, Mr. Goodling.

You may proceed. Your entire statement, if you have one in writing, will, without objection, be entered in the record, and you may summarize orally in any way that you wish.

STATEMENT OF HON. WILLIAM F. GOODLING, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. GOODLING. Thank you, Mr. Chairman.

First of all, could I take one of these pitchers along to show my staff how it is done on my Committee?

Several years ago, I had an opportunity to visit a housing site where a young contractor had built and sold approximately 150 single-unit homes. He was able to do this because he was able to help these first-time homeowners get around the idea of where do I get the downpayment. Usually, first-time home buyers, that is their big stumbling block. What he did was get a bank to finance the 80 percent; he, in turn, took a second mortgage for the down-

payment, for the 20 percent, with the same rates as the bank charged and the same situation as the bank had.

The bank was very happy to do this because they realized that both the home and the land and so on were far more valuable than the kind of money they were putting up for that mortgage, a 30-year mortgage. He sold over 100 of those single-unit homes in 1 year's time—or about 18 months.

I visited there and also went through the homes and visited the families who were living there who were very thankful for this very creative way of helping them become first-time home buyers.

And along came the 1986 tax changes and, inadvertently, his program was hit right on the head and squashed dead in its tracks because there you were aiming at those people who were trying to—businesses and individuals who were seeking tax shelters. The only problem was the IRS then ruled that he fitted into the same category because they said that he had to pay tax the first year on the 100-percent purchase price. Well, of course, that took all of the money away that he was going to use for the downpayment, for the 20 percent. Because when they taxed him, even though he didn't collect the money over that first year but over many years, they taxed him as if all of the money came in in the first year.

What I have tried to do is take us back to where we were in 1986, because I know that was not what you had planned when you made those tax changes. As I said, you were after businesses and individuals who were seeking tax shelters.

What I did in H.R. 1076 is take us back prior to the 1986 tax changes so that he would then be able to continue to use that money to put up that 20 percent downpayment so these first-time home buyers would be able to purchase the homes. I hope that you will take a careful look at the legislation because, as I indicated, I am sure that was not what you had hoped to do in the 1986 tax changes, but it is just, unfortunately, the way the IRS interpreted what was done.

This man is—his creative way of helping people become first-time home buyers and create a lot of jobs in our area because, of course, they are producing homes, was wiped out. So, I would hope that you would take a look at it.

I thank Mr. English also for helping me get to this point because I think it is something you really need to look at and I hope that you will.

Chairman ARCHER. Thank you, Mr. Chairman. I appreciate your suggestions.

I would just quickly file a disclaimer that Phil Crane and I led the opposition to the 1986 act on the floor of the House, so we take no blame for any of the provisions that are in it.

Mr. GOODLING. But you will take a lot of credit if we get it changed.

Chairman ARCHER. Any time we can improve the Tax Code, that is what we are here for.

[The prepared statement follows:]

TESTIMONY OF HON. WILLIAM F. GOODLING A MEMBER IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Good Morning. First, I would like to thank Chairman Archer and Mr. Gibbons for the opportunity to testify on legislation I recently introduced, the "First Time Homebuyers Assistance Act." I would also like to thank my colleague from Pennsylvania, Congressman Phil English, for his assistance.

I believe my bill, the "First Time Homebuyers Assistance Act," will make the American dream of owning a home a reality for thousands of renters. Today's renters often pay as much for rent as homeowners pay for a monthly mortgage payment.

It is not surprising that the 1994 Fannie Mae National Housing Survey found 86 percent of renters believe they would be better off owning a home. To many Americans, homeownership means financial, psychological, and familial security. It means a stronger economy, safer neighborhoods, and a better quality of life.

Given such an optimistic view of homeownership, why do so many renters continue to rent? According to the Fannie Mae survey, an overwhelming 65 percent of renters rank the downpayment as their primary obstacle to owning a home.

Several years ago, one of my constituents, Barry Rauhauser, a home builder in York, PA, developed a unique and innovative arrangement in which moderately-priced single-family homes are constructed for purchase with no downpayment.

A local financial institution finances 80 percent of the loan, while the remaining 20 percent, in the form of a second mortgage, is financed by the local builder. This creative financing plan makes the purchase of a home affordable to hard-working people who cannot afford a downpayment. Mr. Rauhauser has noted that many more banks are accepting this type of financing as they are assured they are well protected and see the positive results of increased homeownership.

My bill will encourage builders to finance the cost of the downpayment for low- to mid-priced single family homes. The current tax code penalizes builders who finance the downpayment on behalf of the purchasers. The law limits a builder's ability to finance second mortgages because it assumes that buyers are paying the entire balance in the year the property is purchased.

The law requires builders to pay taxes on the entire amount of the income received from a mortgage in the year the purchase is made. For a builder, it becomes almost impossible to pay these taxes, not having cash on hand to do so until the balance of the mortgage payment is received at a future date.

In short, the Tax Code prohibits a builder from using the installment method to calculate his tax liability. This situation places a builder in a financial bind and jeopardizes the future of this and similar housing programs.

H.R. 1076 would apply to single family, owner-occupied units. The purchaser must be a first-time homebuyer who qualifies for 100 percent of the loan. Further, the legislation directs that a second mortgage on the property be no more than 20 percent of the sale price and applies only to single-family homes costing no more than 75 percent of the median home price for newly constructed one-family residential real property in a given area.

Last month the Clinton Administration announced a National Homeownership Strategy plan to increase homeownership in America from 64 percent to an all-time high level of 67.5 percent by the year 2000. According to the Department of Housing and Urban Development, this increase represents 8 million additional homeowners. I believe my legislation would contribute significantly to this goal.

As the Committee on Ways and Means considers various tax proposals, I urge the Committee's support of H.R. 1076 which encourages creative financing and is specifically geared to helping those Americans who need the most assistance in buying a home. This legislation is a win-win-win situation for all involved. It's a win for the builder who can create more jobs in the housing industry. It's a win for the economy. And, most importantly, it's a win for the first-time homebuyer who can make the American dream of owning a home an American reality!

Chairman ARCHER. Mr. Johnson, you are recognized. As I mentioned earlier, for all of you, if you have a written statement, the entire statement, without objection, will be printed in the record, and you may proceed verbally to summarize in any way that you wish.

STATEMENT OF HON. TIM JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH DAKOTA

Mr. JOHNSON of South Dakota. Thank you, Mr. Chairman and Ranking Member Gibbons.

I will submit my full written statement for the record and summarize briefly legislation, H.R. 1588, which I bring before the Committee. This legislation would correct an oversight in the Tax Code affecting farmers and ranchers who are forced to sell their livestock prematurely due to weather-related conditions.

I believe that this particular legislation is precisely the kind of responsible but minor change in the Tax Code that these hearings were called to address. While this bill would have a huge impact on a sector of our economy, it is a minor change in the overall scheme of things.

The current Tax Code contains two provisions that serve to spread out the financial pain that drought conditions impose on livestock producers. The first is a provision which allows livestock producers to defer taxes on any gain from forced sales of livestock when they invest the proceeds in similar property within 2 years. In other words, producers may use the proceeds of the sale to rebuild their herds without incurring a tax penalty.

The second provision permits producers who do not reinvest in similar property to include the proceeds of their sale in their taxable income during the following year, rather than during the same year that they are facing the drought.

These provisions have been very helpful to producers who have experienced a drought. However, due to an oversight, they do not apply to livestock sold on account of flooding or other weather-related conditions. Floods, Mr. Chairman, can be just as devastating to producers as drought conditions and can cause the disruption of crops grown to feed livestock, loss of critical pasture land, damage to fences, and high loss of young stock.

The heavy rains and flooding that we have experienced in my State of South Dakota this year, for instance, caused calf losses as high as 40 percent in some areas in the spring, with 10 percent being common. Many areas are still under water from excessive rainfall. A great many ranchers have had to put their cattle out to pasture early, before spring growth, meaning they will face a shortage of forage. With the flooding also producing a steep increase in feed prices, these ranchers will be forced to sell their cattle prematurely.

My legislation would simply take the provisions in the Tax Code relating to forced sale of livestock due to drought and extend them to include flooding and other weather-related conditions.

More evidence of the fairness of this proposed tax change is that farmers who lose crops due to natural disasters, including flooding, are able to benefit from certain provisions in the Tax Code. For instance, farmers who receive insurance or disaster payments when

their crops are lost or damaged due to severe weather conditions are often permitted to include these payments in the year following the disaster. I find it difficult to justify the fact that farmers who lose crops on account of flood conditions are covered by these provisions while producers who are forced to sell livestock because of that same flooding are not.

The Joint Tax Committee has completed an analysis of the revenue implications of the bill. This legislation would have a negligible impact on Federal revenues, averaging about $2 million a year. The assistance that the bill would provide to producers affected by floods and other weather-related conditions is well worth that minor cost.

Mr. Chairman, I am pleased to state that this legislation has bipartisan support in the House. Cosponsors of the bill include Mr. Hostettler, Mr. Peterson of Minnesota, Mr. Lightfoot, Mr. Stenholm, and Mr. Laughlin. Additionally, I want to thank Mr. Gibbons for his kind letter offering support of the bill.

We have a corresponding bill on the Senate side which also has bipartisan support, and this legislation is endorsed by the National Cattlemen's Association, the National Pork Producers Council, the National Farmers Union, and the American Farm Bureau Federation.

Mr. Chairman, thank you for allowing me this opportunity to testify on behalf of this small—but nonetheless, critically important for a certain sector of our economy change in the Tax Code. I am certain that you and the rest of the Committee will agree that it is unfair to deny disaster-related provisions of the Tax Code to livestock producers simply because a disaster involved is a flood rather than a drought. I appreciate very much your careful consideration of this legislation.

[The prepared statement follows:]

TESTIMONY BY CONGRESSMAN TIM JOHNSON ON H.R. 1588, LEGISLATION THAT WOULD ESTABLISH MORE EQUITABLE TAX TREATMENT FOR LIVESTOCK PRODUCERS WHO ARE FORCED TO SELL LIVESTOCK ON ACCOUNT OF WEATHER-RELATED CONDITIONS

BEFORE THE COMMITTEE ON WAYS AND MEANS

JULY 11, 1995

Mr. Chairman, Ranking Member Gibbons, and other members of the Committee, I appreciate the opportunity to come before you to testify on behalf of H.R. 1588, legislation that would correct an oversight in the tax code affecting farmers and ranchers who are forced to sell their livestock prematurely due to weather-related conditions. I believe that this legislation is precisely the kind of responsible, minor change in our tax code that these hearings were called to address.

The current tax code contains two provisions that serve to spread out the financial pain that drought conditions impose on livestock producers. The first provision allows livestock producers to defer tax on any gain from forced sales of livestock when they reinvest the proceeds in similar property within two years. In other words, producers may use the proceeds of the sale to rebuild their herds without incurring a tax penalty. The second provision permits producers who do not reinvest in similar property to include the proceeds of their sale in their taxable income during the following year, rather than during the same year they are facing the drought.

These provisions are very helpful to producers who have experienced a drought. However, due to an oversight, they do not apply to livestock sold on account of flooding or other weather-related conditions. Floods can be just as devastating to producers as drought conditions, and can cause the destruction of crops grown to feed livestock, loss of critical pasture land, damage to fences, and high losses of young stock. The heavy rains and flooding we have been experiencing in my State of South Dakota caused calf losses as high as 40% in some areas this spring (with 10% loss being common), and many areas are still under water from excessive rainfall. A great many ranchers had to put their cattle out to pasture early, before spring growth, meaning that they will face a shortage of forage. With the flooding also producing a steep increase in feed prices, these ranchers will be forced to sell their cattle prematurely. My legislation would simply take the provisions in the tax code relating to forced sales of livestock due to drought and extend them to include flooding and other weather-related conditions such as the kind livestock producers in the upper Midwest and other areas of the country are experiencing.

More evidence supporting the fairness of this proposed tax change is that farmers who lose crops due to any natural disaster, including flooding, are able to benefit from certain provisions in the tax code. For example, farmers who receive insurance or disaster payments when their crops are lost or damaged due to severe weather conditions are often permitted to include these payments in the year following the disaster. Provisions such as this are designed to spread out the impact of taxes on farmers in these situations. I find it difficult to justify the fact that farmers who lose crops on account of flood conditions are covered by these provisions, while producers who are forced to sell livestock because of the same flooding are not.

Although the Joint Tax Committee has not completed its analysis of the revenue implications of this bill, my legislation should have a negligible impact on federal revenues, somewhere in the range of a few million dollars a year. The assistance that this bill would provide to producers affected by floods and other weather-related conditions is well worth the small cost.

Mr. Chairman, I am pleased to state that this legislation has bipartisan support in the House. Cosponsors of the bill include Mr. Hostettler, Mr. Peterson of Minnesota, Mr. Lightfoot, Mr. Stenholm, and Mr. Laughlin. Additionally, I would like to thank Mr. Gibbons for his kind letter offering support of this bill. On the Senate side, identical legislation has been introduced by Senator Daschle, and his bill also has cosponsors from both sides of the isle. A number of important agricultural organizations have announced their support of this bill, including the National Cattlemen's Association, the National Pork Producers Council, the National Farmers Union, and the American Farm Bureau Federation.

Mr. Chairman, thank you for allowing me the opportunity to testify on behalf of this small, but nonetheless very important, change in our tax code. I am certain that you and the rest of the committee will agree that it is unfair to deny the disaster-related provisions of the tax code to livestock producers just because the disaster involved is a flood and not a drought. I ask you to join me in making this common-sense change to the federal tax code, and provide some needed assistance to our nation's livestock producers.

While I am before you, I would like to share my concerns relative to another area where our tax code needs some clarification Since I was not called before the committee to testify on this matter, and I know that you have a very busy schedule, I will not spend a great deal of your time discussing this problem. However, I would like to call your attention to how certain agricultural vehicles are affected by the highway excise tax. As you know, an excise tax is placed on the sale of heavy trucks, trailers, and tractors in order to compensate for the wear and tear of these vehicles on our highways. Many agricultural vehicles — such as those used to prepare and haul feed, seed, and fertilizer — are exempt from this tax based on the principle that their use on the highways is limited. However, it seems that the IRS has interpreted congressional intent in an overly-narrow fashion, and has attempted to apply the excise tax to some agricultural vehicles despite the fact that they are only used on a seasonal basis (3 to 4 months per year), that they contain specialized equipment that is used for loading and unloading farm products, and that several states restrict their use on the highways. I am referring specifically to cotton module trucks and trailers. One company that manufactures these cotton module haulers is based in the town of Eden, South Dakota. I believe that Congress should clarify its original intent in order to ensure that the highway excise tax should not be applied to specialized farm equipment that is used on a seasonal basis. I am working with the National Cotton Council and the National Ginners Association on legislative language that would clarify the tax code as pertaining to agricultural vehicles of this sort. I hope that you will look favorably upon this legislation at the appropriate time.

Chairman ARCHER. Thank you for your testimony.

Our next witness is the gentleman from Massachusetts, Mr. Barney Frank. Mr. Frank, you are recognized, and you may proceed.

STATEMENT OF HON. BARNEY FRANK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. FRANK. Thank you, Mr. Chairman.

I am here with my colleague with whom I share a number of communities, Mr. Blute, because this is a very important issue involving the fishing industry which affects both of our districts.

Your Committee, Mr. Chairman, has previously acted on this particular legislation favorably. In fact, the provision that Mr. Blute and I are seeking—and we have the support, I believe, also of others in our delegation—Mr. Torkildsen, Mr. Studds, Mr. Neal, who has been helpful—it has twice been included in other legislation noncontroversially, but the legislation in which it was included was not noncontroversial and got vetoed.

What we have is a dispute over fishermen on fishing boats and whether they ought to be treated for withholding purposes as employees or independent contractors. We now have agreement as to what it should be in the future; and, indeed, we have an offset in this bill that Mr. Blute and I worked on that makes it a revenue raiser because it will have reporting in the future which everybody would agree to, but it would raise $38 million while it would cost $12 million.

The problem is that a dispute arose in 1970 as to whether or not these fishermen, the crews, were to be treated as employees or contractors. They had always been treated as independent contractors. They got a share of the catch, and so forth.

In 1976 Congress passed a statute that people thought resolved this so there would not be liability. The IRS, however, did not, I believe, interpret this in the spirit in which Congress passed it, and a dispute grew over what "normally" meant. I believe we are talking about people who are unfairly caught in a dispute over what "normally" means, and they are now facing a retroactive liability. It has gone to court. There have been a series of concerns.

What this legislation would do would be to do away with that retroactive liability that has accrued over the period when we think there was legitimate dispute. It is reflective of a position Congress twice took, basically saying these were independent contractors and not employees, but it has reporting for the future.

We have talked to the Treasury Department about this. The Treasury Department thinks that the solution as to the future is a good one. Specifically on the question of the retroactivity, they have told us that they have no opinion whatsoever. They have no opposition, no support. They leave that to us.

I am told they never have supported in their view retroactive liability, but they are not opposing in this case, and we have an industry here in particular that is in some difficulty, the fishing industry.

If we are not able to enact this legislation which wipes out that retroactive liability and says that these are not employees in that period, an industry that is already hurting faces absolute devasta-

tion. You will see some of the people who are still able to make it just be wiped out. Frankly, I believe that the revenue lost to the government would be even greater because you are going to see some people put out of business.

·But even on the static analysis, in our terms, we have an offset that is greater than the revenue lost. As I said, this has twice passed the Congress in exactly the form that we are proposing it now. It was vetoed because it was included in other legislation. The Treasury Department has no objection to it and supports the formula, and we believe it really is a case of equity, and if there were any other way to do it, we would get involved.

Unfortunately, a lawsuit did come during this period. The lawsuit had a mixed result. The IRS won a couple of points, and the fishermen won a couple of points. I think the very mixed nature of the lawsuit shows the ambiguity of the law.

What we have are people who are hard working and decent. No one has accused them of being evasive, of trying to not pay their taxes. They are in a tough industry, and we are trying to give them a clear footing at no cost whatsoever to the government the way this would be worked out. We hope that, once again, this could be included and this time maybe in a piece of legislation that will ultimately get signed.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you for your explanation.

The other gentleman from Massachusetts, Mr. Blute.

STATEMENT OF HON. PETER BLUTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. BLUTE. Thank you very much, Mr. Chairman, for the opportunity to come before the Committee to discuss miscellaneous tax issues. I would also like to thank you for holding these hearings and soliciting the concerns of Members as this Committee works toward consideration of comprehensive tax reform legislation.

I would like to address the Committee regarding two separate tax issues. Before doing so, I would like to thank two Members of the Committee, my colleague from Massachusetts, Mr. Neal, and my good friend from Texas, Mr. Johnson, who have been helpful to me on these issues.

The first issue I would like to address pertains to the tax treatment of certain fishermen. In the interest of time, I would simply reiterate my colleague Mr. Frank's comments about the devastating effects and unfair nature of the IRS claims on the fishing industry in Massachusetts and nationwide.

As my colleague stated, boatowners are subjected to enormous tax burdens as a result of certain IRS interpretations of the IRC, Internal Revenue Code. The IRS is seeking to make boatowners the guarantors of the tax liabilities of their crew members.

Mr. Chairman, by asking for a rewrite of that provision, we propose what I believe is a fair and equitable offset. By requiring seafood dealers to report the identity of the seller, the government will collect taxes on millions of dollars of previously unreported income. I support my colleague's efforts and ask that the Committee give this proposal its very serious consideration.

At this time, I would like to briefly turn to another tax issue that is of great concern to many individuals throughout Massachusetts. Specifically, I would request that the Committee consider an amendment to the Internal Revenue Code which would assist a hardship case in my home State of Massachusetts. The SBLI, Savings Bank Life Insurance Co. of Massachusetts, seeks to clarify that the 12-year dividend payout to consumers is treated as a deductible policyholder dividend as opposed to a nondeductible redemption of any equity interest.

Created in 1907 by the Massachusetts legislature to provide low-cost life insurance to consumers, SBLI is often the subject of national praise and has been noted for providing quality products in nationally recognized publications, including Consumer Reports. Today, SBLI has more than 500,000 policies and $12 billion of in-force insurance.

In 1990 Massachusetts passed legislation to consolidate SBLI into a nonpublic stock insurance company while still allowing for the sale of its products through Massachusetts banking institutions. The plan consolidated 50 separate life insurance departments into a closely held stock company.

In recognition of the improved efficiencies and profitability of the company, the new Massachusetts law requires that the total combined surplus of the prior SBLI insurance department is to be paid out over a 12-year period to current policyholders as an additional policy dividend. SBLI is seeking legislation from this Committee which would ensure clarification from the IRS that this payout is treated as a deductible policyholder dividend since its policyholders have never held the normal attributes of ownership, such as the right to vote and the right to participate in the distribution of assets.

I will submit the rest of my testimony in the interest of time, but I would ask the Committee to consider this amendment.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE PETER BLUTE

ON MISCELLANEOUS TAX ISSUES
BEFORE THE COMMITTEE ON WAYS & MEANS
July 11, 1995

MR. CHAIRMAN:

THANK YOU FOR THE OPPORTUNITY TO COME BEFORE THE COMMITTEE TO DISCUSS MISCELLANEOUS TAX ISSUES. I WOULD ALSO LIKE TO THANK YOU FOR HOLDING THESE HEARINGS AND SOLICITING THE CONCERNS OF MEMBERS AS THIS COMMITTEE WORKS TOWARD CONSIDERATION OF COMPREHENSIVE TAX REFORM LEGISLATION.

I WOULD LIKE TO ADDRESS THE COMMITTEE REGARDING TWO SEPARATE TAX ISSUES. THE FIRST IS REGARDING AN EMPLOYMENT TAX, NAMELY THE TAX STATUS OF CERTAIN FISHERMEN AND THE OTHER IS REGARDING A LIFE INSURANCE TAX ISSUE.

AS YOU MAY KNOW, SINCE 1988 THE INTERNAL REVENUE SERVICE HAS BEEN ATTEMPTING TO NOT ONLY IMPOSE A CONTROVERSIAL INTERPRETATION OF THE WITHHOLDING RULES FOR CERTAIN FISHING CREWS, BUT TO MAKE THE INTERPRETATION RETROACTIVE TO JANUARY 1, 1985. CONGRESS HAS TWICE PASSED LEGISLATION WHICH WOULD HAVE ACCOMPLISHED THE NECESSARY CLARIFICATION OF THE RULES AND ENSURED MORE FAIR TREATMENT OF THE FISHERMEN. UNFORTUNATELY, THE FISHING PROVISION NEVER BECAME LAW BECAUSE TWO DIFFERENT TAX BILLS IN WHICH IT WAS INCLUDED WERE VETOED FOR UNRELATED REASONS. AS A RESULT, MANY MEMBERS OF THE FISHING FLEETS IN MASSACHUSETTS REMAIN IN AN UNCERTAIN AND FINANCIALLY PRECARIOUS POSITION.

SPECIFICALLY, THE IRS HAS CLAIMED THAT THE OWNERS OF FISHING BOATS ARE NOT ENTITLED TO THE EXEMPTION FROM PAYROLL TAX OBLIGATIONS WHICH THE CONGRESS PROVIDED IN 1976 FOR SMALL BUSINESSPERSONS IN THE FISHING INDUSTRY IN SECTION 3121(b)(20) OF THE INTERNAL REVENUE CODE. THERE HAVE BEEN SEVERAL CASES WHERE THE IRS HAS ASSESSED OWNERS WITH UNPAID INCOME AND FICA TAXES WHICH CREW MEMBERS SHOULD HAVE PAID AS SELF-EMPLOYED PERSONS, DESPITE THE FACT THE OWNERS HAD PAID THE ENTIRE COMPENSATION OWED TO EACH CREW MEMBER AFTER EVERY VOYAGE. IN ADDITION, THE IRS HAS ALSO ISSUED A CLAIM THAT IF A BOAT SAILS WITH 9 CREW MEMBERS THEN THE OWNER IS CONSIDERED AN EMPLOYER SUBJECT TO ALL OF THE PAYROLL TAX RESPONSIBILITIES OF ANY OTHER EMPLOYER.

MR. CHAIRMAN THIS AMOUNTS TO THE IRS SEEKING TO MAKE BOAT OWNERS THE GUARANTORS OF THE PAYMENT OF THE TAX LIABILITIES OF THEIR CREW MEMBERS. CLEARLY, THIS IS AN UNFAIR PRACTICE THAT WILL RESULT IN SEVERE FINANCIAL BURDENS ON BOAT OWNERS NOT ONLY IN MASSACHUSETTS, BUT ACROSS THE COUNTRY.

IN PROPOSING A CHANGE IN THIS TAX PROVISION, MY COLLEAGUES AND I HAVE IDENTIFIED A NEW PROVISION OF THE INTERNAL REVENUE SERVICE WHICH WILL REQUIRE THOSE SEAFOOD DEALERS, WHO PURCHASE PRODUCT FOR CASH, TO REPORT TO THE IRS THE IDENTITY OF THE SELLER AND THE AMOUNT OF THE PURCHASE. THIS IS A NEW OBLIGATION TO REPORT TO THE IRS WHICH THE SEAFOOD DEALERS PRESENTLY DO NOT HAVE, NO MATTER WHAT THE SIZE OF THE CASH PURCHASE. BASED ON ESTIMATES BY THE IRS, THE AMOUNT OF UNREPORTED INCOME THROUGHOUT THE COUNTRY CAUSED BY A CASH ECONOMY IN SEAFOOD PRODUCTS IS IN THE RANGE OF TENS OF MILLIONS OF DOLLARS PER YEAR. BY IMPOSING STIFF PENALTIES ON SEAFOOD DEALERS

WHO PURCHASE PRODUCT FOR CASH WITHOUT MAKING THE REQUIRED REPORTS TO THE IRS, THIS PROVISION WILL RAISE SUBSTANTIALLY MORE INCOME TAX YEAR AFTER YEAR THAN WILL BE LOST BY GIVING RETROACTIVE EFFECT TO THE PROVISION THAT WILL AMEND SECTION 3121 (b)(20).

MR. CHAIRMAN, THE SUBSTANTIAL MAJORITY OF FISHING BOAT OWNERS IN THE UNITED STATES WHO MARKET THEIR PRODUCT THROUGH THE WELL-ESTABLISHED COMMERCIAL DISTRIBUTION CHANNELS OBEY THE CONSERVATION GUIDELINES REGARDING THE SIZE OF THE PRODUCT WHICH THEY KEEP, AND PAY ALL OF THEIR FEDERAL AND STATE TAXES. HOWEVER, AS IN ANY BUSINESS, THERE ARE THOSE WHO VIOLATE THE ESTABLISHED NORMS OF PRACTICE, THEREBY SEEKING TO GAIN AN ADVANTAGE OVER HONEST BUSINESSMEN.

ONE WAY TO AVOID THE TAXES AND OTHER REQUIREMENTS IMPOSED ON THE FISHING OPERATORS IS TO SELL EACH CATCH TO UNLICENSED DEALERS WHO BACK THEIR TRUCKS UP TO A PIER AT NIGHT, UNLOAD THE SEAFOOD, AND PAY CASH TO THE CAPTAIN OF THE BOAT. THIS CASH IS NOT REPORTED AS INCOME BY THE RECIPIENTS, MEANING BOTH THE FISHING BOAT OWNER AND THE CREW MEMBERS WHO SHARE THE CASH.

THIS PROBLEM IS NOT LOCAL TO MASSACHUSETTS, BUT IS PRACTICED QUITE FREQUENTLY NATIONWIDE. THEREFORE, MILLIONS AND MILLIONS OF DOLLARS OF INCOME GO UNREPORTED AT A SIGNIFICANT LOSS TO THE GOVERNMENT.

I URGE THE COMMITTEE TO GIVE SERIOUS CONSIDERATION TO THESE PROPOSALS AND TO ENACT LEGISLATION THAT PENALIZES THOSE THAT ARE WORKING AROUND THE SYSTEM, RATHER THAN PENALIZING HARDWORKING BOAT OWNERS THROUGH AN UNFAIR INTERPRETATION OF THE EMPLOYMENT TAX CODE.

MR. CHAIRMAN, I WOULD ALSO LIKE TO ADDRESS THE COMMITTEE REGARDING AN AMENDMENT TO THE INTERNAL REVENUE CODE WHICH WOULD ASSIST A HARDSHIP CASE IN MY HOME STATE OF MASSACHUSETTS.

THE SAVINGS BANK LIFE INSURANCE COMPANY OF MASSACHUSETTS (SBLI) SEEKS TO CLARIFY THAT THE TWELVE-YEAR DIVIDEND PAYOUT TO CONSUMERS IS TREATED AS A DEDUCTIBLE POLICY HOLDER DIVIDEND, AS OPPOSED TO A NON-DEDUCTIBLE REDEMPTION OF ANY EQUITY INTEREST.

CREATED IN 1907 BY THE MASSACHUSETTS LEGISLATURE TO PROVIDE LOW-COST LIFE INSURANCE TO CONSUMERS, SBLI IS OFTEN THE SUBJECT OF NATIONAL PRAISE AND HAS BEEN NOTED FOR PROVIDING QUALITY PRODUCTS IN NATIONALLY RECOGNIZED PUBLICATIONS, INCLUDING CONSUMER REPORTS. TODAY, SBLI HAS MORE THAN 500,000 POLICIES AND $12 BILLION OF IN-FORCE INSURANCE.

IN 1990, MASSACHUSETTS PASSED LEGISLATION TO CONSOLIDATE SBLI INTO A NON-PUBLIC STOCK INSURANCE COMPANY, WHILE STILL ALLOWING FOR THE SALE OF ITS PRODUCTS THROUGH MASSACHUSETTS BANKING INSTITUTIONS. THE PLAN CONSOLIDATED FIFTY SEPARATE LIFE INSURANCE DEPARTMENTS INTO A CLOSELY HELD STOCK COMPANY.

IN RECOGNITION OF THE IMPROVED EFFICIENCIES AND PROFITABILITY OF THE COMPANY, THE NEW MASSACHUSETTS LAW REQUIRES THAT THE TOTAL COMBINED SURPLUS OF THE PRIOR SBLI INSURANCE DEPARTMENTS BE PAID OUT OVER A 12-YEAR PERIOD TO CURRENT POLICYHOLDERS AS AN ADDITIONAL POLICY DIVIDEND. SBLI IS SEEKING LEGISLATION FROM THIS COMMITTEE WHICH WOULD ASSURE CLARIFICATION FROM IRS THAT THIS PAYOUT IS TREATED AS A DEDUCTIBLE POLICYHOLDER DIVIDEND SINCE ITS POLICYHOLDERS HAVE NEVER HELD THE NORMAL ATTRIBUTES OF OWNERSHIP SUCH AS THE RIGHT TO VOTE AND THE RIGHT TO PARTICIPATE IN THE DISTRIBUTION OF ASSETS.

THE JOINT COMMITTEE ON TAXATION REPORTED IN MARCH OF THIS YEAR

THAT THE EFFECT OF THIS PROPOSED AMENDMENT WOULD COST APPROXIMATELY $25 MILLION OVER THE NEXT FIVE YEARS. SBLI ASSERTS THAT DESPITE THIS COST, THE CONSOLIDATION OF SBLI WILL RESULT IN THEIR PAYING MORE IN FEDERAL INCOME TAXES AS ONE LARGE TAXPAYER THAN IN PREVIOUS YEARS. IN 1992, FOR EXAMPLE, SBLI PAID MORE THAN $5 MILLION IN TAXES TO THE FEDERAL GOVERNMENT.

MR. CHAIRMAN, RELIEF FOR SBLI IN ANY TAX LEGISLATION THAT IS BEING CONSIDERED BY THIS COMMITTEE IS BOTH CRITICAL AND TIMELY. SHOULD THIS MATTER NOT BE ADDRESSED DURING THIS SESSION OF CONGRESS, SBLI WILL BE SUBJECT TO A TAX INEQUITY THAT WILL BE PASSED ON TO THE CONSUMERS. IN ORDER TO CONTINUE TO PROVIDE CONSUMERS IN MY STATE WITH COST-EFFECTIVE INSURANCE COVERAGE LEGISLATION MUST BE PASSED TO CLARIFY THE TREATMENT OF THE DIVIDEND PAYOUT. I AM HOPEFUL THAT YOU WILL GIVE THIS PROPOSAL EVERY CONSIDERATION.

MR. CHAIRMAN, THAT CONCLUDES MY TESTIMONY BEFORE THIS COMMITTEE. AGAIN, THANK YOU FOR THE OPPORTUNITY TO COME BEFORE THE COMMITTEE TODAY AND I AM HOPEFUL THAT THE COMMITTEE WILL GIVE SERIOUS CONSIDERATION TO THE AFOREMENTIONED ISSUES.

Chairman ARCHER. My congratulations to each of you for your testimony.

Mr. Gibbons, do you care to inquire? Does any other Member of the Committee wish to inquire? Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Frank and Mr. Blute, I applaud your efforts in cleaning up that part of the Tax Code.

Last week I submitted a bill, H.R. 1972, that had 100 original cosponsors. The bill will clarify the independent contractor and employee status. It is the White House Conference on Small Business' number one issue, as you probably already know. I want to ask you if my legislation would help your particular problem.

Currently, there is a 20-point test that the IRS lays out to determine whether someone is an employee or an independent contractor. As you well know, it is a very subjective test and the IRS can find one person an employee, the other person an independent contractor, and they have the exact same criteria.

Then, as you have so eloquently testified to, they go back and they make that small businessowner come forward with back taxes, unemployment insurance, and FICA and hire an accountant and attorney. It is really a waste of time and a lot of waste of money, and it takes a lot of people under.

My legislation would create an alternate test of three simple criteria: Was there a written contract between the fisherman and the person he was working with? Was there a written contract? If there was, that would be the first stipulation.

The second thing would be, has he invested time or money in equipment or training? Has he got his own fishing boat or has he got his own type of training for that particular job?

Three, is he independent? Is he working for several entities or is it just one business that he is working under? Would those three criteria help your particular instance?

Mr. FRANK. I think some of them would, Mr. Christensen. There are some peculiarities here because of the fishing industry and what were traditional practices there. There is a phrase called "pers," which I sometimes know what it means when I study it hard, but at other times I hope it is not on the test, as to whether or not these people were or weren't "pers." Part of this problem had to do with how you interpreted "normally." Did normally mean— it was whether they measured it annually or quarterly.

I think the answer is, yes, your proposals would help us, but there may be some other peculiarities there. They were relying on what they found to be common practice.

I would say one thing which confirms what you say. They had situations where different IRS agents would come to different conclusions, and I think that goes to the point you made about the indeterminacy of this which is not helpful. I have not seen your legislation, and I will take a look at it.

Mr. CHRISTENSEN. Yes, absolutely. You have put your finger on a real touchy issue with "Main Street America." You mention the independent contractor IRS rules and you raise the hair on the back of their head because it is definitely an issue that is causing a lot of concern in small business.

Mr. FRANK. In this case, Main Street includes the ocean.

Mr. CHRISTENSEN. That is right.

Mr. BLUTE. I would just congratulate you for your legislation, and I intend to cosponsor it because I think you are right on target.

Mr. CHRISTENSEN. H.R. 1972.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you.

Congressman Goodling, I think you have been a very effective advocate for this bill, and I know you have been fighting for years to get what is now House Resolution 1076 passed. I appreciate your efforts.

I guess my simple question was, if we move to an installment method of reporting income from the sale of this residential property, would there be any sort of substantial revenue loss to the Federal Government?

Mr. GOODLING. It has been indicated that when all of these hearings are over we are going to get that kind of information.

I do not believe there would be a substantial loss, and it is the way it was done up until the change of 1986. I think where you would pick up probably much more revenue than you would ever lose is the fact that you are creating jobs and, therefore, people are paying more and more money as taxpayers because of the creation of those jobs. Because as these first-time homeowners are able to purchase a home simply because they can use that money to put up their downpayment, it creates those jobs and provides more tax revenue coming to the Treasury of the United States.

I think the increased employment—and this would be all over the Nation. Home buying is down at the present time. Home building is down at the present time. Usually, it is the first to go down when you are going into a recessionary period and the first to come back when you are coming out. I think that anything we could do at this point would certainly be an advantage to receiving more revenue for the Treasury of the United States.

Mr. ENGLISH. I agree with you. Although we haven't seen an official revenue estimate, my guess is that this will have very little negative and possibly a positive effect on our revenue position and, in the process, will provide a dramatic new way for a lot of younger families to enter home ownership. Again, I salute you for this creative proposal. Thank you, sir.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. NEAL. Mr. Chairman.

Chairman ARCHER. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

I just would like to speak once again in support and offer reenforcement to the argument that has been made by Mr. Frank and Mr. Blute. This is an issue particularly for fishermen that has languished for some time, and we would like, if possible in this session, to get it corrected.

In addition, the Savings Bank Life Insurance issue I think is an important consumer issue back in Massachusetts. The truth is that they have just gotten caught in a peculiar circumstance, and I hope that the Committee and the House will have an opportunity in this session to correct both of those measures. Given the longstanding issue of the fishermen for Mr. Frank and Mr. Blute, I think that is equally important.

Chairman ARCHER. Anyone else?

Gentlemen, thank you very much.

Our next panel will be Robert Israeloff, chairman of the Board of Directors, American Institute of CPAs; Patricia Healy, counsel, Utility Decommissioning Tax Group; and Rich Shavell, senior manager and director of Construction Tax Advisory Services of Zelenkofske, Axelrod & Co., Jenkintown, Pennsylvania, on behalf of ABC, Associated Builders & Contractors.

If the three of you are here, would you take seats at the witness table?

Mr. DASIC. Mr. Chairman, my name is Ray Dasic. I am a partner of Patricia Healy. She is here. She stepped out, but she is physically present in this building. I haven't been able to find her.

Chairman ARCHER. Thank you for that notification. I think what we will do is hear from Mr. Shavell, since he is here, and be prepared to hear from her when she returns.

Chairman ARCHER. Mr. Shavell, I think you have probably heard my previous comments that your entire written testimony, without objection, will be printed in the record, and you may proceed with your oral presentation. We would appreciate it if you would limit it to 5 minutes.

Mr. SHAVELL. Thank you.

Chairman ARCHER. Mr. Shavell, you are recognized.

STATEMENT OF RICH SHAVELL, SENIOR MANAGER AND DIRECTOR OF CONSTRUCTION TAX ADVISORY SERVICES, ZELENKOFSKE, AXELROD & COMPANY, JENKINTOWN, PENNSYLVANIA, ON BEHALF OF ASSOCIATED BUILDERS & CONTRACTORS

Mr. SHAVELL. My name is Rich Shavell. I am director of Construction Tax Advisory Services at Zelenkofske, Axelrod & Co., in Jenkintown, Pennsylvania.

I am pleased to have the opportunity to speak before the Ways and Means Committee today on the issue of whether nonresidential construction contractors performing long-term contracts should be subject to the look-back method of accounting. The look-back requirement has been a matter of concern for the members of ABC.

ABC represents 18,000 contractors, subcontractors, and suppliers through 81 chapters nationwide who share the merit shop philosophy of awarding construction contracts to the lowest responsible bidder.

As you may be aware, the look-back method grew out of the 1986 Tax Reform Act and the requirement that long-term contractors utilize the percentage of completion method. The percentage of completion method requires contractors to estimate contract revenues and costs. The look-back method goes further and requires contractors, at the completion of the contract, to look back to the beginning of the contract and substitute actual costs and revenues for those estimated amounts to determine if taxable income has been underreported or overreported on a hypothetical basis. This hypothetical under or overreported taxable income is tax effected, and an interest charge is computed based on the hypothetical tax.

These complex interest computations use daily compounded interest rates that change quarterly. Refunds to contractors can re-

sult as easily as required payments. Small contractors in many cases are exempt from the percentage of completion method for regular tax purposes and thus would appear to be exempt from the look-back method.

However, for alternative minimum tax purposes, all nonresidential contractors must recognize income under the percentage of completion method. Thus, many contractors must report look-back computations solely for alternative minimum tax purposes.

In many cases, the look-back method must be performed with all of its complexities simply to reflect that no liability is owed. Further, these computations reverse under these hypothetical rules so that these complexities must be addressed each and every year so that future years' computations can be later performed.

There are several reasons that the look-back method should be eliminated. First, the look-back method is revenue neutral and does not meet its initial function of a watchdog on the construction industry. We do not see the look-back method affecting nonresidential contractors' estimates under the percentage of completion method. The strict lending and credit requirements of surety bond companies and banks provide a strong incentive for contractors to not underestimate revenue. Financial integrity is in the best interest of the contractor. Construction contractors necessarily apply good business sense and experience to achieve successful estimates.

Second, the current de minimis rules are inadequate to alleviate the complex administrative burdens.

Third, the look-back method is a redundant enforcement tool. There are already significant penalties in the Internal Revenue Code to address situations where contractors underestimate or underreport their income.

Fourth, contractors do not have the financial management tools to implement complexities like the look-back method. Unnecessary overhead and professional fees are the result.

Fifth, the look-back method should not target construction contractors. We are not convinced it was the intent of Congress in 1986 to burden nonresidential construction contractors with the look-back method.

Attempts at look-back exemptions for those hardest hit by these burdensome calculations have proven ineffective, especially in light of the necessity of performing look-back for alternative minimum tax purposes. Thus, look-back is superfluous as an enforcement mechanism.

Because of the unique nature of the construction industry, the look-back method has no real relevance and is revenue neutral. Even when, as is frequently the case, look-back calculations result in a refund or even a payment, the compliance costs are such that look-back consistently puts the construction industry at a disadvantage.

ABC believes that the look-back method should be eliminated for nonresidential construction contractors filing tax returns after January 1, 1995. ABC welcomes the opportunity to work with the Members of the Committee to eliminate this burdensome and unnecessary extra check on construction contractors.

I thank you for your consideration of this proposal. This concludes my prepared testimony.

[The prepared statement follows:]

STATEMENT OF RICH SHAVELL
ZELENKOFSKE, AXELROD & CO.
ON BEHALF OF ASSOCIATED BUILDERS & CONTRACTORS

My name is Rich Shavell. I am Senior Manager and Director of Construction Tax Advisory Services for the accounting firm of Zelenkofske, Axelrod & Co. in Jenkintown, Pennsylvania. I am pleased to have the opportunity to speak before the Ways and Means Committee today on the requirement that monies derived to nonresidential construction contractors from long term contracts be subject to the "look-back" method of accounting. The look-back requirement has been a matter of longstanding concern for the members of Associated Builders and Contractors (ABC). ABC believes that look-back should be eliminated for construction contractors. Its calculations place unnecessary burdens on the construction industry and yet its effect on Treasury is revenue neutral.

ABC represents 18,000 contractors, subcontractors, and suppliers in 81 chapters nationwide who share the merit shop philosophy of awarding construction contracts to the lowest responsible bidder regardless of labor affiliation, through open and competitive bidding. With merit, or open shop, contracting representing approximately 80 percent of the construction market, ABC is proud to be their voice.

THE LOOK-BACK RULE

As you may be aware, the look-back rule for long-term contracts using percentage of completion method (PCM) accounting grew out of the 1986 Tax Reform Act. The rule requires that when a contract is completed, the contractor must "look-back" and substitute the actual costs and revenues for the estimated costs and revenues used in prior years' PCM computations. This must be done for each year the contract was in progress under the percentage of completion method of accounting. Small firms in many cases are exempt from the PCM for regular tax purposes, but must continue to apply look-back for alternative minimum tax (AMT) purposes.

Tax liability for all years of the contract's life must be recalculated for both regular tax and alternative minimum tax purposes. Then, the differences are determined between the taxes paid each year and taxes that would have been paid each year had final rather than estimated amounts been available. Then more calculations are required using daily compounded interest rates on the differences to determine whether interest is owed to or due from Treasury.

The look-back calculations can number quite literally in the thousands. Filling out the look-back form can take upwards of 15 hours (and has been known to reach 30 hours), and that does not include the many more hours of calculations made before the contractor reaches the point of filling out the form.

For example, in a simple two year contract with a price of $1 million, look-back calculations must be performed several times. The contractor must look-back after the first year and compare his estimated costs to the actual costs. These calculations must be repeated after the second year. Then if the contract is accepted, but some additional work is requested that stretches into the following year, look-back must again be reapplied under the post-completion adjustment rules in the regulations. Additionally, under the post-completion rules any revenue (or cost) received through a claim or dispute after a contract is completed is subject to look-back.

CURRENT EXCEPTIONS TO LOOK-BACK ARE INSUFFICIENT

The current de minimis rule, which exempts contracts which are the lesser of $1 million or one percent of average gross revenues, is too narrow to be effective. Long term contracts are typically larger than $1 million, and a contractor would have to have one very low priced long term contract in comparison to all others to meet the one percent rule. Additionally, attempts to exempt smaller firms from look-back calculations have been unsuccessful due to the necessity of performing the calculations for alternative minimum tax purposes. For these reasons, ABC advocates the total elimination of look-back for construction contractors.

LOOK-BACK DUPLICATES OTHER ENFORCEMENT MECHANISMS

Look-back accounting is superfluous. Unlike situations in other industries, the price of the construction product is set on a very competitive basis before work begins.

The competitive bidding procedures that are inherent to the construction industry demand exacting estimates of costs and revenues. Construction contracts are often fixed priced with net income margins averaging one or two percent. This does not leave much room for imprecise estimates. Indeed, the percentage of completion method was designed to address deferrals of income by requiring contractors to recognize income based on the costs incurred to date. The percentage of completion method is burdensome enough with out adding a redundant compliance tool.

The strict lending and credit requirements of surety bond companies and banks provide a strong incentive to not underestimate revenue. Additionally, stiff penalties exist in the Internal Revenue Code for understatement of income tax. Financial integrity is in the best interest of the contractor. Construction contractors necessarily apply good business sense and experience to achieve successful estimates.

Although I do not have the resources to provide you with a sophisticated study on the negative effects of look-back on the construction industry, I can tell you that in my years of experience in construction and with ABC on both the tax and legislative committees, I have found that construction contractors end up paying thousands of dollars to comply with look-back while it has virtually no impact on their recognition of revenue. Indeed, when I testified on this issue several years ago, Treasury testified that look-back is revenue neutral.

ELIMINATION OF LOOK-BACK IS REVENUE NEUTRAL

Elimination of look-back is a revenue neutral proposal. In fact, look-back was never intended to be revenue positive. Look-back was enacted for two reasons. First, it was intended to perform as an extra watchdog, working in conjunction with PCM to provide a deterrent to deferral. Look-back was also intended to assist contractors who estimate incorrectly, particularly large manufacturers using PCM.

For long term contracts the manufacturing or defense industries face quite a different situation than that found in the real property construction industry. For obvious reasons, it is far more difficult for the defense and manufacturing industries to estimate costs and revenues. However, the experience of the construction industry is that real property construction contractors are necessarily accurate in estimating their contracts. While look-back may help industries who have difficulties anticipating developments in long term contracts, it places excessive burdens on the construction industry and rarely results in significant monetary exchanges with Treasury.

CONCLUSION

Attempts at look-back exemptions for those hardest hit by the burdensome calculations have proven ineffective, especially in light of the necessity of performing look-back for alternative minimum tax purposes. Look-back is superfluous as an enforcement mechanism. Elimination of look-back is revenue neutral. Because of the unique nature of the construction industry, the look-back method has no real relevance. Even when, as is frequently the case, look-back calculations result in a refund or a payment, the compliance costs are such that look-back consistently puts the construction industry at a disadvantage. Associated Builders and Contractors believes that look-back accounting should be eliminated for nonresidential construction contractors filing tax returns after January 1, 1995.

ABC welcomes the opportunity to work with members of the Committee to eliminate this burdensome and unnecessary extra check on construction contractors. I thank you for your consideration of this proposal.

This concludes my prepared testimony. I would be pleased to address any questions from the Committee.

Chairman ARCHER. Thank you, Mr. Shavell.

Our next witness is Patricia Healy. And in the event that you were out of the room, if you have a written statement, without objection, it will be printed in its entirety in the record. You may proceed verbally to summarize. We would like you to stay within 5 minutes, if you will. I would say the same thing to Mr. Israeloff.

STATEMENT OF PATRICIA M. HEALY, COUNSEL, ON BEHALF OF UTILITY DECOMMISSIONING TAX GROUP AND NUCLEAR ENERGY INSTITUTE

Ms. HEALY. Thank you, Mr. Chairman. Good morning.

My name is Patricia Healy. I am a partner with the law firm of Reid & Priest.

I am testifying today on behalf of the Utility Decommissioning Tax Group and the NEI, Nuclear Energy Institute. The Utility Decommissioning Tax Group includes 26 nuclear electric utility companies and 28 investment management firms and trustees involved with nuclear decommissioning funds. NEI has approximately 300 member companies, including all U.S. nuclear electric utilities that operate the Nation's facilities.

The members of the Utility Decommissioning Tax Group and NEI strongly support the elimination from the Internal Revenue Code of the requirement that a utility company seek and obtain a ruling from the IRS before being permitted to make a deductible contribution to qualified decommissioning funds under code section 468A. This proposal is contained in H.R. 1637, the Nuclear Decommissioning Costs Simplification Act of 1995, which was introduced in this Congress by Representative Phil Crane.

This legislation has a single, unassailable purpose—to decrease unnecessary administrative costs that, under current law, are being borne both by the government and by taxpayers alike. This result can be achieved without any revenue loss to the government or any adverse effect on nuclear plant safety.

Nuclear companies collect moneys to pay for future decommissioning costs paid by customers over the life of the plant. In 1984 Congress enacted code section 468A, which allowed a utility company to currently deduct its contributions to a qualified decommissioning fund that it established for a nuclear power plant. The fund is a trust to which the utility contributes amounts that it collects from its customers that will be used exclusively to pay for future decommissioning costs of a nuclear plant. If a nuclear utility has multiple reactors, it has got to establish separate funds for each plant.

Code section 468A contains a unique feature. It requires the taxpayer to request and obtain from the IRS a schedule of ruling amounts, a private letter ruling for each plant that it owns before it can make a contribution to that fund. A schedule of ruling amounts is requested, considered, and issued by the national office of the IRS. The schedule, in essence, represents advance approval by the IRS of the taxpayer's annual deductions for nuclear decommissioning costs.

This requirement to obtain an advance ruling in code section 468A is the only instance in the Tax Code in which the taxpayer is required to obtain a ruling in advance before claiming a deduc-

tion on its tax return. The current procedures for obtaining schedules of ruling amounts are burdensome and expensive. They provide absolutely no benefit to the government in terms of revenue raising or enhancement of compliance. Each request for a schedule carries a user fee of approximately $3,600. The fee did not exist in 1984 when code section 468A was enacted.

Where companies have multiple reactors, they must submit multiple requests and pay multiple user fees, even where the documentation is similar if not identical. In addition to the user fees, taxpayers are obligated to hire outside counsel or use internal resources to prepare the ruling request and process them with personnel at the IRS.

The ruling process is a recurring one. Typically, the utility company must seek a revised schedule of ruling amounts each time its public service commission adjusts the amount of decommissioning costs included in rates. This can occur as frequently as annually.

In addition, in a number of circumstances, the IRS has arbitrarily limited schedules of ruling amounts to 5-year periods, thus requiring a taxpayer to make a total of eight filings over the typical 40-year life of the plant. The IRS has issued over 400 schedules of ruling amounts since code section 468A was enacted. We are aware of no instance in which the IRS has denied the taxpayer's request for the schedule of ruling amounts, thus demonstrating that the ruling process itself does not enhance taxpayer compliance.

The ruling procedure and the associated costs should be eliminated. The proposed legislation, H.R. 1637, would do this. The computation of the ruling amounts would not change. The amount of the deductible contributions would not change. The rules governing the operation of these decommissioning funds also would not change.

For the record, I note the description of this proposal prepared by the staff of the Joint Committee on Taxation erroneously states that it would repeal the provision that allows the IRS to disqualify a fund where the assets are not used for decommissioning or where there is self-dealing between the fund and the utility. H.R. 1637 does not contain these provisions, and the Utility Decommissioning Tax Group and NEI are not advocating these changes.

In sum, the effect of H.R. 1637 would be to treat the deduction under code section 468A like every other deduction in the Code. It would be audited in the normal course. The proposal would eliminate costly and unnecessary regulation. The Utility Decommissioning Tax Group and NEI believe this proposal makes good sense and should be enacted.

We thank you for your consideration of this matter. I am prepared to answer any questions of the Committee Members.

[The prepared statement follows:]

STATEMENT OF THE UTILITY DECOMMISSIONING TAX GROUP AND THE NUCLEAR ENERGY INSTITUTE TO THE HOUSE WAYS AND MEANS COMMITTEE

MISCELLANEOUS TAX REFORMS

PROPOSAL TO REPEAL THE RULING REQUIREMENT FOR NUCLEAR DECOMMISSIONING COSTS

SUBMITTED BY PATRICIA M. HEALY, ESQ.
PARTNER, REID & PRIEST LLP
JULY 10, 1995

I am Patricia M. Healy, a partner in the law firm of Reid & Priest LLP. I am submitting this statement on behalf of the Utility Decommissioning Tax Group ("Group") and the Nuclear Energy Institute ("NEI"). The Group is composed of 26 electric utility companies that have interests in nuclear power plants and 28 investment management companies and trustees that are involved with the administration of nuclear decommissioning funds. Attached as Exhibit A is a list of the members of the Group. NEI has approximately 300 member companies including all U.S. nuclear electric utilities that operate the nation's 109 nuclear power plants.

The Group and NEI wish to express their strong support for the proposal to eliminate from the Internal Revenue Code ("Code") the requirement that a utility company seek and obtain a ruling from the Internal Revenue Service ("Service") before being permitted to make deductible contributions to a qualified nuclear decommissioning fund under Code section 468A. This proposal is contained in H.R. 1637, the Nuclear Decommissioning Costs Simplification Act of 1995, which was introduced in this Congress by Representative Phil Crane (R-Illinois).

This legislation has a single, unassailable purpose--to decrease unnecessary administrative costs that, under current law, are being borne by both the Service and taxpayers alike. Achieving this purpose would result in absolutely no revenue loss to the government nor in any adverse effect on nuclear plant safety.

By way of background, Code section 468A was enacted in 1984 as an exception to the economic performance rules for deductions (which also were enacted in 1984). Section 468A permits a utility company to deduct its contributions to a "qualified" nuclear decommissioning fund that it has established for a nuclear power plant. A qualified nuclear decommissioning fund is a trust to which a utility contributes amounts that it collects from its customers to pay for decommissioning a nuclear plant at the end of its useful life. A utility company must establish a separate qualified nuclear decommissioning fund with respect to each nuclear plant in which it has an ownership interest.

The amount that may be contributed in a given year to a qualified nuclear decommissioning fund is limited by Code section 468A to the lesser of the "cost of service amount" or the "ruling amount." The cost of service amount is the amount of decommissioning costs for the associated nuclear plant that the utility company is authorized to recover from its customers through the rates it charges. The ruling amount is computed under a regulatory formula which is designed to do two things: (1) assure that contributions are made no more rapidly than on a "level" annual basis and (2) limit the annual contribution to that portion of decommissioning costs that is allocable to the life of the nuclear plant after 1984, the year of enactment of section 468A.

Code section 468A, however, contains a unique feature. It requires a taxpayer to request and obtain from the Service a "schedule of ruling amounts" before making any contributions to a qualified nuclear decommissioning fund. A schedule of ruling amounts is requested, considered and issued under the Service's rules governing private letter rulings. A schedule of ruling amounts represents the Service's advance approval of the taxpayer's deduction for nuclear decommissioning costs. The requirement to obtain a schedule of ruling amounts is the only instance in the Code in which a taxpayer is required to obtain an advance ruling before claiming a deduction on its income tax return.

The proposed legislation would simply eliminate the requirement to seek an advance ruling from the Service. The computation of the ruling amounts would not change in any way, so the amount of deductible contributions to qualified funds would not change in any respect. The rules governing the operation of qualified nuclear decommissioning funds would not change in any respect either.

Thus, the effect of the proposal would be to treat the deduction under Code section 468A like every other deduction in the Code. The taxpayer would compute and claim the deduction, which then would be subject to audit by the Service. Given the fact that all Federal income tax returns of nuclear electric utilities are audited each year by the Service as part of the Coordinated Examination Program, all deductions claimed under Code section 468A not only would be subject to examination by the Service, but in fact will be examined by the Service's auditors.

The current procedures for obtaining schedules of ruling amounts are extremely burdensome and expensive, particularly in view of the fact that they provide absolutely no benefit to the government in terms of revenue raising or enhancement of compliance. Each request for a schedule of ruling amounts must be accompanied by a user fee of $3,575 payable to the Service. In the case of companies having ownership interests in multiple nuclear power plants, a separate user fee must be paid for each power plant, even if (as is usually the case) the documentation for the computation of the ruling amounts is identical. In addition to the user fee, taxpayers are obliged to hire outside counsel or to use internal resources to prepare the ruling requests and to process the ruling request with personnel at the Service.

The ruling process is a recurring one: a utility company typically must seek a revised schedule of ruling amounts for each of its nuclear plants each time its public service commission adjusts the amount of decommissioning costs included in its rates (usually every few years, although some companies must do so every single year). In addition, in a number of circumstances, the Service has arbitrarily limited schedules of ruling amounts to five-year periods, thus requiring a taxpayer to make a total of eight filings over the typical 40-year operating life of a nuclear plant.

The Service has issued over 400 schedules of ruling amounts since Congress enacted Code section 468A. Our firm has handled approximately 275 of these requests. We are aware of no instance in which the Service has denied the taxpayer's request for a schedule of ruling amounts, thus demonstrating that the ruling process itself does not enhance taxpayer compliance. This ruling procedure and the attendant costs for both the government and taxpayers should be eliminated.

The proposal contained in H.R. 1637 will eliminate costly and unnecessary regulation, without compromising the public fisc or nuclear safety in any way. It makes good sense and should be enacted.

EXHIBIT A

UTILITY DECOMMISSIONING TAX GROUP

Alliance Capital Management
Arizona Public Service Company
Bank of New York
Bankers Trust Company
Brown Brothers Harriman & Company
Capital Guardian Trust Company
Carolina Power & Light Company
Central & Southwest Services, Inc.
Commonwealth Edison Company
Delaware Investment Advisers
Delmarva Power & Light Company
The Detroit Edison Company
Duke Power Company
Entergy Services, Inc.
Fidelity Management Trust Company
Fisher Investments, Inc.
FPL Group, Inc.
Houston Industries, Inc.
Illinois Power Company
Indiana Michigan Power Company
Iowa Electric Light & Power Company
J.P. Morgan
Lehman Ark Management
Long Island Lighting Company
Loomis Sayles & Company Inc.
Mellon Bank
NBD Bank, N.A.
Niagara Mohawk Power Corporation
NISA Investment Advisors, L.C.
Northeast Utilities Service Company
Northern States Power Company
Nuveen Duff & Phelps Investment Advisors
Ohio Edison Company
Pacific Gas & Electric Company
PanAgora Asset Management
PECO Energy Company
Piper Capital Management
Provident Investment Counsel
Pub. Service Company of New Mexico
Public Service Electric & Gas Company
Rogers, Casey & Associates
San Diego Gas & Elec. Company
Sanford Bernstein & Company, Inc.
Scudder, Stevens & Clark, Inc.
Southern California Edison Company
State Street Bank and Trust Company
Strong Capital Management, Inc.
T. Rowe Price Associates
Texas Utilities Services, Inc.
U.S. Trust Company
Vermont Yankee Nuclear Power Corp.
Wellington Management Trust Company
Western Resources, Inc.
William M. Mercer Asset Planning

SUPPLEMENTAL STATEMENT OF THE UTILITY DECOMMISSIONING TAX GROUP AND THE NUCLEAR ENERGY INSTITUTE TO THE HOUSE WAYS AND MEANS COMMITTEE

MISCELLANEOUS TAX REFORMS

PROPOSAL TO REPEAL THE RULING REQUIREMENT FOR NUCLEAR DECOMMISSIONING COSTS

SUBMITTED BY PATRICIA M. HEALY, ESQ.
PARTNER, REID & PRIEST LLP
JULY 27, 1995

I am Patricia M. Healy, a partner in the law firm of Reid & Priest LLP. This submission on behalf of the Utility Decommissioning Tax Group (Group) and the Nuclear Energy Institute (NEI), supplements my statement dated July 10, 1995, concerning H.R. 1637, the Nuclear Decommissioning Costs Simplification Act of 1995.

On July 11, 1995, one day after I submitted my earlier statement, the staff of the Joint Committee on Taxation (JCT) released its description of miscellaneous tax proposals (JCS-19-95), which included a description of H.R. 1637 (although not specifically designated as such). The explanation of H.R. 1637 set forth in JCS-19-95 erroneously states that H.R. 1637 would repeal the provision of section 468A of the Internal Revenue Code (Code) that allows the Internal Revenue Service (IRS) to disqualify a qualified nuclear decommissioning fund where the fund's assets are not used for decommissioning or where there is self-dealing between the fund and the utility. See JCS-19-95, page 12 and 13.

The purpose of this supplemental statement is to state unequivocally that H.R. 1637 does not contain the foregoing provisions cited in the description of H.R. 1637 prepared by the JCT, and to affirm that the Group and NEI are not advocating these changes. As provided in my earlier statement, H.R. 1637 simply would eliminate the requirement that a taxpayer seek and obtain a ruling from the IRS before claiming a deduction for contributions to a qualified nuclear decommissioning fund under Code section 468A.

Chairman ARCHER. Thank you, Ms. Healy.
Mr. Israeloff, you may proceed.

STATEMENT OF ROBERT L. ISRAELOFF, CHAIRMAN, BOARD OF DIRECTORS, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ISRAELOFF. Thank you, Mr. Chairman.

Mr. Chairman and Members of this distinguished Committee, I am Bob Israeloff, a local CPA from Long Island, New York, and chair of the Board of Directors of the AICPA, American Institute of Certified Public Accountants.

The AICPA is the national professional organization of certified public accountants comprised of more than 320,000 members who advise clients on Federal, State, and international tax matters as well as prepare income and other tax returns for millions of Americans. Thank you for the opportunity to present our views today.

Prior to passage of the 1986 Tax Reform Act, partnerships, S corporations, and personal service corporations were, like today's C corporations, entitled to more flexibility in choosing fiscal years. Many such entities had years ending other than December 31, in numerous situations because their natural business year ended other than in December.

During the hearings on the Senate version of the 1986 act as a way to pay for liberalization of the low-income housing credit requested by Senator George Mitchell, these three types of entities were all required to adopt calendar years for tax purposes. The loss of the fiscal year election for some small businesses that are formed as S corporations and partnerships has proven to be a major disruption to their business operations because the calendar year end can fall in the middle of their busiest seasons. Taking time out to comply with this arbitrary requirement hamstrings their ability to maximize production, generate revenues, and create jobs.

In addition, because these businesses also use their tax year, which is now the calendar year, for financial reporting, they have to close their books as of December 31 and their independent accountants are faced with the need to undertake year-end audits and credit-compliance reviews for shareholders and creditors in the same few months as required for the preparation of tax returns. Consequently, these entities have found their accountants are least available at the time they are most needed.

The specific result on the CPA profession has been to intensely compress its workload. Financial statement audits, reviews and compilation, other financial work required to be done for banks and creditors and tax return preparation, all have to be addressed for these entities in the first 3½ months following the close of the calendar year. This has been a good deal more than a tax problem for CPA firms. While driven by a tax law change, the result has been a practice management problem of major proportions with many firms, especially small- and medium-sized firms such as mine, finding 65 to 75 percent of their annual workload falling between January 1 and April 15. To a CPA, it is the equivalent of scaling Mount Everest the first 4 months of the year and trekking through Death Valley the rest of the year.

In 1987, Congress enacted a limited improvement in the law—section 444—permitting electing entities to have a fiscal year ending in September, October, or November; but at the price of paying a deposit to the government, an interest-free loan, if you will, which approximated the tax to be deferred through election of the fiscal year. It has been recognized that the fiscal year deposit approach of Internal Revenue Code section 444 was of limited value, but it was not possible to obtain further relief because of the revenue neutrality requirements of the Budget Act in existence at that time, which requirements continue today.

As a result, the great majority of partnerships and S corporations on fiscal years in 1986, and those coming into existence thereafter, which would have elected fiscal years, are now operating on a calendar year.

The problem has become even more exacerbated with the enactment of the 1993 increase in individual tax rates. Because of the mechanics of section 444, the deposit presently payable on deferred income has increased with those individual rates and is now set at 40.6 percent, even though most owners of electing entities will themselves be in the 31- or 36-percent brackets, or even lower brackets. Thus, simple financial self-interest dictates that for most affected entities, the proper course of action is to terminate the fiscal year election, making the CPAs' workload compression problems even more intense.

On May 17, Hon. E. Clay Shaw introduced the Small Business Tax Flexibility Act of 1995, H.R. 1661, a bill that will lead to fairer tax treatment of small businesses and will help relieve the compressed workload forced on CPA's by enactment of the Tax Reform Act of 1986. The AICPA strongly endorses H.R. 1661 as it is intended to maintain the government's cash flow while at the same time providing a way for CPA's to credibly recommend to their partnership and S corporation clients that they adopt a fiscal year.

Under this approach, a partnership or S corporation may elect any fiscal year not limited to September, October, or November as under section 444. However, an entity electing a fiscal year would be required to pay in quarterly estimated taxes to the IRS on behalf of its owners, the partners, or shareholders. Rather than determining an individual owner's tax bracket, a flat statutory rate would be required to be paid on the entity's quarterly income.

The statutory rate at which these payments are made has been determined based on revenue neutrality needs. That rate is 34 percent for most electing entities and 39.6 percent for high-income entities. At the end of the partnership or S corporation year, when an information form schedule K–1 is sent to the owner, it would indicate, as it does today, the amount of income the owner must report on his or her form 1040. It would also, however, indicate how much estimated tax had been paid on behalf of the owner, and the owner would take credit for that tax in determining how much was owed from the IRS.

The bill also contains a de minimis section exempting entities that would owe less than $5,000 for the year from paying estimated tax. While this exempts a significant number of entities from the administrative aspects of the provision, it involves very little loss of revenue to the government.

Additionally, numerous sections are included to avoid the opportunity for abuse. While this adds some complexity to the provision, it only affects those attempting to stretch the provision beyond its purpose.

The AICPA is also committed to working with the IRS and Treasury to ensure that this legislation not only provides a solution to the problems created for small businesses and CPA's but can be administered in a reasonable manner. By allowing businesses to choose the fiscal year that best suits their business cycle, the business and the CPA will benefit. The government will get the money it expects and the business can choose the fiscal year it wants. Everyone wins.

Again, we thank the Committee for the opportunity to present our views, and I would be pleased to answer any questions.

Chairman ARCHER. My compliments to all three witnesses.

Are there any Members who wish to inquire?

Mr. CRANE. Mr. Chairman.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Mr. Chairman, I don't have an inquiry, but I wanted to thank Ms. Healy for acknowledging that H.R. 1637 would eliminate costly and unnecessary regulation.

Thank you.

Ms. HEALY. Thank you, Congressman.

Chairman ARCHER. Any other Member?

Mr. Laughlin.

Mr. LAUGHLIN. Mr. Shavell, I noticed in your testimony, you talked about the elimination of look-back as revenue neutral. Do you have any information about the cost to the members of your industry of the preparation of that provision?

Mr. SHAVELL. Cost, meaning administrative costs?

Mr. LAUGHLIN. Yes, the preparation costs for that provision.

Mr. SHAVELL. Our firm services over 120 contractors and the cost of doing look-back is always an issue for our construction clients.

Mr. LAUGHLIN. That is the cost of trying to determine, what is it per client, or a ballpark——

Mr. SHAVELL. It depends on the volume of contracts, because you are computing look-back contract by contract. To use a simple example, assume I have a contractor who has, say, 10 to 15 contracts that are going to be subjected to the look-back method. I would estimate that the typical fee would be in the neighborhood of $1,500 to $2,500. This is in addition to preparing tax returns.

Mr. LAUGHLIN. That is what I was trying to determine, what was the cost, either per contract or per contractor, of preparing the look-back provisions.

That is all I have.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Shavell, I have enjoyed your testimony. I have been very concerned about the impact of the look-back provision on contractors in Pennsylvania, and we appreciate your coming down today to testify. I have a couple of specific questions.

There are a number of de minimis rules currently in the Code to alleviate precisely this kind of a situation. Have any of them

been effective in reducing the burden of look-back, and is simply an expansion of the de minimis rules a possible alternative?

Mr. SHAVELL. The de minimis rules have not been effective, is the straight answer. The problem is that a contractor is not exempted from performing the look-back method with the de minimis rules. The de minimis rules will exempt certain contracts from going through the computations.

The rules don't exempt that many contracts to begin with, and furthermore, you still have to go through the computation to determine whether those specific contracts can be exempted. In essence you are going through a lot of effort to find out if you can throw out a few smaller contracts from the computations.

Mr. ENGLISH. Does the volume of business have any effect on the requirement that contractors do a look-back process?

Mr. SHAVELL. That is the most frustrating point. The Code provides an exemption from the percentage of completion method for contractors that meet certain requirements. We are talking about the small contractor exemption under section 460(e). If the contractor's average gross annual revenue is under $10 million, they do not have to report on the percentage of completion method for regular tax purposes.

The problem is that for alternative minimum tax purposes, they have to use the percentage of completion method, thereby using estimated profit computations. The look-back method also applies to those alternative minimum tax computations because that is where the small contractor is performing the percentage of completion computations. If you are considering a small contractor, that you would ordinarily believe would be exempted from such complex computations, the regulations say that they are required to do those computations for alternative minimum tax purposes.

Mr. ENGLISH. What has been your experience with IRS enforcement of the look-back provision?

Mr. SHAVELL. Last year I had the distinct pleasure of speaking at an AICPA function in Las Vegas on the construction industry and certain tax issues. On this panel I had the opportunity to ask the audience whether or not they had faced any enforcement measured on their clients by the Internal Revenue Service. It was obvious—the fact was that nobody had faced any enforcement. Our experience has been that this is so complex that the Internal Revenue Service, I believe, has some difficulty in enforcing the rules because the rules are so complex themselves.

Mr. ENGLISH. What size payments and refunds have you seen?

Mr. SHAVELL. If the contractor is a small contractor doing under $10 million, you are seeing small payments in maybe the $800 range, maybe $300 refunds, $500 refunds. If you see a large contractor, the numbers are typically offsetting, and again you are seeing smaller and smaller refunds and payments in relationship to the volume of the business. It is just an insignificant number.

Mr. ENGLISH. In the time remaining, can you give us a sense of how look-back came about, how it was put in the Code as it applies to contractors?

Mr. SHAVELL. What happened was that in the middle eighties, there was concern that the completed contract method was being abused by certain long-term contractors, and I am not necessarily

just specifying the construction industry. Also, you have the aerospace and the defense industry that are required to use term-long contract methods, such as the completed contract method or the percentage of completion method.

In order to address the concern over the completed contract method, the method by which these taxpayers were recognizing revenue needed to be adjusted so there was a move toward a percentage of completion method. Unfortunately, this pulled in the entire construction industry as well. Later there was an exemption for home construction contractors so home construction contractors have been exempted from the percentage of completion method and also the look-back.

Mr. ENGLISH. Does this have a greater impact on your membership than, say, on Grumman?

Mr. SHAVELL. Absolutely.

Mr. ENGLISH. Thank you very much.

Thank you very much, Mr. Chairman.

Mr. SHAVELL. Thank you.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. I thank the witnesses, and I have a brief question for Mr. Israeloff regarding the taxable year, the ability of sub S corporations and partnerships to elect any fiscal year. Having practiced with a lot of sub S corporations and partnerships as clients, I can fully appreciate the concern you raise. You said 65 to 75 percent of your workload occurs between January 1 and April 15.

I think it is something like 90 percent for some of the small accounting firms that I have had experience with, and it also seems to me that you would have a more even distribution of workload at the company level, the client level, with other professionals and at the IRS level, and there is a certain efficiency in that. Common sense would indicate that we ought to permit more flexibility. But I just wanted to probe a little bit as to how we do it.

You talked about quarterly payments being based on some statutory rate that would be set and it would be based on revenue neutrality. Can you expand on that a little and explain how that would work?

Mr. ISRAELOFF. Yes. Obviously, when a business—when an individual can report income in the year—1 year later on a fiscal year, in other words, for example, a June year, the income earned from July 1 through December 31 is not reported by that entity until the following June 30, so the owner would report it in the following year. There is a deferral, never a loss, a deferral of revenue to IRS. What we are trying to do is make the IRS, the government, whole by having the entity pay in an estimated tax on the earnings as the company goes along so that the government would get its money in, let's say, 1995, even though the owner wouldn't report the income until 1996. For revenue neutrality, the studies that have been done—we have a whole economic survey, right now the way the bill has been introduced, it has got a flat 34-percent statutory rate in the proposed legislation.

Mr. PORTMAN. That rate of 34 percent is based on historical data.

Mr. ISRAELOFF. Yes, all historical data. The same data used, I understand, back in 1986 and bringing it all the way forward.

Mr. PORTMAN. In essence, although you don't address this specifically in your testimony, perhaps you are not in a position to comment on it today, but in essence you are saying there would be no revenue impact based on the historical data that the Joint Tax Committee staff or some other entity might use to analyze the provision, because you would, in a sense, be ensuring that the government would continue to have the revenue flow through the flat statutory rate.

Mr. ISRAELOFF. I am prepared to say exactly that. We have done the studies and we feel that the 34-percent statutory rate will make the government whole. In addition, there is a provision in there that says if a business has owners that average more than a $250,000 income per owner from that business, which is a very large S corporation or partnership, then the statutory rate would be 39.6 percent, equal to the highest individual rate. We have tried to put everything in the bill that provides security to the government that the revenue flow will be there.

Mr. PORTMAN. That sounds like sort of the flat tax proposals I have heard of. Flat tax, but at an incremental level.

I thank you and thank the Chairman.

Chairman ARCHER. Thank you.

We have a 15-minute vote, with 10 minutes still remaining on the floor of the House, to be followed by a series of 5-minute votes. I hesitate to start the next panel when we can only stay here for about another 5 minutes before we have to leave for this first 15-minute vote. The Chair will recess the Committee until the conclusion of the 5-minute votes.

We don't know how long that will be and I apologize for that to our next set of witnesses. But there is no other alternative.

We will recess now to vote. We will come back immediately after the beginning of the last 5-minute vote.

The Committee will stand in recess.

[Recess.]

Chairman ARCHER. The Committee will come to order.

We are going to try again, although we expect more votes on the floor of the House.

If we could ask our next panel to be seated, we have Charles Smith, president of Smith Management Co., Houston, who represents the National Automobile Dealers Association; Doug Metz, managing director, Wine & Spirits Wholesalers of America; John Huber, counsel, Petroleum Marketers Association of America; and Edwin L. Harper, president, chief executive officer of the Association of American Railroads.

If you gentlemen would have seats at the witness table, I will be pleased to hear your presentations. Hopefully, the Committee will make up in quality what it lacks in quantity with the number of Members who are here.

I do apologize to you because we never know when these votes will come up, and obviously, we have got to get over there and make the votes when they do.

Mr. Smith, would you like to lead off?

I suppose I should formally introduce you because you are my constituent from Houston, Texas, and we are delighted to have you before us today.

I would say to all of you that, as I mentioned to other witnesses, if you have a statement in writing, without objection, the entire statement will be entered into the record, and you may proceed verbally, limiting your verbal presentation to 5 minutes.

Mr. Smith, here we go again. Would you like to commence?

STATEMENT OF CHARLES M. SMITH, PRESIDENT, SMITH & LIU MANAGEMENT CO., HOUSTON, TEXAS, ON BEHALF OF NATIONAL AUTOMOBILE DEALERS ASSOCIATION AND AMERICAN INTERNATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. SMITH. Sure.

Good morning, Mr. Chairman. It is a pleasure to be here.

I am Charles Smith, and I am an automobile dealer from Houston, Texas, representing both domestic and international franchises. My family has been in the business since 1917, and I am here to testify on behalf of thousands of American small businessmen and women across this Nation just like myself who have been unfairly shouldering the burden of our Nation's sole "luxury" tax, the 10-percent excise tax on the price of automobiles above $32,000.

The so-called "luxury taxes" were originally placed on certain boats, planes, jewelry, furs, and autos by Congress in 1990 in an effort to soak the rich by taxing the purchases of high-income individuals. In 1993, Congress repealed all luxury taxes except on autos. Congress became convinced that these taxes did not impact the high-income purchaser but instead caused harmful unintended consequences for American businesses.

While the wisdom of imposing the tax on autos is subject to the same question, it was not repealed simply because it raised too much revenue. The auto excise tax has had a significant adverse impact on the U.S. auto industry. While dealerships are not necessarily in jeopardy of closing down due to the excise tax, our already narrow profit margins have been further eroded by this tax.

I didn't come up to Capitol Hill armed with facts or figures from the Congressional Budget Office or the most popular think tank in town. I am merely a small businessman working hard, paying taxes, creating jobs in my community, and doing the best to live the American dream.

While I am not an expert on tax policy, I can tell you how this tax is affecting my business and the jobs in my dealerships. Mr. Chairman, the auto tax is a tax on small business. I have seen its effects on the bottom line.

Sales in my showroom have been jeopardized because after my customers have agreed to a price, I have to go back and say, by the way, you owe 10 percent excise tax on top of the agreed price. The intended target of the tax, the customer, sidesteps it by forcing me to pay all or part of the tax. They feel like it is a totally unfair tax.

You may think it is worth my paying the excise tax on each car to make a sale, but let me point this out: Auto dealerships in America realize an average of only $130 net profit per new vehicle retail, $130. Obviously, a few hundred dollars in excise tax on each new vehicle can push already razor-thin profits into the red.

As the price of the vehicles has risen over the past few years, I have seen the effects of the tax spill over onto vehicles which

American middle-class families demand to meet their transportation needs. Today, vehicles impacted by the tax include the popular vehicles, minivans, sports utilities, and family sedans. Models of the Ford Explorer and the Oldsmobile Aurora, for example, now stand above the threshold of the tax. The consumers that purchase these vehicles are not the wealthy we hear so much about, but middle-class Americans trying to purchase a vehicle to fit their transportation needs.

This tax is also fundamentally unfair and unjust. Today, the average price of a new car is $20,000. It is a strange tax policy that does not call the $1 million yacht or $500,000 diamond necklace or $75,000 fur coat a luxury item but targets a $32,000 car. Obviously, something is wrong.

I understand this Congress is looking to cut the Federal deficit. I wholeheartedly—and I repeat, I wholeheartedly support this effort and simply ask Congress not to do it on the backs of the American small business auto dealers. All we ask is that the Committee consider phasing down of this unfair tax so that we can sunset it at its scheduled date in 1999.

Mr. Chairman, auto dealers like me have paid their fair share, and we will continue to pay our fair share in the future under this proposal. I commend Congresswoman Dunn and Congressman Levin for their efforts in support of the phasedown and sunset on the auto tax and several other Members of the Committee who have indicated a willingness to move ahead on the issue.

Mr. Chairman, as I have previously pointed out, small business auto dealers have been paying the price for a flawed tax for the past 5 years. Let's wind down this unfair tax, remove the burden of a national sales tax on a single industry and allow small businesses' entrepreneurs to drive the engine of growth and prosperity in this country.

On behalf of the members of the National Automobile Dealers Association and the American International Automobile Dealers Association, I urge this Committee to support a phasedown and sunset of the auto tax.

I would like to add for the record that this proposal I have addressed today enjoys the full support of General Motors, Ford Motor Co., and all international automakers.

Thank you for allowing me this opportunity to appear before you, and I will happily answer any questions.

Chairman ARCHER. Thank you, Mr. Smith.

Mr. Metz, you may proceed.

STATEMENT OF DOUGLAS W. METZ, MANAGING DIRECTOR, WINE & SPIRITS WHOLESALERS OF AMERICA

Mr. METZ. Thank you, Mr. Chairman.

My name is Doug Metz, managing director of the Wine & Spirits Wholesalers of America. Our members under license purchase for resale over 90 percent of the distilled spirits distributed in the 32 licensed States, the District of Columbia, and Puerto Rico. We appreciate the opportunity to testify in support of a simple revenue-neutral change in the method of paying the Federal excise tax on distilled spirits.

This proposal was advanced 10 years ago, and the two colleagues immediately to your right and the gentleman to your left were supporters of the measure. It failed largely because of an inability to provide a revenue-neutral offset to the cost of the revenue lag.

We believe we have solved that this year, Mr. Chairman. This proposal would consolidate responsibility for collection of the Federal excise tax on distilled spirits in one and not two Federal agencies. It would reduce a major regulatory burden by eliminating dual agency supervision of distilled spirits warehouses.

We have appended to our record photographs showing the arbitrary requirement of construction of a cage to be bonded as a part of the warehouse facility. On one side of the cage Customs has jurisdiction. On the other side of the cage, the BATF, Bureau of Alcohol, Tobacco and Firearms. We would eliminate that.

The proposal would simplify collection and compliance by combining the wholesale point of payment of both Federal and State excise taxes on distilled spirits. And last, it would end the favored treatment of imported bottled products which makes wholesaler costs for competing domestic products some 40 percent higher.

The problem that I am addressing today is one of great importance to hundreds of small American businesses. Currently, wholesalers can purchase foreign bottled distilled spirits "in-bond," that is, tax free, paying the Federal excise tax to the Federal Government directly after sale to a retailer. In contrast, when a wholesaler buys domestically bottled distilled spirits, which is nearly 86 percent of his total spirits inventory, the price includes the Federal excise tax prepaid by the distiller.

The inequity caused by this discrimination favoring foreign over domestic products means that hundreds of U.S. family-owned businesses increase their inventory financing costs, as I mentioned, by 40 percent when buying U.S. products. Under this proposal, wholesalers would be able to purchase domestically produced or bottled spirits "in-bond" as now permitted for competing foreign products.

It would allow suppliers to save the carrying costs on the tax which they bear pending payment by wholesalers in the 18 control States which operate their own liquor systems. The movement of the Federal excise tax point of payment on domestic spirits from the supplier to the wholesaler will create a one-time 60-day lag in tax receipts by the Treasury.

This revenue lag would be neutralized by requiring "All-In-Bond" electing companies annually on September 20, to make an estimated payment of excise taxes due in October and November based on tax payments for the same months for the preceding year.

In addition to the described benefits to hundreds of American wholesalers as well as suppliers of bottled distilled spirits and the 18 control States, the proposal offers significant advantages for the Federal Government.

First, it places responsibility for assuring tax collection and compliance with a single agency of jurisdiction over matters related to the sale of alcohol beverages, namely the BATF.

Second, it offers BATF an opportunity to streamline excise tax collections and minimize auditing practices by utilizing procedures already used by the States. Every wholesale purchaser of domestically bottled spirits currently pays excise taxes.

It reduces the regulatory compliance burden by eliminating the requirement for segregated warehouse supervision by two Federal agencies.

It offers significant overall savings to Treasury because the States perform the same function and there are opportunities for synergies and interaction with the States.

In conclusion, Mr. Chairman, I believe that this "All-In-Bond" proposal is a sound tax policy and offers an opportunity to benefit American business.

Thank you very much.

[The prepared statement and attachments follow:]

TESTIMONY OF DOUGLAS W. METZ
WINE AND SPIRITS WHOLESALERS OF AMERICA, INC.

Thank you, Mr. Chairman, for the opportunity to testify in support of a simple, revenue neutral change in the method of paying the federal excise tax on distilled spirits. This proposal would (1) consolidate responsibility for collection of this tax in one federal agency; (2) reduce a major regulatory burden by eliminating dual agency supervision of distilled spirits warehouses; (3) simplify collection and compliance by combining the wholesale point of payment of federal and state excise taxes on distilled spirits; and (4) end the favored treatment of imported bottled products which makes wholesaler costs for competing domestic products some 40 percent greater.

My name is Doug Metz, Managing Director of the Wine and Spirits Wholesalers of America (WSWA). WSWA members, under license, purchase for resale over 90 percent of the distilled spirits distributed in the 32 license states, the District of Columbia and Puerto Rico.

The problem that I am addressing today is of great importance to hundreds of small American businesses. Currently, wholesalers can purchase *foreign* bottled distilled spirits "in-bond" (tax-free), paying the federal excise tax (FET) to the federal government directly after sale to a retailer. In contrast, when a wholesaler buys *domestically* bottled spirits (nearly 86 percent of his total spirits inventory) the price includes the FET, pre-paid by the distiller.

The inequity caused by this discrimination (favoring foreign over domestic products) means that hundreds of U.S. family-owned wholesale businesses increase their inventory financing costs by 40 percent when buying U.S. products.

Under the proposal, wholesalers would be able to purchase domestically produced or bottled spirits "in-bond" as now permitted for competing foreign products. It would allow suppliers to save FET carrying costs borne pending payment by wholesalers and the eighteen control states which operate their own liquor systems.

Movement of the FET payment point on domestic spirits from the supplier to the wholesaler will create a one-time, 60-day lag in tax receipts by the Treasury. This revenue lag would be neutralized by requiring All-In-Bond electing companies annually, on September 20, to make an estimated payment of excise taxes due in October and November based on tax payments for the same months of the previous year.

In addition to the described benefits to hundreds of American wholesalers as well as suppliers of bottled distilled spirits and the eighteen control states, the proposal offers significant advantages for the federal government. It:

- Places responsibility for assuring tax collection and compliance with the single agency of jurisdiction over matters related to the sale of alcohol beverages, namely the Bureau of Alcohol, Tobacco and Firearms (BATF).

- Offers BATF an opportunity to streamline excise tax collections and minimize auditing practices by utilizing procedures already used by states. Every wholesale purchaser of domestically bottled spirits currently pays state excise taxes.

- Reduces regulatory compliance burden by eliminating requirement for segregated warehouse supervision of spirits by two federal agencies, BATF and Customs.

- Offers significant overall savings to Treasury. The states already perform an excise tax collection function nearly as significant in dollar terms as the federal government's, and conduct audits at least once a year. The Treasury could piggy-back on state procedures with

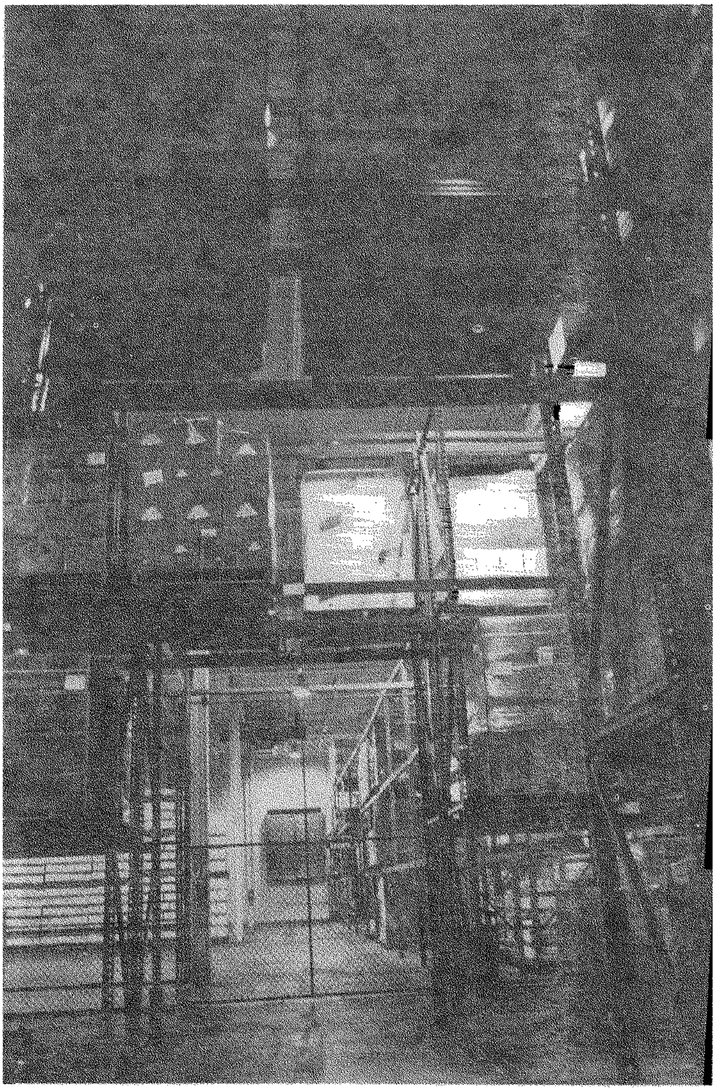
a high degree of confidence that all excise taxes are being collected. The use of joint excise tax reporting forms, with identical copies going to state agencies and the Treasury, offers cost saving opportunities.

- Restrains increases in tax collection points through minimum gallonage requirement and by operation of brand franchising contracts and state laws which qualify purchasers of distilled spirits at wholesale.

In conclusion, Mr. Chairman, I believe that this "All-In-Bond" proposal promotes sound tax policy by ending discrimination against domestic products while freeing up substantial working capital for U.S. family-owned businesses. In addition, it unifies the point of payment of both federal and state excise taxes, thus strengthening tax administration and compliance by providing parallel tax audit trails. "All-In-Bond" provides additional revenue protection in the form of annual estimated tax payments. It is revenue neutral. Attached to my written testimony are photographs depicting the regulatory burden resulting from the requirement to regulate warehouse facilities under dual agency supervision.

Mr. Chairman, I appreciate the Committee's time and trust that the Committee will include this proposal in the package under consideration.

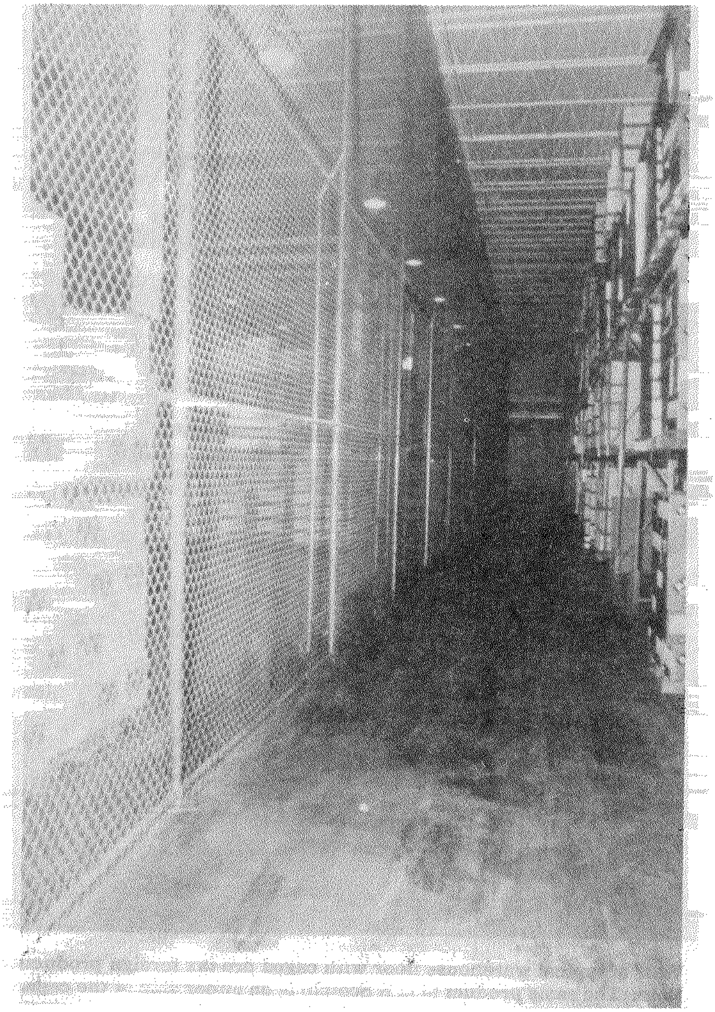
Attachments

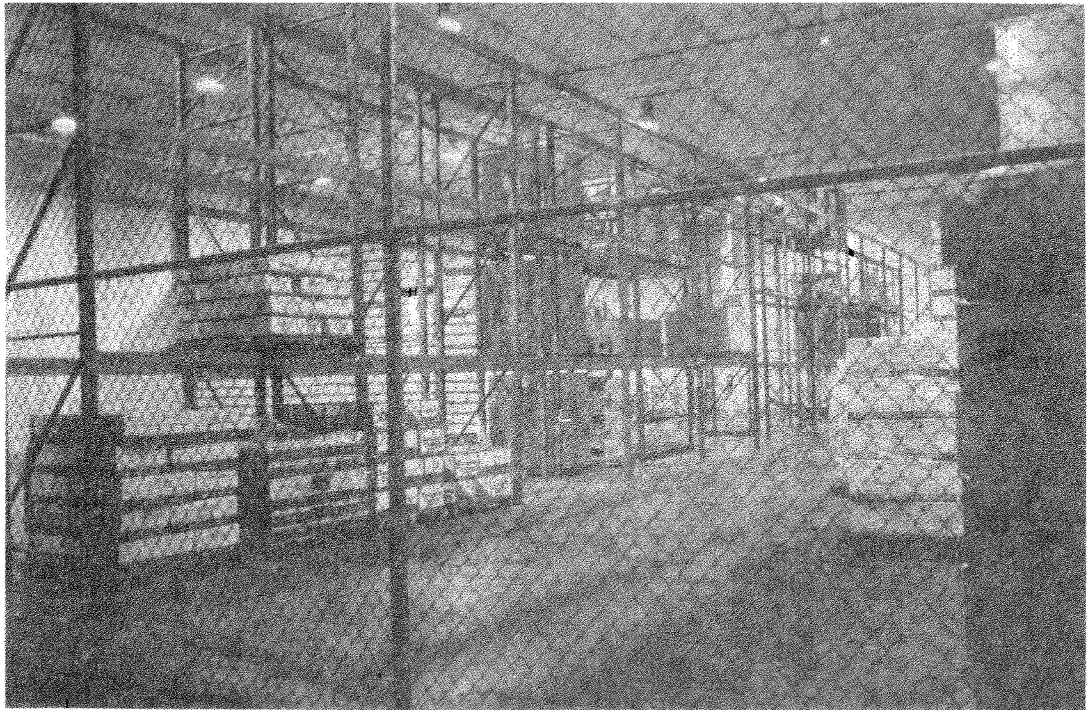


View of typical warehouse floor with caged pre-tax foreign products. Note: The same product (J & B Scotch) is on either side of the cage.

Bonded portion of the warehouse for pre-tax foreign products (supervised by U.S. Customs).

Unbonded portion of warehouse for tax-paid domestic goods (supervised by BATF).





**Bonded portion of warehouse for pre-tax foreign goods.
Note inflexible, wasted space due to existing regulations.**

Chairman ARCHER. Thank you, Mr. Metz.

I have only a couple of minutes to go vote. Hopefully, there will be another Member of the Committee who will arrive shortly who will share the continuation of the hearing for this panel.

I would ask you if you would keep your seats, and we will recommence just as soon as we can.

Thank you.

[Recess.]

Ms. DUNN [presiding]. The Committee will reconvene.

Mr. Huber, I apologize for our break for votes, but please do continue with your testimony.

STATEMENT OF JOHN HUBER, PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. HUBER. Thank you.

On behalf of the PMAA, Petroleum Marketers Association of America, I would like to express our support to this Committee in its examination of many tax issues affecting small businessmen and petroleum marketers.

PMAA has two primary concerns with the present tax system. The first involves the excise tax collection system for motor fuels. The second involves the efforts of the Internal Revenue Service to restrict access to depreciation schedules for marketers.

First, we would like to congratulate and express our thanks to Congressmen McCrery, Jacobs, Herger, and English for their efforts to resolve many of the outstanding issues relating to motor fuel excise taxes.

As you know, in 1993, the collection point for diesel tax collection was changed in an effort to reduce evasion and increase revenues. Unfortunately, these changes have had a direct and substantial impact on the marketers that PMAA represents.

We believe that these impacts were not anticipated by the Congress and that it is appropriate to reexamine the tax collection system to mitigate the impact of these changes on petroleum marketers. We believe the modest changes that are included in H.R. 1947 can improve the tax collection system without compromising the tax.

PMAA's primary concern with the tax is its impact on marketers selling gasoline to State and local governments. These entities are entitled to purchase gasoline tax free. Unfortunately, marketers selling to them purchase the gasoline tax paid and sell it to them tax free and then apply for a refund of taxes from the IRS. These refunds take from 45 days to 4 months to process. The result is that marketers are floating interest-free loans to the government for a substantial period of time. H.R. 1947 would mandate that the IRS pay claims within 20 days or pay interest on the claim.

Additionally, H.R. 1947 would improve the refund situation for many classes of diesel users who must apply for their own refunds, including construction companies, loggers, and all the other miscellaneous users.

Intercity buses have also had a difficult time with refunds over the past year. H.R. 1947 would provide them with a method to buy diesel at the legal rate and eliminate their need to file claims with the IRS.

This bill would also improve the tax collection system for sales of diesel to noncommercial vessels. Under current law, these vessels must only buy undyed diesel fuel which is not available at many marinas.

PMAA would also encourage the Committee to consider two other areas of the excise tax collection system which need to be remedied.

We would like to direct the attention of the Committee to the expiration of 26 U.S. Code 6427(f) which allows marketers to file claims for refunds on gasoline which is blended with ethanol. We would encourage the Committee to take action to ensure that this provision does not expire October 1.

We would also like to direct the Committee's attention to a conflict between IRS regulations and how the industry does business. At this time, both gasoline and diesel are taxed upon removal from the terminal. The IRS has instituted a policy that the person owning the fuel immediately prior to its removal from the tank is a taxpayer and must remit the tax.

Under current regulations, the following transactions cannot occur. A marketer may not sell diesel tax free to a State and local government with an oil company credit card. A marketer who is licensed as an ethanol blender cannot buy gasoline at a tax-reduced rate at an exchange terminal. We believe that the position holder concept rule adopted by the IRS could be greatly improved by providing necessary flexibility.

PMAA would now like to draw your attention to an issue regarding depreciation of facilities used to market petroleum products. Under the modified accelerated cost recovery system, petroleum marketing facilities are entitled to depreciate the real property over 15 years. This schedule is reflective of actual practice in the industry and the typical useful life of a gasoline station.

However, the IRS has issued audit guidelines which indicate that if over 50 percent of the floor space of a gasoline convenience store sells nonautomotive items, then the building must be depreciated over 39 years. Such a policy has been established even though the majority of revenues from these buildings comes from gasoline or diesel sales and even though the appearance of the building and property clearly indicates that it is a service station. This policy will be particularly hard on small business petroleum marketers.

Again, we thank the Chairwoman and the Members of this Committee for their concern and interest in resolving many outstanding issues. We will gladly respond to any questions that you may have.

[The prepared statement follows:]

TESTIMONY OF JOHN HUBER
PETROLEUM MARKETERS ASSOCIATION OF AMERICA

On behalf of the Petroleum Marketers Association of America, I would like to express our support to this committee and its examination of many tax issues affecting small businessmen and petroleum marketers. PMAA is a federation of 41 state and regional trade associations representing more than 10,000 independent petroleum marketers throughout the United States. These marketers sell in excess of 40 percent of the gasoline, 75 percent of the home heating oil and 60 percent of the diesel fuel consumed in this country. Eighty-nine percent of PMAA's membership is classified as small business under size categories established by the Small Business Administration.

PMAA has two primary concerns with the present tax system. The first involves the excise tax collection system for motor fuels. The second involves the efforts of the Internal Revenue Service to restrict access to depreciation schedules for marketers that are more attractive and more reflective of actual business practices.

First, we would like to congratulate and express our thanks to Congressmen McCrery, Jacobs and Herger for their efforts to resolve many of the outstanding issues relating to motor fuel excise taxes. As you know, in 1993 the collection point for diesel tax collection was changed in an effort to reduce evasion and increase revenues. Unfortunately, these changes have had a direct and substantial impact on the marketers that PMAA represents. We believe that these impacts were not anticipated by the Congress and that it is appropriate to reexamine the tax collection system to mitigate the impact of these changes on petroleum marketers. We believe the modest changes that are included in H.R. 1947 can improve the tax collection system without compromising the tax.

PMAA's first and primary concern with the tax is its impact on marketers who are selling gasoline to state and local governments and non-profit educational organizations. These entities are entitled to purchase gasoline tax free. Unfortunately, marketers selling to them must purchase the gasoline tax paid and then sell it to them tax free and apply for a refund of taxes from the Internal Revenue Service. These refunds may take from 45 days to four months to process. The result is that marketers are floating interest free loans to the government for a substantial period of time. H.R. 1947 would mandate that the IRS pay claims within 20 days or pay interest on the claim. This would encourage the IRS to pay the claims more quickly, and have no impact on taxes collected.

Additionally, H.R. 1947 would improve the refund situation for the many classes of diesel users who must apply for their own refunds. Construction companies must often buy diesel tax paid, even though they use it in a tax free manner. Under current law they can only apply quarterly for these refunds, and the Service is under no obligation to process their claims rapidly. H.R. 1947 would ensure that these small businesses recover their excess tax payments quickly. Intercity buses have also had a difficult time with refunds over the past year. H.R. 1947 would provide them with a method to buy diesel at the legal rate, and eliminate their need to file claims with the IRS.

This bill would also improve the tax collection system for sales of diesel to non-commercial vessels. Under current law, these vessels must only buy undyed diesel fuel, which is not available at many marinas. This provision would allow marinas to sell to all classes of diesel powered boats without having to install a second diesel pump.

PMAA would also like to direct the committee's attention to two other areas of the excise tax collection system which need to be remedied. First, we would like to direct the attention of the committee to the expiration of 26 U.S.C. 6427(f), which allows marketers to file claims for refund on gasoline which is blended with ethanol. We would encourage the committee to take action to ensure that this provision does not expire.

We would also like to direct the committee's attention to a conflict between IRS regulations and how the industry does business. At this time, both gasoline and diesel are taxed upon removal from the terminal. The IRS has instituted a policy that the person owning the fuel immediately prior to its removal from the tank is the taxpayer and must remit the tax. Unfortunately, this policy makes it impossible for many transactions to occur efficiently. Under current regulations, the following transactions cannot occur. A marketer may not sell diesel tax free to a state and local government with an oil company credit card. A marketer who is licensed as an ethanol blender cannot buy gasoline at a tax reduced rate at an exchange terminal. We believe that the position holder concept rule adopted by the Service could be greatly improved by providing flexibility and utilizing the tracking systems already in place in the private sector.

PMAA would now like to direct the attention of the committee to an issue regarding depreciation of facilities used to market petroleum products. Under the Modified Accelerated Cost Recovery System (MACRS), petroleum marketing facilities are entitled to depreciate the real property over fifteen years. This schedule is reflective of actual practice in the industry and the typical useful life of gasoline stations. However, the IRS has issued audit guidelines which indicate that if over fifty percent of the floor space of a gasoline/convenience store sells non-automotive items then the building must be depreciated over 39 years. Such a policy has been established even though the majority of revenues from these buildings comes from gasoline or diesel sales, and even though the appearance of the building and property clearly indicates that it is a service station. This policy will be particularly hard on small business and petroleum marketers. We would encourage the Committee to examine this issue and encourage the Service to develop guidelines which are more appropriate to the gasoline retail industry.

Again, we thank the Chairman and the members of this committee for their concern and interest in resolving many outstanding issues. We will gladly respond to any questions that you may have.

Ms. DUNN. Thank you very much, Mr. Huber.

Does anyone on the Ways and Means Committee wish to question the witnesses?

Apparently there are no questions. You did such a great job. We thank you all for coming and for your testimony.

Mr. Harper.

Mr. HARPER. Yes, may I make a statement?

Ms. DUNN. Oh, I am sorry. You haven't testified. I am very sorry, Mr. Harper. Of course, we would love to hear what you have to say.

STATEMENT OF EDWIN L. HARPER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATION OF AMERICAN RAILROADS

Mr. HARPER. Thank you very much, Madam Chairman.

I know it is kind of confusing taking the hand-off. Madam Chairman, Members of the Committee, I am Edwin L. Harper, president and chief executive officer of the Association of American Railroads. I appreciate this opportunity to address a threatened tax inequity against the Nation's freight railroads.

Unless the Congress acts before October 1, 1995, the railroads will be singled out as the only transportation mode paying 1.25 cents per gallon deficit reduction fuel tax. It simply is discriminatory to require the railroads to pay 1.25 cents more per gallon toward deficit reduction than their major competitors.

To avoid putting the railroads at a competitive disadvantage, the Association of American Railroads respectfully urges that all modes of transportation contribute equally to deficit reduction. This can be done fairly and with no revenue impact.

Prior to 1990, the sole purpose of the transportation fuels tax was to finance the Highway Trust Fund. Therefore, railroads, like other nonhighway users, did not pay this tax. The 1990 Reconciliation Act extended the fuel tax beyond its historical role as the highway user fee by introducing a 2.5-cent-per-gallon deficit reduction tax on transportation fuels.

The original 2.5-cent tax was payable by most transportation modes into the General Fund of the Treasury. The 1993 Reconciliation Act imposed an additional 4.3-cent-per-gallon deficit reduction rate on all surface transportation modes. At present, and until October 1, 1995, both railroads and trucks pay a combined deficit reduction rate of 6.8 cents; that is the 4.3- plus 2.5-cent-per-gallon deficit reduction rate of transportation fuel.

Under the 1993 Reconciliation Act, the 2.5 cents paid by highway users will be redirected into the Highway Trust Fund instead of being dedicated to deficit reduction. Thus, on October 1, 1995, the railroads will be left as the only payers of the original deficit reduction tax at a rate of 1.25 cents per gallon. Highway users will pay only 4.3 cents per gallon into the Treasury's General Fund, while railroads will pay 5.55; that is, the 4.3 plus the 1.25 cents per gallon for deficit reduction.

Unless the deficit reduction rate levied on the railroads is reduced to the level of its competitors, the railroad industry will be subjected to tax discrimination, as we have shown in a chart in the record that we have submitted. Currently, the railroads and the trucking industry both pay 6.8 cents. As of October 1, 1995, unless

the Congress acts, the railroads will be paying 5.55 cents and the trucking industry 4.3 cents, as well as inland waterways.

Tax equity begins with the recognition that the differences between the railroads and their competitors are in the funding of infrastructure. The Highway Trust Fund, funded by highway user taxes, provides the financing for the construction and maintenance of the public roads used by the trucking industry.

The railroad industry operates over its own privately funded, privately maintained rights of way with respect to which the industry also pays significant property taxes and interest on debt. Moreover, because the railroads do not enjoy, require, or want a trust fund, the diversion of the excise tax paid by trucks into the Highway Trust Fund should be balanced by a repeal of the fuel tax paid by the railroads.

If, on the other hand, a fuel tax is deemed appropriate for deficit reduction, all transporters should be required to make equal contributions. This can be done without creating a revenue shortfall.

First, if airlines are excluded from paying fuel taxes, a 0.028-cent-per-gallon tax on fuel used by the same transporters, including railroads, subject to the 1993 deficit reduction tax, would raise enough revenue to eliminate the 1.25-cent discriminatory tax on railroads. This proposal would allow fuel taxes paid by the other modes to be directed into their respective trust funds in a revenue-neutral manner, with all modes contributing equally to deficit reduction.

Alternatively, if airlines begin to pay the 4.3-cent-per-gallon fuel tax effective October 1, the railroad tax could be decreased from 5.5 cents to 4.3 cents, which the airlines would also be paying. This reduction would equalize fuel taxes at 4.3 cents for all modes and bring in revenues of $482 million.

Thank you. I would be happy to answer any questions you might have.

[The prepared statement follows:]

STATEMENT BY EDWIN L. HARPER
ASSOCIATION OF AMERICAN RAILROADS
ELIMINATION OF THE 1.25 CENT-PER-GALLON DEFICIT REDUCTION FUELS TAX
before the
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
July 11, 1995

Mr. Chairman and members of the committee, I am Edwin L. Harper, president and chief executive officer of the Association of American Railroads. I appreciate this opportunity to address a threatened tax inequity against the nation's freight railroads. Unless Congress acts before October 1, 1995, the railroads will be singled out as the only transportation mode paying the 1.25 cents-per-gallon deficit reduction fuel tax. It is simply discriminatory to require railroads to pay 1.25 cents more per gallon towards deficit reduction than their major competitors. To avoid putting the railroads at a competitive disadvantage, the Association of American Railroads respectfully urges that all modes of transportation contribute equally to deficit reduction. This can be done fairly and with no revenue impact.

I. UNDER CURRENT LAW BOTH RAILROADS AND THEIR MAJOR COMPETITORS CONTRIBUTE EQUALLY TO DEFICIT REDUCTION.

Prior to 1990, the sole purpose of the transportation fuels tax was to finance the Highway Trust Fund. Therefore, railroads (like other non-highway users) did not pay this tax. The 1990 Reconciliation Act extended the fuel tax beyond its historical role as a highway user fee, by introducing a 2.5 cents-per-gallon deficit reduction tax on transportation fuels.

The original 2.5 cent tax was payable by most transportation modes into the general fund of the Treasury. The 1993 Reconciliation Act imposed an additional 4.3 cents-per gallon deficit reduction rate on all transportation modes. At present and until October 1, 1995, both railroads and trucks pay a combined deficit reduction rate of 6.8 (4.3 plus 2.5) cents-per-gallon of transportation fuel.

II. UNLESS CONGRESS ACTS BEFORE OCTOBER 1, 1995, RAILROADS WILL BE PLACED AT A DISADVANTAGE, BECAUSE THEY WILL BE REQUIRED TO PAY MORE TOWARDS DEFICIT REDUCTION THAN THEIR COMPETITORS.

Under the 1993 Reconciliation Act, the 2.5-cents tax paid by highway users will be redirected into the Highway Trust Fund instead of being dedicated to deficit reduction. Thus, on October 1, 1995, railroads will be left as the only payers of the original deficit reduction tax at a rate of 1.25 cents-per-gallon. Highway users will pay only 4.3 cents-per-gallon into the Treasury's general fund, while railroads will pay 5.55 (4.3 plus 1.25) cents-per-gallon for deficit reduction. Unless the deficit reduction rate levied on the railroads is reduced to the level of its competitors, the railroad industry will be subjected to tax discrimination as shown:

Transport-Mode	Current Tax Per-Gallon	October 1, 1995 Tax Per Gallon
Railroads	6.8 cents	5.55 cents
Trucking	6.8 cents	4.3 cents
Inland Water	4.3 cents	4.3 cents

III. EITHER THE DEFICIT REDUCTION FUEL TAX IMPOSED ON RAILROADS SHOULD BE REPEALED OR ALL MODES SHOULD BE ASSESSED A LOWER TAX RATE TO RESTORE BALANCE.

Tax equity begins with recognition of the differences between railroads and their competitors on infrastructure funding. The Highway Trust Fund, funded by highway user taxes, provides the financing for the construction and maintenance of the public roads used by trucks. The railroad industry operates over its own privately funded rights-of-way, with respect to which the industry pays significant property taxes and interest on debt. Moreover, because the railroads do not enjoy, require, or want a trust fund, the diversion of the excise tax paid by trucks into the Highway Trust Fund should be balanced by the repeal of the fuel tax paid by railroads.

If, on the other hand, a fuel tax is deemed appropriate for deficit reduction, all transporters should be required to make equal contributions. This can be done without creating a revenue shortfall. First, if airlines are excluded from paying fuel taxes, a .028 cent-per-gallon tax on fuel used by the same transporters, including railroads, subject to the 1993 deficit reduction tax would raise enough revenue to eliminate the 1.25-cent discriminatory tax on railroads. This proposal would allow fuel taxes paid by the other modes to be directed into their respective trust funds in a revenue neutral manner, with all modes contributing equally to deficit reduction

Ms. DUNN. Are there any questions?

Since there are no questions, we thank you, Mr. Harper, for your testimony.

Gentlemen, thank you very much for being here today.

We have a last panel with witnesses, Andrew Lawlor, Peter Roberts, and Harvey Shulman.

Welcome, gentlemen. Why don't we begin, even though Mr. Shulman is not yet here.

Dr. Lawlor, would you like to begin?

STATEMENT OF ANDREW C. LAWLOR, PH.D., ASSOCIATE VICE PRESIDENT FOR ACADEMIC PROGRAMS, ON BEHALF OF EDINBORO UNIVERSITY OF PENNSYLVANIA, EDINBORO, PENNSYLVANIA

Mr. LAWLOR. Certainly. Madam Chairman and Members of the Committee, thank you for holding these hearings on miscellaneous tax reform items, and thank you for allowing me to testify on behalf of Edinboro University of Pennsylvania.

I am here in support of an important education initiative. Our university, as a member of the Pennsylvania State System of Higher Education, supports legislation introduced by a Member of the Committee, Congressman Phil English, providing an exclusion for income earned on State prepaid tuition programs and encouraging States to adopt education savings accounts.

First, let me provide a brief introduction to public higher education and Edinboro University of Pennsylvania. Edinboro is located in northwestern Pennsylvania in Mr. English's congressional district. Edinboro was founded in 1857 as Edinboro Academy and has since become one of the 14-member institutions of the Pennsylvania State System of Higher Education. We currently offer over 100 different baccalaureate and master degree programs and have an enrollment of nearly 7,500 students. Under the leadership of President Foster F. Diebold, Edinboro University now generates locally an economic impact of comfortably more than $120 million annually, utilizing a $70 million annual budget.

As I am sure you will realize, of the 3,400 colleges and universities in the United States, roughly one-half are public sector institutions. Edinboro University is pleased to be among the public sector which, as a whole, educates approximately 80 percent of the total number of students in the United States.

I am here today for two reasons: First, to talk about the success of the tuition assistance program in Pennsylvania in order to encourage other States to adopt similar programs; and, second, to explain a tax problem our program will soon be faced with that Congressman English has been working to address and I hope the Committee will assist him with.

Our university is involved in a program established by the State of Pennsylvania in September 1993, the TAP, Pennsylvania Tuition Account Program. TAP is designed to provide for the advance purchase of college tuition credits in order to assist families of all income levels planning for the future educational expense of their children. TAP enables people to beat inflation and save money by locking in a price today to pay for tomorrow's tuition.

The TAP is administered by the Pennsylvania Treasury. The treasury is responsible for investing the money so that when a child is ready for college, the account will have increased in value to cover any increase in tuition. Though the program is designed to cover tuition of all State systems, State-related and community colleges in Pennsylvania, TAP credit may be applied to any accredited college in the United States.

TAP has been overwhelmingly successful for our State. On June 6 of this year, our State treasurer reported that Pennsylvania families have helped the program reach a new milestone by purchasing more than $30 million in TAP credits for their children's future college education. More than 11,300 children have been enrolled in the tuition prepayment program since it was started.

The problem we will soon face, however, concerns the tax liability of prepurchased credits. While this is a smart, successful program, unfortunately any increase in the value of the credits is subject to Federal income taxation. The purchaser will incur a tax liability when the credits are used or in the event of a refund.

While Pennsylvania's program is new and those participating are not able to use the credits, when they do, they will meet with a huge tax burden. Other States with similar programs are all too familiar with what a disincentive this liability is to the program, and States who are contemplating a program are thinking twice about it.

Congressman English has introduced bipartisan legislation to address this problem. The bill will encourage States to adopt college tuition savings programs and help States with existing programs by exempting the earnings on tuition credits of individuals participating in these programs from gross income for tax purposes. This is the main tenet of his legislation, the issue he submitted for Committee consideration, and the only drawback to programs like TAP.

I am hopeful that this legislation will prove to be the low-cost proposal that many of us who have worked on it feel it is. Nonetheless, I know this proposal has universal appeal and the potential to improve the quality of life for citizens of every State as well as providing a well-educated work force.

I urge the Committee's strong consideration of this proposal. It is time to stop penalizing families who are trying to save for their children's education.

Thank you for the opportunity to testify.

[The prepared statement follows:]

Dr. Andrew C. Lawlor, Edinboro University of Pennsylvania

Mr. Chairman and Members of the Committee, thank you for holding these hearings on miscellaneous tax reform items and thank you for allowing me to testify on behalf of Edinboro University in support of an important education initiative. Our university, as a member of the Pennsylvania State System of Higher Education, supports legislation introduced by a Member of the Committee, Congressman Phil English, providing an exclusion for income earned on State Prepaid tuition programs and encouraging states to adopt education savings accounts.

Edinboro University is located in Northwestern Pennsylvania in Mr. English's Congressional District. Edinboro was founded in 1857 as Edinboro Academy and has since become one of the 14 member institutions of the Pennsylvania State System of Higher Education. We currently offer over a hundred different baccalaureate and masters degree programs and have an enrollment of nearly 7,500 students. We generate locally an economic impact of comfortably more than $120 million annually, utilizing a 70-million dollar annual budget. As I am sure you realize, of the 34-hundred colleges and universities in the United States, roughly half are public sector institutions. Edinboro is pleased to be among the public sector institutions which, as a whole, educate approximately 80 percent of the total number of students in the United States.

I am here today for two reasons. First, to talk about the success of a tuition assistance program in Pennsylvania in order to encourage other State's to adopt similar programs, and second, to explain a tax problem our program will soon be faced with that Congressman English has been working to address and that I hope the Committee will assist him with.

Our university is able to take advantage of a program established in the State of Pennsylvania in September, 1993 -- the Pennsylvania Tuition Account Program, or TAP program. The TAP program is designed to provide for the advance purchase of college tuition credits in order to assist families of all income levels planning for the future educational expense of their children. The TAP program enables people to beat inflation and save money by locking in a price today to pay for tomorrow's tuition.

For the Pennsylvania program, a "tuition credit" equals 1/24th of the annual tuition at member colleges and universities for full-time undergraduate students. Tuition credit prices are set annually based on current tuition prices, expected tuition inflation and the expected earnings of the Fund. The program allows the credits to be used anytime after they mature, the minimum period being four years.

The TAP program is administered by the Pennsylvania Treasury. Treasury is responsible for investing the money so that when a child is ready for college, the account will have increased in value to cover any increase in tuition. Though the program is designed to cover tuition of all State System, State Related, and Community Colleges in Pennsylvania, TAP credits may be applied to any accredited college in the U.S.

The TAP program has been overwhelmingly successful for our State. On June 6th of this year our State Treasurer reported that Pennsylvania families have helped the program reach a new milestone by purchasing more than $30 million in TAP credits for their children's future college education. More than 11,300 children have been enrolled in the tuition pre-payment program since it was started.

While this program helps both the State investing the funds and the families who save, it also helps the enrollment of universities like Edinboro that are popular among middle-income families. The program assures that funds invested for college are available when needed without unexpected depletion, to assist those who are able to sacrifice to plan for the future. All too often we encounter individuals who have always wanted to attend college, but are financially unable to do so when the time comes. This situation not only hurts the individuals and their families, but it impedes our country's opportunity to have a well-educated citizenry.

The problem we will soon face concerns the tax liability of the pre-purchased credits. While this is a smart, successful program, unfortunately, any increase in the value of the credits are subject to Federal income taxation. The purchaser will incur a tax liability when the credits are used, or in the event of a refund. While Pennsylvania's program is new and those participating are not yet able to use the credits, when they do - they will be met with a huge tax burden. Other states with similar programs are all too familiar with the disincentive this liability is to the program, and states who are contemplating starting a program are thinking twice.

Congressman English has introduced bipartisan legislation to address this problem. The bill will encourage states to adopt college tuition savings programs and help states with existing programs by exempting the earnings on tuition credits of individuals participating in these programs from gross income for tax proposes. This is the main tenet of his legislation, the issue he submitted for Committee consideration and the only drawback to programs like TAP.

While I am unaware of many of the specifics of the administration of the program and the revenue implications of the desired exemption -- considering that Pennsylvania's program is only two years old and that the fund has to be allowed to mature for four years -- there would be no revenue impact for our State. I know, however, that States like Michigan and Florida have had similar programs that have been in existence for much longer periods of time. I am hopeful that this will prove to be the low-cost proposal that many of us who have worked on it feel it is. Nonetheless, I know that this proposal has universal appeal and the potential to improve the quality of life for citizens of every state -- as well as increasing their human resource potential.

I urge the Committee's strong consideration of this proposal. It is time to quit penalizing families who are trying to save for their children's education.

Thank you for the opportunity to testify.

Ms. DUNN. Thank you very much, Dr. Lawlor.
Mr. Roberts.

STATEMENT OF PETER A. ROBERTS, PRESIDENT, CHIEF EXECUTIVE OFFICER, COLLEGE SAVINGS BANK, PRINCETON, NEW JERSEY

Mr. ROBERTS. Yes. I would like to thank the Committee for giving me this opportunity to testify today.

Briefly, I am the founder, chairman, and chief executive officer of College Savings Bank, a New Jersey chartered FDIC-insured savings bank located in Princeton.

College Savings Bank was formed for the primary purpose of originating and marketing the patented CollegeSure CD, certificate of deposit, America's first commercially available and nationally marketed college cost prepayment product. I am also the inventor of the CollegeSure CD.

One solution to increasing the rate at which families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

Legislation, H.R. 1328, recently has been introduced which would make State college savings programs exempt from Federal taxes. H.R. 1328 excludes from gross income any amounts distributed from qualified State educational savings plans when used to pay for college. Also, the bill exempts from Federal taxation State agencies that administer educational savings plans. In the short run, this might increase college-targeted savings and, we all hope, overall savings.

However, the bill has several significant flaws with long-term consequences. The new legislation converts taxable prepaid investment contracts into tax-exempt obligations with yields matching the pretax yields of U.S. Treasury and corporate obligations.

The bill, if enacted, would create preemptive State savings products which would crowd out virtually all private sector competition in the marketplace. This form of tax exemption will distort investor choices and divert the portion of the family's total savings earmarked for college away from other savings vehicles and into State savings plans.

Now, the effect of tax exemption on State savings plans is very different from the effect of tax exemption on municipal bonds. Whereas the market adjusts the yields on municipal bonds to be lower than the yields on taxable bonds, the yields on the obligations issued by State savings plans are reflective of the yields on the taxable investments in the trusts, and, because the obligations issued by the trust are nonnegotiable, they are not able to seek equilibrium to the yields on other tax-exempt instruments.

The tax-exempt feature creates a superordinary aftertax yield, preempts all comparable investments in the marketplace, and has the effect of flooding the market with subsidized above-market-rate and below-market-price instruments. In international banking parlance, they call this rate dumping.

The disintermediation and market-damaging effects caused by a preemptive savings product will discourage those entities that now

seek to help savers and reduce the range and variety of investment choices. What is more, in order to compete with federally subsidized obligations issued by the State savings plans, the rate on tax-exempt bonds will rise, thereby increasing the cost of capital to States and municipalities, and eventually budget deficits will swell and jobs will be lost.

Let's increase the college savings rate through market-based solutions. Congress should reject the approach in H.R. 1328 and instead focus on developing market-based incentives, provide college savers with a wide range of investment choices, maintain a level playingfield, reach a broad spectrum of eligible families, and create a competitive, healthy, and innovative marketplace that is necessary to maximize the national savings rate.

The best way to maximize the effectiveness of the tax benefits offered to college savers would be to extend such benefits to all savings placed in an ADSA, American dream savings account, such as the one proposed in H.R. 1215. All the legislation needs is—to be clarified to say that State prepaid tuition contracts are eligible investments, as any other investment that is eligible for an IRA.

Although there are no deductions for contributions to the ADSAs, earnings on the amounts deposited by parents in the ADSA would not be taxed and would be exempt from taxation when withdrawn to pay college expenses. The proposal contains contribution limits.

The ADSA helps level the playingfield for all market participants and avoids the market-damaging effects that may be caused by a preemptive government savings product. State savings plans could resolve their Federal tax problems via the ADSA. Like the present proposal, amounts distributed from State savings plans to pay higher education expenses generally would be exempt from Federal taxation. In addition, the tax asymmetry afflicting State college savings trusts would be resolved.

State college savings trusts generally are subject to tax on gross interest income currently but able to claim interest expense deductions only in future years when tuition benefits are paid out. This exposes the trust to enormous tax liabilities in the early years, which reduces their assets and net worth.

By placing the prepaid contract in the ADSA, the trust, without impacting the tax benefit to the family, can claim interest expense deductions in current years, offsetting the trusts taxable interest income. This would reduce the need to exempt the State educational savings trusts from Federal taxation as provided in the current proposal and greatly reduce the cost to the Federal taxpayer.

The ADSA is a market-based solution. It helps provide college savers with a wide range of investment choices, reaches a broad spectrum of eligible families, and creates a competitive and innovative marketplace necessary to maximize the college savings rate. Without increasing the size of government, ADSAs tap the abundant resources of the private sector to cultivate thrift among families with college-bound children and improve the rate at which families save. Furthermore, it addresses the present needs of public and private sector savings programs.

Thank you very much.

[The prepared statement and attachment follow:]

TESTIMONY OF PETER A. ROBERTS
COLLEGE SAVINGS BANK, PRINCETON, N.J.

I would like to thank Chairman Archer and other members of the Ways and Means Committee for giving me this opportunity to discuss the role that the private sector can play in helping to increase the rate of savings in the United States and, in particular, the rate of savings for a college education.

Briefly, I am the founder, chairman, and chief executive officer of College Savings Bank, a New Jersey-chartered, FDIC-insured savings bank located in Princeton.

College Savings Bank in 1987 was formed for the primary purpose of originating and marketing the patented CollegeSure® Certificate of Deposit, America's first commercially available and nationally marketed college cost prepayment product.

I am also the inventor of the CollegeSure CD.

QUESTIONABLE SOLUTION: PREEMPTIVE STATE SAVINGS PRODUCTS

One solution to increasing the rate at which families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

Legislation recently has been introduced which would make state college savings programs exempt from federal taxes. H.R. 1328 excludes from gross income any amounts distributed from qualified state educational savings plans and used to pay for college. Also the bill exempts from federal taxation state agencies that administer educational savings plans.

In the short-run, this might increase college-targeted savings and, we all hope, overall savings. However, the bill has several significant flaws with long-term consequences.

The new legislation converts taxable prepaid investment contracts into tax-exempt obligations with yields matching the pre-tax yields of U.S. Treasury and corporate obligations (See Figures).

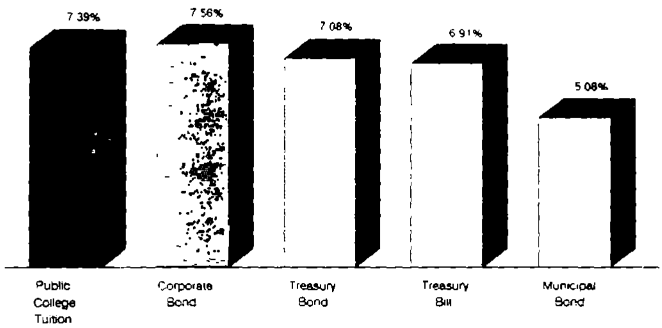
The bill, if enacted, would create pre-emptive state savings products which would crowd out virtually all private sector competition in the marketplace. This form of tax exemption will distort investor choices and divert the portion of a family's total savings earmarked for college away from other savings vehicles and into the state savings plans.

The effect of tax exemption on state savings plans is very different than the effect of tax exemption on municipal bonds. Whereas the market adjusts the yields on municipal bonds to be lower than the yields on taxable bonds, the yields on the obligations issued by state savings plans are reflective of the yields on the taxable investments in the trust and, because the obligations issued by the trust are non-negotiable, not able to seek equilibrium to the yields on other tax-exempt instruments. The tax-exempt feature creates a superordinary after-tax yield which preempts all comparable investments in the marketplace. It has the effect of flooding the market with subsidized, above-market rate and below-market priced instruments. In international banking parlance, it's called 'rate dumping.'

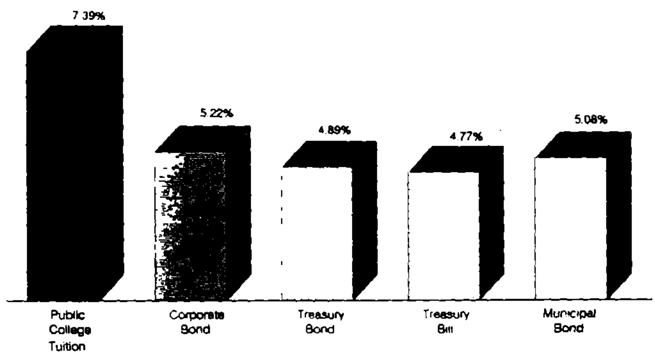
FIGURES

Average Annual College Inflation Rate Versus Rates of Return on Selected Corporate, U.S. Treasury, and Municipal Securities , 1964-1992

Pre-Tax



After-Tax



NOTES: The after-tax graph assumes a 31% marginal income tax rate.

College inflation is measured as the annual rate of change in tuition and required fees (in-state) for all public higher education institutions in the United States as reported in "Digest of Education Statistics", U.S. Department of Education, Washington, D.C. (1993)

Average annual rates of return on corporate bonds, U.S. Treasury bonds and U.S. Treasury bills were calculated from total annual returns reported in "Stocks, Bonds, Bills and Inflation, 1994 Yearbook," Ibbotson Associates, Inc., Chicago (1994).

Average annual rate of return on municipal bonds was calculated in the same manner as Ibbotson Associates computed annual corporate and Treasury returns based on monthly yield data for 10-year, prime grade, general obligation municipal bonds reported in "Analytical Record of Yields and Yield Spreads," Salomon Brothers Inc., New York, September 1990 and monthly updates through 1992.

The disintermediation and market-damaging effects caused by a preemptive savings product will discourage those entities that now seek to help savers and reduce the range and variety of investment choices. **What's more, in order to compete with federally subsidized obligations issued by the state savings plans, the rate on tax-exempt bonds will rise, thereby increasing the cost of capital to states and municipalities.** And, eventually, budget deficits will swell and jobs will be lost.

LET'S INCREASE THE COLLEGE SAVINGS RATE THROUGH MARKET-BASED SOLUTIONS

Congress should reject the approach in H.R. 1328 and instead focus on developing market-based incentives that:

- Provide college savers with a wide range of investment choices;
- Maintain a level playing field;
- Reach a broad spectrum of eligible families; and
- Create a competitive, healthy and innovative marketplace that is necessary to maximize the national savings rate.

ALTERNATIVE FEDERAL LEGISLATION

The best way to maximize the effectiveness of tax benefits offered to college savers would be to extend such benefits to all savings placed in an American Dream Savings Account (ADSA) proposed in H.R. 1215.

Eligible investments for an ADSA should include: deposits made in state-sponsored college savings plans, bank accounts, investment accounts, and other accounts that satisfy Individual Retirement Account requirements. Although there are no deductions for contributions to ADSAs, earnings on amounts deposited by parents in an ADSA would not be taxed and would be exempt from taxation when withdrawn to pay college education expenses. The proposal contains contribution limits.

The ADSA helps level the playing field for all market participants and avoids the market damaging effects that may be caused by a preemptive government savings product.

State savings plans could resolve their federal tax problems via the ADSA. Like the present proposal (H.R. 1328), amounts distributed from state savings plans to pay higher education expenses generally would be exempt from federal taxation.

In addition, the tax asymmetry afflicting state college savings trusts would be resolved. State college savings trusts generally are subject to tax on gross interest income currently but able to claim interest expense deductions only in future years when tuition benefits are paid out. This has exposed the trusts to enormous tax liabilities in the early years which reduce their assets and net worth.

By placing the prepaid contract in the ADSA, the trust (without impacting the tax benefit to the family) can claim interest expense deductions in current years, thereby offsetting the trust's taxable interest income. This would reduce the need to exempt the state educational savings trusts from federal taxation, as provided in the current proposal, and greatly reduce the cost to the federal taxpayer.

The ADSA is a market-based solution. It helps provide college savers with a wide range of investment choices, reaches a broad spectrum of eligible families, and creates a competitive and innovative marketplace necessary to maximize the college savings rate. Without increasing the size of government, ADSAs tap the abundant resources of the private sector to cultivate thrift among families with college bound children and improve the rate at which families save. Furthermore, it addresses the present needs of public and private sector savings programs.

Ms. DUNN. Thank you, Mr. Roberts.
Mr. Shulman.

STATEMENT OF HARVEY SHULMAN, COCHAIR, COALITION TO REPEAL SECTION 1706

Mr. SHULMAN. Thank you.

Madam Chair, imagine a witness asking this Committee's support for a principle on which there has been agreement among Mr. Armey, Mr. DeLay, Mr. Crane, Mr. Herger—and also Mr. Gephardt, Mr. Ford, Mr. Neal, Mr. Owens, and many others. Imagine a witness telling you that a similar agreement also exists among Senators Kennedy, Moseley-Braun, Mikulski, Simon, Robb, and Hollings—and also Senators Coats, Faircloth, Warner, Gregg, Lott, Hatfield, and dozens of others.

I am delighted to say that there is such agreement on the principle that we need to eliminate the employment tax discrimination which exists against the computer and engineering industries—discrimination which was created by the enactment of section 1706 of the 1986 Tax Reform Act.

It is hard to believe, Madam Chair, but section 1706 was a tax reform experiment that singled out only the technical services industry and made it uniquely difficult for only agencies in our industry to use self-employed workers.

Section 1706 did so by removing the so-called section 530 employment tax safe haven from only our industry. As a result, we are the only industry in the United States which must judge its employment tax obligations solely on the basis of an ancient and unpredictable common law employment test.

It is not surprising, therefore, that thousands of technical services firms refuse to do any business with technical consultants who are sole proprietors or otherwise small businesses. Likewise, it is not surprising that tens of thousands of computer and engineering consultants have a unique barrier to face in their quest for the economic empowerment that comes from self-employment.

In short, section 1706 created havoc and unfairness in our industry by paternalistically forcing employment status on many workers. Doesn't it amaze you that we actually have an employment tax law that uniquely hinders entrepreneurship in America's high-tech industries?

Our written testimony provides the details of the reasons for the section 1706 experiment and why new facts not known in 1986 have undermined the bases for section 1706. Relying on such facts—not myths and theories, but facts—a consensus has emerged among leaders in government, business, and professional associations to repeal section 1706. They recognize that repeal is not special interest legislation but, instead, is giving back to us the same thing that every other industry in the United States enjoys.

For example, in 1987 the Small Business Administration urged repeal of section 1706. In 1991 a study of the Treasury Department concluded that section 1706's coverage was "difficult to justify on equity or other policy grounds." The Treasury Department found that tax compliance of self-employed engineering and computer consultants was actually above average compared to other industries that still have the employment tax safe haven.

In 1992 the House Government Operations Committee flat out stated that section 1706 "should be repealed."

In 1994 the prestigious American Tax Policy Institute found that, now that the original basis for section 1706 "has been refuted," the law should be repealed. The institute said there is "no justification" to exclude firms which use technical workers from the employment tax safe haven.

In closing, please heed the statements of two Members of Congress who could not be from more different backgrounds, districts, and political philosophies but who both value the economic empowerment of self-employment in our high-tech industry. As Speaker Gingrich wrote in Newsweek Magazine:

> We need to comb through our laws to clean out the barriers to starting businesses and creating new wealth. We need to alter Tax Codes that virtually punish people for working as independent contractors or starting their own businesses. We must clear the path for the next Tom Edison or Ray Kroc or Bill Gates or Steve Jobs.

The Speaker's words echo those of Congressman Major Owens from Bedford-Stuyvesant, who testified before this Committee 3 years ago and said the following:

> I have heard from many African-American computer programmers who have had the door to self-employment slammed in their face because of section 1706. Many businesses are unwilling to use the services of valid self-employed consultants because they do not want to attract the attention of the IRS auditors. Some of the students—in Brooklyn Technical High School in my district—might have the dream of being self-employed. We want to encourage them and make their high-tech industries grow. In this light, how can I justify a discriminatory law like section 1706 to them?

Madam Chair, where there is a will, there must be a way. A strong bipartisan consensus has emerged to repeal section 1706 and eliminate the unique discrimination against our industry. The time for more study and discussion is over. It is time for action. Please do not let us down.

[The prepared statement and attachment follow:]

Before the
Ways and Means Committee
United States House of Representatives
July 11, 1995

STATEMENT OF HARVEY SHULMAN, COCHAIR COALITION TO REPEAL SECTION 1706

We are the representatives of small business entrepreneurs, who own or manage over ten thousand software, engineering, data processing and technical writing companies throughout the United States -- including many thousand that are minority and/or women-owned. We are delighted that Congress is finally moving to repeal of Section 1706 of the 1986 Tax Reform Act -- <u>an employment tax law which on its face discriminates against America's high technology industry</u> and has a particularly adverse effect on small business as well as minority and women entrepreneurs in our industry. Congress has begun to see, more clearly than in the past, the need to help small business, and to encourage entrepreneurship in our high-tech industry; as a coalition representing both constituencies, we ask for your support and leadership now.

We will not attempt, in this short statement, to explain all the details of our problem. Instead we are providing attachments with this letter. These attachments show that because of Section 1706, the technical services industry is the only industry in the United States that does not have the "employment tax safe haven" protection of Section 530 of the 1978 Revenue Act, or any other alternative "safe haven". Instead, pursuant to Section 1706 our employment tax obligations are governed only by the vague and unpredictable 20 question common law test -- the very test for which Section 530 was enacted as a safeguard from the common law test's frequently capricious effects. These effects of Section 1706 are felt most adversely by new market entrants. Why? Because the common law test emphasizes a lengthy history of entrepreneurship, large capital investment, several concurrent customers, advertising and other factors that are more difficult for many newly self-employed independent consultants to meet. In addition <u>all</u> self-employed high-tech professionals have faced far fewer consulting opportunities as businesses are fearful to use their services because of Section 1706.

Every independent analysis of Section 1706 -- including the Treasury Department, the House Government Operations Committee, the American Tax Policy Institute, and <u>ComputerWorld</u> (the leading publication for the computer industry) -- has found Section 1706 to contain unreasonable and discriminatory provisions.

If we really want to promote America's high-technology industry and restore tax fairness, then the <u>repeal of Section 1706 should be included in the upcoming tax bill</u>.

For more information: Coalition to Repeal Section 1706
1250 Connecticut Ave, N.W. - Suite 700
Washington, D.C. 20036
(202) 637-6483

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1 Members of the Coalition include American Consulting Engineers Council; Black Data Processing Associates; Computer Software Industry Association; Data Processing Management Association Design Professionals Coalition Independent Computer Consultants Association; Information Systems Consultants Association; Institute of Electrical and Electronics Engineers, Inc. -- United States Activities; National Association of Computer Consultant Businesses; National Association of Women Business Owners National Writers Union; Professional & Technical Consultants Association; Software Forum; and Technical Consultants National Association.

- REPEAL SECTION 1706 OF THE 1986 TAX REFORM ACT - NOW IS THE TIME TO END THE EMPLOYMENT TAX DISCRIMINATION AGAINST THE TECHNICAL SERVICES INDUSTRY

Is there "employment tax discrimination" against the technical services industry? Yes. The technical services industry is the only industry in this country where a firm's employment tax liabilities are determined under only one test, the "20-factor common law employment test" which originated in medieval England (a test which even government officials have regularly criticized as "unpredictable", "arbitrary", and "subjective"). In every other industry, every firm has its employment tax obligations determined under two alternative tests: either the "20-factor common law employment test" or a "back-up, alternative employment tax safe haven" (which, under Section 530 of the 1978 Revenue Act, allows a firm to treat workers as "self-employed" if the firm has a "reasonable basis" for such treatment). If a worker is determined to be self-employed under either test, then the worker -- and not the firm -- must pay the employment taxes The denial of both alternatives to the technical services industry is clearly discriminatory. Section 1706 has seriously hurt many small businesses and has deterred thousands of entrepreneurial computer programmers, analysts and engineers from becoming self-employed.

How did the discrimination against the technical services industry arise and has it ever been studied? Several years ago the technical services industry also had the same protection granted to other industries under the Section 530 "back-up, alternative employment tax safe haven", but this protection was eliminated by Section 1706 of the 1986 Tax Reform Act. Section 1706 originated as a "revenue offset" measure that was estimated to raise $12 million per year (immediately after its passage, OMB and the Treasury Department estimated that only 0-$5 million per year might be gained at best). But it was also somewhat of an "experiment" in reaction to claims that the Section 530 "back-up, employment tax safe haven" was "too liberal" and had led to tax noncompliance which sometimes resulted in unfair competitive advantages to certain firms and workers claims which, it should be noted, would apply to every industry. Unfortunately, however, this "experiment" put the technical services industry in the very same vulnerable situation that all firms faced in the 1970's and that led to enactment of the Section 530 "back-up, alternative employment tax safe haven". As a result, Congress received thousands of complaints that the Section 1706 "experiment" had failed, and it passed Section 6072 of TAMRA requiring the Treasury Department to study the impact of Section 1706.

Does the Treasury Department Study provide new information which supports replacement of Section 1706? Yes. The Treasury Department Study was released in March 1991. The Treasury Department Study contains new information, available for the first time, which confirms that the discrimination against the technical services industry cannot be justified -- and that legislative relief is necessary. First, the Study concluded that although the technical services industry had been the only industry singled out for loss of the Section 530 "back-up, alternative employment tax safe haven", that discrimination had been imposed against an industry in which there is actually better tax compliance in comparison to many other industries. When Congress enacted Section 1706, it did not know this fact! Second, the Study found that especially because of its application to only so-called "three-party situations" in the technical services industry", Section 1706 is "difficult to justify on equity or other policy grounds." Third, the Study confirmed that application of the "20 factor common law [employment] test can be difficult, in particular in the multi-party situations affected by Section 1706" (emphasis added); indeed, the Study quoted an Assistant Treasury Secretary who admitted that this test "may also produce inappropriate results" and "does not yield clear, consistent, or satisfactory answers".

Does it matter whether the technical services industry has a "back-up, alternative employment tax safe haven"? Yes. Without a "back-up, alternative employment tax safe haven", if an IRS auditor determines that a worker is an employee of a firm that paid him or her -- rather than self-employed -- the IRS imposes substantial back employment tax assessments on the firm, even if the worker already paid those taxes and even though those assessments could bankrupt the firm. That is why a "back-up alternative employment tax safe haven" was and continues to be important.

If the present situation is unworkable because of Section 1706, what can be done for the technical services industry? It is time for Congress to restore to our industry - the only industry presently excluded - the protections of Section 530 which were taken from our industry in 1986. This may also require a transitional provision to deal with all that has happened since 1986.

Would restoration of a "safe haven" for the technical services industries be "special relief"? Absolutely not Restoration of a "safe haven" for the technical services would simply give our industry the same kind of protection already available to small businesses in every other industry. All industries should enjoy protection from arbitrary IRS action when they use the services of self-employed workers. Repealing Section 1706 is not "special interest" legislation.

How much support is there for changing Section 1706? The support to eliminate Section 1706 is overwhelming and continually growing:

> There is widespread support in our industry, including from the American Consulting Engineers Council, the Black Data Processing Associates, the Computer Software Industry Association, the Data Processing Management Association, the Independent Computer Consultants Association, the Institute of Electrical and Electronics Engineers, the Information Systems Consultants Association, the National Association of Computer Consultant Businesses, the National Association of Women Business Owners, the National Writers Union, Professional & Technical Consultants Association, the Technical Consultants National Association and others.
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> In 1987, the U.S. Small Business Administration stated that the absence of "succinct guidance alone argues most effectively for the repeal of Section 1706."
>
> As stated above, in 1991 the Treasury Department concluded that the reach of Section 1706 is "difficult to justify on equity or other policy grounds."
>
> In November 1992 the House Government Operations Committee, after a detailed study and hearings, recommended in House Report No. 102-1060, p. 15 that "the limited exception from Section 530 protection for certain technical service workers, commonly referred to as Section 1706, should be repealed."
>
> In 1994, a White Paper issued by the prestigious, non-partisan American Tax Policy Institute concluded that "the original basis for [Section 1706] enactment has been refuted" and urged its repeal; "There is no justification to support the exclusion of three party technical service workers. Their exclusion merely serves to complicate the law."

THE WALL STREET JOURNAL WEDNESDAY, APRIL 7, 1993

The IRS vs. the Self-Employed

By JAMES BOVARD

The Internal Revenue Service is carrying out a sweeping campaign to slash the number of Americans permitted to be self-employed—and to punish the companies that contract with them. The IRS's attack has devastated thousands of small businesses and is undermining high-tech industries, the health-care industry and even freedom of religion. IRS officials indicate that more than half the nation's self-employed should no longer be allowed to work for themselves.

This controversy originates in arcane federal regulations on the proper classification of workers. If a person is an employee, the employer must withhold all of that person's payroll taxes and remit them to the IRS, pay half of the employee's Social Security taxes and all of the unemployment insurance tax. But if an individual is an independent contractor, a business need only file a Form 1099 with the IRS reporting how much it paid that person, and the contractor pays his taxes directly to the IRS.

The IRS has long sought to forcibly reduce the number of self-employed Americans and maximize the number subject to tax withholding. The IRS enforcement campaign is targeting businesses with less than $3 million in assets—in most cases businesses without in-house counsel that cannot afford a lengthy court fight. The House Government Operations Committee concluded in a report in November that "IRS enforcement activities [on independent contractors] present small business taxpayers with a veritable nightmare of problems and policies that defy common sense."

Master and Servant

The IRS bases its classification decisions primarily on a list of 20 questions on the relationship between the employer and the contractor-employee. These questions are derived from common law precedents dating to the Middle Ages. An assistant U.S. Treasury secretary admitted in 1981 that the common law employment test was "developed centuries before the income tax to determine the rules of the doctrine that the master is liable for the torts of his servant." A 1991 Treasury Department report conceded that "the common law tests . . . lack precision and predictability" and in many cases do not "yield clear, consistent or satisfactory answers."

Once an IRS agent announces that a company has misclassified its employees (as happens in nine of 10 audits), the company often faces a staggering tax bill—largely because the IRS intentionally forces businesses to double-pay taxes already paid by independent contractors. The House Government Operations Committee noted: "The assessments are based on the use of preset mandatory formulas which even the IRS admits result in double tax collections. These back tax assessments have been responsible for putting a number of those businesses out of business." IRS agents have assessed more than $500 million in penalties and back taxes since 1988 (averaging $68,000 per company) and forced businesses to reclassify over 400,000 independent contractors as employees. (The IRS is now "converting" almost 2,000 independent contractors into employees each week.)

> *The IRS enforcement campaign is targeting businesses with less than $3 million in assets—in most cases, businesses that cannot afford a lengthy court fight.*

These businesses, in most cases, have not broken any clear law or manifested any intent to dodge taxes. Harvey Shulman, counsel for the National Association of Computer Consultant Businesses, observed: "I have had grown men and women—40 or 50 years old—cry on the phone to me, telling me that their marriage is threatened, they are seeking counseling, all because the business that they built up in the last 15 years of their lives—the house and other things they've earned from the fruits of their labor—is all threatened by this IRS employment classification audit. They ask me, 'What did I do wrong? Why am I being persecuted?'"

Many IRS officials threaten harsh penalties to coerce businesses to sign agreements promising not to use independent contractors in return for a reduction or waiver of the taxes and penalties. Such perpetual cease-and-desist orders may be appropriate when the government is dealing with wife-beaters or child molesters, but they are bizarre when it is seeking a pretext to permanently control the day-to-day operation of small businesses.

One industry that is especially hurt by the IRS crackdown is health care. Marc Catalano, president of the Private Care Association, an association of health-care agencies, accused the IRS of following a "search and destroy posture with respect to businesses that use independent contractors." Comprehensive Care Corp. was hit in 1991 with an IRS demand for $19.4 million in back taxes and penalties for treating psychologists and physicians as independent contractors.

John Bailey, a psychologist at the Family Therapy Center of Madison, Wis., complained to a congressional committee last August that his clinic "has come under attack. . . . The IRS methods have been too subjective, applied with ferocity and arbitrariness, and have caused untold grief for us and other well meaning small businesses." Mr. Bailey reported that the IRS "attack has threatened the very survival" of several Wisconsin clinics.

The IRS tried to penalize several Pennsylvania corporations for paying dentists as independent contractors instead of employees. But the Pennsylvania Dental Board had warned the corporations that it would be illegal under state law for the corporations to hire dentists as employees since the corporations themselves were not licensed to practice dentistry. A federal judge threw out the IRS's case in 1991.

The IRS is launching a high-profile assault on the use of independent contractors in Hollywood. The IRS began a similar crackdown on the Minnesota film industry last year. One Minnesota film producer complained to a local magazine that IRS agents "want me to classify a lighting tech who works for two hours and who I never see again as a part-time [employee]. That's absurd."

In some regions, IRS officials have ordained that all United Methodist ministers must be reclassified as employees. The Rev. Robert McKibben of Alabama informed the House Ways and Means Committee that he was told by an IRS examiner that "all ministers" are "statutory employees." Mr. McKibben informed the IRS agent of a U.S. Tax Court decision upholding the self-employment status of United Methodist ministers, but the IRS official said he was not bound by the ruling.

Mr. McKibben observed that the systematic misclassification of ministers "results in . . . the IRS dictating to the church the type of relationship they must have." Craig Hoskins, counsel for the church, estimated that more than 1,000 Methodist clergymen have faced IRS audits over their employment status. (The IRS has not yet attempted to impose penalties on God for not withholding taxes from the ministers' pay.)

High-tech industries have probably been hit hardest by the IRS's crackdown. In 1978, Congress enacted a provision to prevent the IRS from penalizing companies that had a "reasonable basis" for classifying people as independent contractors. But in the 1986 tax act, Sen. Daniel Patrick Moynihan (D., N.Y.) slipped in an amendment—Section 1706—that revoked the "reasonable basis" protection for engineers, computer programmers and other technical service professionals.

A 1987 Data Processing Managers Association survey found that 74% of firms decreased their contracts made directly with independent technical service consultants as a result of Section 1706. Rep. Major Owens (D., N.Y.) said last year that "many African-American computer programmers and analysts have had the door to self-employment slammed in their faces because of Section 1706."

IRS agents are often heavy handed in how they carry out employment tax audits. IRS officials have encouraged private companies to secretly betray their competitors. At a 1990 meeting in California, an IRS agent distributed "snitch sheets" to business people and asked them to make allegations of illegal independent contractor use by other companies. The IRS agent told attendees to mail the completed snitch sheets to him in unmarked plain envelopes and promised to follow up all leads.

Tax Dodging

The IRS estimates that 3.4 million Americans now working as independent contractors should be reclassified as employees. The Small Business Administration says that there are roughly five million independent contractors. Thus more than half of all the independent contractors in the U.S. could be forced to find a boss.

The IRS justifies its crackdown because some of the self-employed dodge taxes. But the Treasury Department concluded in a 1991 report on technical service workers: "Misclassification of employees as independent contractors increases tax revenues . . . and tends to offset the revenue loss from undercompliance by such individuals, because direct compensation to independent contractors is substituted for tax favored employee fringe benefits."

The IRS apparently believes that payroll tax withholding is more important than Americans' freedom of contract. Being self-employed and starting one's own business have long been part of the American Dream. But the IRS has apparently decided that it can no longer afford to permit others to pursue their dreams.

Mr. Bovard, an independent contractor, writes frequently on public policy.

Ms. DUNN. Thank you, Mr. Shulman.

We will start with questions from Mr. English, please.

Mr. ENGLISH. Thank you, Madam Chairman.

Dr. Lawlor, thank you for coming down from northwestern Pennsylvania to testify on the one aspect of the legislation that we are considering, and we very much appreciate your perspective on this.

Having been in higher education for a long time, working for a university that provides affordable, higher quality education in a way that many people in my district benefit from participation in Edinboro University who otherwise could not afford higher education, what impact does paying, say, a capital gain on a prepaid tuition program have on the affordability for these kids?

Mr. LAWLOR. Congressman English, being that many of our students come from working families, I feel that the capital gains would probably be pretty devastating and, in fact, families may not elect to participate in this kind of plan to begin with and therefore are going to tend to look for other sources of aid, perhaps through State or Federal loans or grants.

In effect I believe that this bill really would help students and their families to take the long view and plan for a college education to benefit both of them, but also, in the end, the entities incurring those grants and loans.

Mr. ENGLISH. I have run into many constituents who have confirmed that their reluctance to participate in the TAP is based on this expected tax liability. Edinboro receives a substantial subsidy from the State, as does the rest of the State system of higher education, does it not?

Mr. LAWLOR. That is right.

Mr. ENGLISH. That allows you to provide tuition at an affordable rate, like any other State school around the country.

Mr. LAWLOR. Right. Currently, I believe that rate is—about 49 percent from the State.

Mr. ENGLISH. Mr. Roberts, as I understand your testimony, you discuss some market-damaging effects from this legislation, including things like swelling budget deficits and jobs lost. Can you quantify any of that, from this narrowly crafted bill, that is aimed at a specific range of current State programs?

Mr. ROBERTS. Well, if you begin to offer tax-exempt obligations in the marketplace that have a yield that is comparable to treasuries or corporate obligations, the other tax-exempt bonds in the marketplace will have to seek that level to compete.

Mr. ENGLISH. I understand that, Mr. Roberts. I am curious, though, if you can quantify, since this is such a narrowly crafted tax bill which was done so for minimal revenue loss. The expected universe of people participating in it is not a large one. Is it really going to have that kind of crowding-out effect?

Mr. ROBERTS. I believe when you have that sort of tax advantage that other States might be compelled to offer such a product and there will be more obligations in the marketplace. Florida already has $1 billion in obligations in the marketplace. If their product is tax exempt and they issue $1 billion in municipal bonds a year, I believe it will cause a rise in those municipal bonds of many basis points, which will have millions of dollars in higher capital costs to the States and municipalities.

Mr. ENGLISH. OK. You are concerned then that this is going to have a dramatic effect on the cost of capital, even though it has been narrowly crafted.

Let me ask you, do you have a problem—and knowing you are currently suing Florida and trying to knock their program out, do you have a problem with the idea of subsidizing these kinds of State programs? I mean, even as we subsidize higher education for State institutions?

Mr. ROBERTS. I believe that we should maintain a level playingfield. Either they are all taxable, including the private sector, or you provide tax incentives across the board. Otherwise, you are going to cause tremendous distortions in the marketplace.

Mr. ENGLISH. I want to thank you for coming in with a specific alternative proposal which appeals to me because it is broad based, but how much is it going to cost? Do you have any sense, revenue lost?

Mr. ROBERTS. What is the revenue estimate on your proposal?

Mr. ENGLISH. On your proposal.

Mr. ROBERTS. On the American dream savings account?

Mr. ENGLISH. No, on what you propose to do with the American dream savings account.

Mr. ROBERTS. I am not sure it will impact it, the revenue estimate, one bit.

Mr. ENGLISH. I would be happy to take a look at your proposal, and I appreciate your being here to testify. I obviously disagree with your objection to providing this kind of a tax preference to State programs that I don't think were originally intended to be taxed under the Federal code, but I appreciate this puts you under some competition.

Madam Chairman, I thank you for the opportunity to question these witnesses.

Ms. DUNN. Thank you, Mr. English.

Are there other Members of the Ways and Means Committee who wish to question the witnesses? Mr. Ford.

Mr. FORD. Thank you, Madam Chairman. I will be very brief.

Just picking up where Mr. English left off, Mr. Roberts, the cost estimates on your proposal versus that of Dr. Lawlor's, even though Mr. English has indicated that it is narrowly pointed in the direction, can you just briefly explain your proposal. I am not sure that this is a rifle shot because this certainly can be opened up and may be made generic. States can easily come within the guidelines of the legislation Dr. Lawlor supports.

The American dream savings account for higher education is something that we will continue to examine closely. How do you compare Dr. Lawlor's bill with your proposal now? What is the distinct difference between those proposals regarding their impact on those seeking higher education?

Mr. ROBERTS. Thank you, Mr. Ford, for that question.

The American dream savings account probably has the latitude to allow a State prepaid tuition contract to be an eligible investment. It could be clarified slightly in the legislation, but I believe it now has that latitude.

The American dream savings account has a contribution limit of a couple thousand dollars a year, whereas Mr. English's proposal,

there is really no contribution limit. Mr. English's proposal is really in many ways a giveaway to the rich because you can put just as much money in as you like and the wealthier person can put in more money than the less wealthy person.

Mr. English's proposal is a big government proposal. It increases the size of State governments. The American dream savings account is more of a private sector initiative where you don't increase the size of government but you are able to cultivate thrift among college savers.

Mr. English's proposal would end up being cross-subsidized by States who don't have such a program. That is, say New Jersey, which currently doesn't want a big government, may not want a big government solution, might end up subsidizing, say, the taxpayers of Pennsylvania or, specifically, the people who are participating in that program.

Those are, basically, the differences. The American dream savings account is less tax regressive, doesn't cause the cross-subsidization, and isn't a big government proposal.

Mr. FORD. Will the States have to assume some of this responsibility under Mr. English's proposal?

Mr. ROBERTS. Oh, the States would create government-sponsored enterprises, like government-sponsored banks or government-sponsored mutual funds. They call them prepaid tuition trusts. They would create those because they would have a significant tax advantage over all the private sector competitors; and may feel compelled to create those sorts of institutions. It would create a burden on the States to administer such enterprises.

Mr. FORD. Thank you very much.

Ms. DUNN. Thank you, Mr. Ford.

Mr. Payne.

Mr. PAYNE. Thank you very much, Madam Chairman. I want to thank all the witnesses.

I just had one brief question for Mr. Shulman about section 1706. In your testimony, you stated that when this action was taken in 1986, that the estimate at that time was that some $12 million would flow into the Treasury each year as a result of doing this. I suppose the thinking at that time was that there were revenues that were being missed, that somehow this system would ensure that those taxes would be paid, is that correct?

Mr. SHULMAN. I think that is basically correct. The revenue estimate has actually been something that has been bounced around quite a bit. At that time, the difference between the Social Security rate paid for employees and that paid by self-employed workers was different. That was one component of it. There was also some belief that some revenue was lost by simple nonpayment.

But when the Treasury Department came out with its study in 1991, Treasury concluded that when you look at employees and independent contractors, at least in our industry, different things offset one another.

For example, employees get a lot of tax-free fringe benefits. They get a lot of things that are never taxable. When independent contractors in our industry pay for those things, they pay for them with aftertax dollars; also Treasury noted the FICA rate and the SICA rate were equalized. Treasury basically concluded that there

ought to be pretty much revenue neutrality in our industry when someone works as an independent versus an employee. That information was not known back in 1986.

Mr. PAYNE. Had that information been known in 1986, the revenue estimate would have been zero.

Mr. SHULMAN. I believe it would have been zero. In fact, the Office of Management and Budget and the Treasury Department back then estimated the revenue might be zero to $5 million gain "at best," and I think "at best" is exactly "the best" it would be.

Mr. PAYNE. The policy reason for doing this was to raise revenue?

Mr. SHULMAN. The policy reason at the time was it was a revenue offset for another provision that was taken out of the bill. There was some concern by some individuals back then that computer programmers and engineers were really tax cheats, that they all drive fancy cars and they take lots of deductions and they don't pay their taxes. There was never any study done, there were never any hearings, nothing ever was done to look into this. It was a floor amendment in the Senate.

Interestingly, it was the Treasury report that, when it looked at the data, found that the tax compliance in our industry was much greater and much higher than industries that still enjoy the safe haven.

Mr. PAYNE. The Treasury has essentially refuted the estimate of $12 million. And if the purpose of the section was to raise the $12 million, the conclusion would logically be that there is no reason why this provision should be in the Tax Code.

Mr. SHULMAN. I agree that is logical, Congressman.

Mr. PAYNE. Thank you very much.

Mr. SHULMAN. Thank you.

Ms. DUNN. Thank you, Mr. Payne. And thank you, gentlemen.

This Committee will stand in recess until 10 a.m. tomorrow morning, at which time this hearing will reconvene.

[Whereupon, at 1:01 p.m., the hearing was adjourned, to reconvene on Wednesday, July 12, 1995, at 10 a.m.]

MISCELLANEOUS TAX REFORMS

WEDNESDAY, JULY 12, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

Chairman ARCHER. The Committee will come to order.

Today we continue with our hearings on miscellaneous tax reform, and our first witness, if he is here, is Senator McConnell.

I do not see Senator McConnell, so we will postpone his testimony until his arrival, and in the meantime, we are pleased to hear from our former colleague on the Ways and Means Committee, the gentleman from Louisiana, Mr. Jefferson.

Jeff, you know the rules here. You can put your entire printed statement in the record without objection, and if you would like to proceed in oral summary, we would be pleased to hear your suggestions.

STATEMENT OF HON. WILLIAM J. JEFFERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. JEFFERSON. Thank you, Mr. Chairman. It is good to be back in this Committee room, if only this time as a witness.

I hope to work closely with you and with the Committee and with my colleagues—one from Louisiana I see has arrived—on this legislation which I am going to discuss very briefly, which does four important things.

First, it helps the Federal Government to continue its low-income housing policy in a very important way. Second, it serves to save the Federal Government money as a second goal. Third, it reinvigorates the real estate market from the point of view of investors, developers, and owners. And fourth, it will help to revitalize communities.

I am going to summarize my discussion and ask that my statement be submitted in the record.

The bill addresses a well-recognized need—that there is a crisis in the existing inventory of low-income housing that is privately owned but insured and assisted by HUD, the Department of Housing and Urban Development. There are projections that there can be defaults in this area that could end up costing the Federal Government some billions of dollars, some as high as $10 billion.

This bill permits that projects with a majority of low-income housing tenants, which projects are insured by HUD, are eligible for assistance.

In a nutshell, here is what the bill does. Right now, if you have a housing development in a low-income area, let us say, with low-income tenants in it, and you want to dispose of it, there is no market for it; and there is no market for a number of reasons. The 1986 tax law made it less attractive to own these properties, and because there is no market for it, the projects continue to deteriorate because there is no incentive to invest in them. The result is that the tenants have a poor place to live; the owners have a project for which there is no market; communities deteriorate; and in the end, the Federal Government has to pick up a lot of the default.

So, we make a few changes here. The two most significant ones are that we set up a straight-line depreciation method for 15 years, instead of 27.5 years, which it presently is, and we entitle these investors to some relief from the passive loss rules.

The benefit is going to be that for those owners of these properties, after this is put in place, they will have an incentive—they will only get the benefits of this bill, Mr. Chairman, if they put their own money in as well. This induces them to make private investment into these properties for which, afterward, they receive these tax incentives and deductions, and the depreciation accelerated as it is here, straight line, and they then have an incentive to put in their money.

This is only going to go to new owners. People who own property now are not going to get the benefit of it. The benefit they will get is that they will have a market to exchange property in. Once they are able to find someone who is willing to take advantage of these inducements and to take this property on, they will pay a capital gains tax which in effect will pay for the whole bill.

If you look at the fiscal notes on this, you will see that over 5 years, this bill costs $80 million, yet it stands to save the Federal Government billions of dollars from defaults that may occur.

We asked the Chairman of the Banking and Housing Committee, Mr. Lazio, who is working on important legislation that is going to reduce the participation of HUD and the Federal Government in this area, whether this was a good complement to what he was aiming to do. You may recall, Mr. Chairman, that he wrote a letter to you and to Mr. McCrery a few weeks ago saying that he thought this legislation would be a good complement to what he is trying to do in his Banking Committee work.

I think it is consistent with the goals and objectives of the Banking Committee Chairman, and Senator D'Amato is a cosponsor of the companion legislation in the Senate, so this bill does have bipartisan support.

In the end, I think if this Committee sees fit to pass it, it will achieve the four objectives we have in mind, which I shall just restate and then conclude.

It will, first off, potentially save the Federal Government tens of billions of dollars in defaults. Second, it will create for the first time in many years, at least since 1986, a real vital market in low-income housing transactions for those who own the properties and

those willing to purchase them. Third, it will revitalize communities that are now being run down because there is no incentive for owners to invest in these properties, and there is not an exchange going on, so they are just deteriorating. In the fourth place—and perhaps it goes in the first place—it will continue to enable the Federal Government to meet its objective of giving low-income persons the opportunity for decent housing, at a cost that the government can afford.

With those objectives, Mr. Chairman, I would submit that this bill is one that I think this Committee ought to pass and ought to embrace, because I think it meets the objectives of this Congress, particularly the objectives of this new Congress, to save money for the Federal Government, to meet important goals of relying on private investment as leverage to move Federal policies along, and of revitalizing communities with some private sector capital.

With that, I would yield my time and ask the Committee for its careful consideration of this bill and, ultimately, its passage.

[The prepared statement follows:]

Statement on H.R. 931, The Low-Income Housing Preservation Act
by
Congressman William J. Jefferson

Thank you for the opportunity to speak for a few minutes about H.R. 931, the Low-Income Housing Preservation Act. The bill addresses the widely-recognized crisis in the existing inventory of low-income housing that is privately owned, but insured and assisted by HUD. This inventory of low-income-housing is aging. Many of the projects are at least 20 years old and are not receiving the additional private capital they need. These projects are badly needed to meet the housing needs of low-income tenants. They also represent a major investment of the federal government. If these housing units are allowed to fail, the federal government will suffer a significant financial loss as the insurer of the mortgages on the projects.

H.R. 931 makes some limited changes in the tax treatment of these projects to address this pressing problem. Projects participating in several specific HUD programs that have a majority of low-income tenants would qualify. Altogether, there are almost a million units, located in every state of the union that would be eligible for the bill's benefits. Investors who purchase and restore qualifying projects will be entitled to deduct the

property over 15 years, instead of 27.5 years, and they will be entitled to limited relief from the passive loss rules. This benefit will continue only so long as the project continues to serve a majority of low-income tenants. Whenever investors sell their interests in the project, they will pay capital gains taxes on their investments. Additionally, a variety of safeguard provisions will insure that the bill's incentives will remain carefully targeted and limited.

I am grateful that six members of this committee have co-sponsored the legislation, and that there are some 39 co-sponsors from both parties. I hope that the Committee will act favorably on this bipartisan legislation, because under current budgetary and industry conditions, this bill makes especially good sense. Here are a few of the reasons:

* *H.R. 931 builds on the success of the Low-Income Housing Tax Credit in leveraging private capital and initiative. Since the 1986 Tax Act, the tax credit has proved a very successful way to encourage private construction of new low-income projects. But the tax credit has had little or no applicability to the preservation of existing projects. In my state, for example, in 1994 approximately 1.11% of*

the value of the tax credits were made available to the kind of projects that would benefit from this bill. The history of the tax credit suggests we can have similar success in the area of existing low-income projects. H.R. 931 will not interfere with the continued effectiveness of the tax credit program, but it follows the precedent set by that law, and it is fully consistent with this Committee's long-standing commitment to providing incentives to encourage the private sector to provide low-income housing.

* *H.R. 931 will reduce the considerable expense the U.S. government will have to incur if nothing is done, and some of these projects default on their HUD-insured mortgages. Recently, I have had the chance to talk personally with Chairman Lazio about the work he is doing in the Banking Committee to reform HUD's multifamily housing programs. He views H.R. 931 as an important complement to his own work because in future years there is inevitably going to be less direct HUD assistance to these projects. There is going to be more need for the projects to compete in the market place for tenants. By enhancing the physical and financial condition of these projects,*

the bill will ease the transition of owners and tenants alike to the new HUD policies, and reduce the number of defaults. [You may recall, Mr. Chairman, that Mr. Lazio wrote to you last month in support of the bill, and I would ask consent to put that letter in the record.] I would also add that on the Senate side, the Chairman on the Banking Committee, Mr. D'Amato, is a co-sponsor of the companion Senate bill.

* *H.R. 931 is cost-effective. The Joint Tax Committee has estimated that the bill would cost a total over the first 5 years of $86 million. The bill provides for a deduction, and not a credit, so that when the project is eventually resold, the Treasury will recoup lost revenues in the form of capital gains taxes. At the same time, it is evident that the bill would save many times this amount in claims against the HUD insurance fund. Even before taking into account some of the proposed reforms under consideration in the Banking Committee, HUD estimated that it would lose some $10 billion in multifamily loan default over the next 6 years. H.R. 931 will reduce the expense to the government of mortgage defaults, and increase the amount the*

government can recoup when owners do default. Finally, it is just common sense and costs generally less to save the existing projects and the government's ivestment in them rather than let the current housing inventory deteriorate until the government must help replace the housing units at great expense.

* *H.R. 931 will have a direct and beneficial effect on housing conditions in many areas of the country. By improving the projects themselves, the bill will have a significant effect on the living conditions of the tenants in the projects. I have seen the need for new capital to improve the condition of these projects in my own district, and I am confident that the same pressing needs exist in the districts of many members of this committee. By improving the projects, the bill will also improve the condition of the neighborhood and the overall quality of life for residents of the areas. Many of the millions of individuals living in theses units are elderly or disabled. The bill will reduce the number of these tenants who are forced to move because the projects are abandoned, or they are no longer able to afford the rents in light of the cutback in the level of HUD assistance.*

* *H.R. 931 offers a reasonable solution to the problem faced by a significant number of investors who invested in projects before the sweeping changes made in the 1986 Tax Act, and who are now locked into the properties without the practical ability to sell their interests. Under current market conditions, should the investors try to sell, they would raise less in cash than they would owe in taxes due to the very low tax basis the investors have in the property. Very few if any owners are prepared to sell their interests under those circumstances. H.R. 931 offers a practical way to address this problem, without actually forgiving any taxes an investor may owe.*

In short, Mr. Chairman, I believe this is a sensible solution to a serious problem. Please let me know if I can provide you with any additional information. Thank you for your attention, and for holding this hearing.

Chairman ARCHER. Mr. Jefferson, thank you for a very thoughtful presentation.

Our next witness is a well-respected Member of the Senate, the Senator from Kentucky, Mr. McConnell. You may proceed, and if you wish to have your entire written statement inserted in the record, without objection, we will do so, and we would be pleased to hear your oral presentation.

STATEMENT OF HON. MITCH McCONNELL, A U.S. SENATOR FROM THE STATE OF KENTUCKY

Senator MCCONNELL. Thank you, Mr. Chairman. I appreciate the opportunity to be here, and I will be very brief. I am also pleased to see my Kentucky colleague, Jim Bunning, here.

Mr. Chairman, the facts are clear. Education costs are outpacing average wages, and this has created, obviously, a barrier to attending college. Throughout the eighties, education costs have risen by over 8 percent per year, or roughly double the rate of inflation. In 1994 the average tuition in America rose by 6 percent. It was also the smallest increase since 1989, according to the College Board. In Kentucky, tuition rocketed 11.2 percent at the University of Kentucky and the University of Louisville in 1993.

As tuition continues to increase, so does the need for assistance. In 1990 over 56 percent of all students accepted some form of financial assistance, and the statistic was even higher for minority students. It is increasingly common for students to study now and pay later. In fact, more students than ever are forced to bear the additional loan costs in order to receive an education. In 1994 the Federal education loan volume rose by 57 percent from the previous year. On top of that, students have increased the size of their loan burden by an average of 28 percent.

Mr. Chairman, not only are more students taking out loans, but they are taking out bigger loans as well. This year, nearly one-half of the college graduates hit the pavement with their diplomas in one hand and a stack of loan repayment books in the other.

I believe we need to reverse this trend by boosting savings and helping parents meet the educational needs of their children before they enter college. I have introduced in the Senate S. 386, a bill that will make changes to the Tax Code, maximizing the scope and the investment in State-sponsored education savings plans. This legislation has been endorsed by the National Association of State Treasurers, the National Association of State Scholarships and Grant Programs, and Kentucky Advocates for Higher Education.

This legislation, which I hope this Committee might see fit to make part of some tax measure coming out of Ways and Means, would permit parents to contribute up to $3,000 annually in aftertax dollars to State-sponsored plans. This amount will be indexed to match the annual growth in education costs.

The real benefit of this program will allow earnings to accumulate tax free when used to meet education costs. Any earnings not used for educational purposes will be taxed at the student's individual rate. I believe this will provide a significant benefit to families and correct, at least in this particular instance, the unfair tax discrimination toward savings.

Under this plan, participants do not have to be rich to benefit. In fact, the average monthly contribution in my State is just $47.22. This proposal rewards those who are serious about their future and who are committed over the long term to the education of their children.

For the more than 30 States that have established savings programs, whether they are prepaid, savings or bond programs, this legislation will provide tax-exempt status to the organizations that administer these programs. In November 1994, the U.S. Appeals Court in Cincinnati ruled that the Michigan Education Trust is not subject to Federal income tax. Although the circuit court was quite clear on this issue, it is my understanding that the IRS is looking for a different avenue to tap this growing investment pool.

This tax designation will serve two purposes. One, it will send a clear message regarding each organization's mission to help families finance a child's education. Second, it will reduce the administrative expenses, thus increasing the investment in education.

Mr. Chairman, I accept your invitation to put my full statement in the record, but encourage the Committee to take a look at this. I understand Mr. English is promoting legislation very similar to this. I certainly want to congratulate him, and he is certainly in a good position, being on the Committee, to maybe convince everyone to include this in some package that emerges from this Committee.

I also want to say how good it is to see my colleague Jim Bunning again. I appreciate so much this opportunity to appear.

[The prepared statement follows:]

McCONNELL STATEMENT
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON S. 386
THE HIGHER EDUCATION TRUST FUND SAVINGS ACT
JULY 12, 1995

Mr. Chairman, and Members of the Committee, I appreciate you taking time to hold these hearings and greatly appreciate you allowing me to testify on what I feel is a very important matter -- the education of our children. Unfortunately, the dream of a college eduction is simply out of reach for many who can not meet the skyrocketing costs of higher education. I am sure all of my colleagues will agree that this nation's future success is dependent on the education of all our children today.

The facts are clear. Education costs are outpacing average wages and this has created a barrier to attending college. Throughout the 1980's education costs have risen by over 8 percent per year, or roughly double the rate of inflation. In 1994, the average tuition in America rose by 6 percent. It was also the smallest increase since 1989, according to the College Board. In Kentucky, tuition rocketed 11.2 percent at the University of Kentucky and the University of Louisville in 1993.

As tuition continues to increase, so does the need for assistance. In 1990, over 56 percent of all student accepted some form of financial assistance and the statistic was even higher for minority students. It is increasingly common for students to study now, and pay later. In fact, more students than ever are forced to bear the additional loan costs in order receive an education. In 1994, federal education loan volume rose by 57 percent from the previous year. On top of that, students have increased the size of their loan burden by an average of 28 percent. So, not only are more students taking out loans, but they are taking out bigger loans as well.

This year, nearly half of the college graduates hit the pavement with their diplomas in one hand and a stack of loan repayment books in the other. I believe that we need to reverse this trend by boosting savings and helping parents meet the education needs of their children before they enter college. I have introduced S. 386, a bill that will make changes to the tax code maximizing the scope and the investment in state-sponsored education savings plans. This legislation has been endorsed by the National Association of State Treasurers, the National Association of State Scholarships and Grant Programs and the Kentucky Advocates for Higher Education.

This legislation, which I urge this Committee to include as part of the Committee tax bill, will permit parents to contribute up to $3,000 annually in after-tax dollars to a state-sponsored plan. This amount will be indexed to match the annual growth in education costs.

The real benefit of this program will allow earnings to accumulate tax-free when used to meet education costs. Any earnings not used for educational purposes will be taxed at the student's individual rate. I believe this will provide a significant benefit to families and correct, at least in this instance, the unfair tax discrimination toward savings.

Under this plan, participants don't have to be rich to benefit. In fact, the average monthly contribution in Kentucky is just $47.22. This proposal rewards those who are serious about their future and are committed over the long term to the education of their children.

For the more than 30 states that have established savings programs -- whether they are prepaid, savings or bond programs -- this legislation will provide tax-exempt status to the organizations that administer these programs. In November 1994, the U.S. Appeals Court in Cincinnati ruled that the Michigan Education Trust is not subject to federal income tax. Although the Circuit Court was quite clear on this issue, it is my understanding that the IRS is looking for a different avenue to tap this growing investment pool.

This tax designation will serve two purposes. One, it will send a clear message regarding each organization's mission to help families finance a child's education. Second, it will reduce the administrative expenses, thus increasing the investment in education.

This legislation is not a funding cure but is a serious effort to encourage long-term savings, by eliminating the tax disincentive to do so. Aside from limited assistance through bond programs, we have done everything to encourage borrowing, thereby further escalating the cost of education.

I believe it is widely agreed that it is in our best interest as a nation to maintain a quality education system for everyone. We need to make a decision, however, on how we will spend our limited resources to ensure that both access and quality are maintained.

It is unrealistic to assume that the government can afford to provide for everyone. Therefore, the best option is to help families to reach the goal of a college education through savings.

The alternative option is to continue in our futile attempt to outpace the rising cost of education through subsidies and aid. More than likely, this would exacerbate the dollar chase, driving costs even higher. It is also important to note the tremendous burden borne by taxpayers as a result of the federal government guarantee of student loans. Between 1988 and 1993, the federal government, rather taxpayers, lost $14 billion to loan defaults.

Before I close, I would like to take a moment and acknowledge Mr. English for his efforts in the House to move this issue along. Although our bills differ slightly, I believe aspects from both bills can provide families with an incentive to save for education purposes which I believe is critical to the nation's well being.

I hope that Members of this Committee will carefully this issue and will work with me in helping families provide for their children's higher education.

Mr. Chairman, I ask that a copy of my bill be printed in the record. Again, I would like to thank the Committee for permitting me to testify today.

Chairman ARCHER. Senator, thank you, and again my compliments to both of you because I think you have both made some very constructive suggestions to this Committee.

I do want to ask you about a concept that seems to be afoot in this capital city now, and that is the concept of corporate welfare. I know that your leader, Mr. Jefferson, speaks of it frequently; the President has spoken of it in his budget. I am not sure what the definition is, but I am told the definition is any tax provision that is out of the ordinary and does not follow the norm.

Mr. Jefferson, as I understand your proposal, you want to give a special tax preference to certain business entities that put in low-income housing. Do you consider that to be corporate welfare?

Mr. JEFFERSON. No, sir. I think it is just common sense. We follow the policy in this Committee and in our government that if there are targeted activities that we want to provide incentives to see fostered, that one way we have thought to do that is through the Tax Code from time to time, in various special circumstances. There has been a goal, as we all know, of the Federal Government to try to see to it that there is a low-income housing market out there that works for low-income tenants. One way we have tried to do that is through the tax credit method which is on the books now, which is working really well, but it only works for new units.

In my State, only 1.1 percent of the units that got that tax credit were old ones. For existing units, there is a complete void. This brings some parity into that area, and no, it is not corporate welfare. There are going to be a lot of small people, first of all, a lot of small businesses, that are going to benefit from this that own just one or two units and cannot do anything with them. There will be some large concerns, also, but there will be many, many more smaller ones. There are millions of these across the country, and if you look at the list, in every State, many units will be affected.

No, sir, I do not believe that this would come under—I do not know what the definition is to begin with, but as far as I am concerned, I do not believe this is, and if it is, this is one we ought to do because it works for a lot of people.

Chairman ARCHER. Well, as I understand your response—and I am sympathetic to it—you are saying that if this Committee or the Congress elects to reduce the tax burden on certain operations within our society to achieve certain goals that are desirable, even though that creates something that is out of the ordinary in the way of taxation of businesses, then that is something we should consider, as I understand your response.

Mr. JEFFERSON. Yes, sir.

Chairman ARCHER. And that each of these instances where we have certain items in the Tax Code that are different from the norm, if they can be justified as bringing about the kind of result that we want to see in society, then that is something we should continue to pursue.

Mr. JEFFERSON. Yes, sir.

Chairman ARCHER. Senator McConnell, your suggestion, which is not for businesses but which is for creating an additional area where certain income, as we now classify it, would not be taxed, is in some ways similar to the deduction for home mortgage interest, which some people say is an unjustified preference under the

Tax Code. I do not want to put words in your mouth, but I assume your response would be similar to that of Mr. Jefferson, that where we can use the Tax Code to bring about desired results, that is an appropriate thing for us to do. Would that be a fair statement?

Senator MCCONNELL. Mr. Chairman, as long as we continue to tax income—something that I gather you think we ought to take another look at, and I am somewhat drawn to the suggestions that you have made, that maybe we ought not go at the business of raising revenue for the Federal Government the way we do—but as long as we continue to tax income, obviously, it seems to me we are going to, up here in this city and in this Congress, determine what kinds of activities we ought to encourage and what kinds of activities we ought to discourage. What I am saying is that as long as the business of earning income is a taxable event, it seems to me the business of educating our children is extraordinarily important, and we ought to favor efforts to save money to pay for the education of our children.

As long as the Code is going to be roughly similar to what it is today, I think these kinds of preferences are inevitable, and in many instances desirable.

Chairman ARCHER. Well, I thank both of you for your presentations.

Are there any other Members of the Committee who wish to inquire?

Mr. Bunning.

Mr. BUNNING. I would like to ask the Senator, do you know how many people presently take advantage of this in other States besides Kentucky?

Senator MCCONNELL. Congressman, I am not sure how many do. It is estimated by all of the organizations that support this legislation that if there were some preferential treatment at the Federal level, the participation would go up dramatically. Under the measures that I have suggested here, it is aftertax dollars; it is only the buildup that I would insulate against taxation. But I do not think we have a clear picture of how many are participating. All of the State treasurers feel that the number participating would dramatically increase if there were some tax advantage to doing so.

Mr. BUNNING. Do you know how much the proposal might cost?

Senator MCCONNELL. Yes. If you have the contributions in aftertax dollars, the best revenue estimate we have is $1.5 billion over 5 years, as opposed, for example, to the President's suggestion on television earlier this year which would have about a $23 billion bite.

Mr. BUNNING. In Kentucky, how many people are taking advantage of this now?

Senator MCCONNELL. I am sorry. We do not know the answer to that; we should, but we do not.

Mr. BUNNING. OK. Thank you for your testimony.

Senator MCCONNELL. Thank you, Congressman.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Mr. Chairman, I want to compliment Mr. Jefferson on his presentation this morning. I think the presentation that he gave us makes a lot of sense—common sense, as he put it.

Mr. Chairman, I have two letters that I would like to offer for the record, one from your good friend, Jack Kemp, and another from two Subcommittee Chairmen of the Banking Committee, Mr. Lazio and Mr. Baker. I think the thrust of both of these letters is that an ounce of prevention is worth a pound of cure; and unfortunately, in our static analysis that we use in this Congress, we are stuck with an $86 million cost of this legislation over 5 years.

However, if you read the two letters from Mr. Kemp and Mr. Lazio, you will see that what we are trying to do with this legislation is prevent the eventual default of a large number of instruments that are backed up by HUD and that could cost this government considerably more than the static analysis indicates the cost of this bill will be.

I urge the Committee to consider this legislation as we move forward.

Thank you, Mr. Chairman.

[Letters from Mr. Kemp, Mr. Lazio, and Mr. Baker follow:]

JACK KEMP
March 23, 1995

Honorable Bill Archer
U.S. House of Representatives
1236 Longworth House Office Bldg.
Washington, DC 20515

Dear Bill:

I want to urge you to act this year on an innovative tax proposal that would be a significant plus for the nation's supply of affordable housing, while obviating the need for much more costly alternative housing programs.

The proposal leverages private capital to fix-up and maintain a large category of multifamily rental projects serving low-income tenants. This inventory of privately-owned projects plays a vital role in the nation's overall efforts to meet the housing needs of low-income residents in Houston and in hundreds of other towns throughout the country. Yet these projects are aging, and the inventory is in crisis because it is not attracting the new private capital needed to rehabilitate and maintain the projects. In order to promote resumption of private investment in these projects, the proposal provides limited relief from the depreciation and passive loss rules for those projects that meet the bill's substantial criteria.

The Joint Tax estimated last year that the proposal would cost no more than $100 million in all over five years. It would pay for itself many times over, because it would allow Congress to eliminate existing or proposed HUD preservation programs that would cost much more, and that in my experience are not all that effective.

This is the kind of approach I believe we should be doing more to implement as Republicans. It places greater reliance on private initiative and the discipline of the market place, rather than government grant programs. It is cost effective. It would help cities rebuild, but it would not bail them out. It would demonstrate that a Republican Congress can find new and better ways to respond effectively to the needs of low-income members of the population. On this last point, it is my understanding that a majority of the Black Caucus co-sponsored the legislation in the last Congress. This included Charlie Rangel and all the other Black Caucus members of the Ways and Means Committee.

For your background, I have enclosed a summary of the proposal and its purposes. I look forward to calling you and talking with you further about it.

Very sincerely yours,

Jack Kemp

P.S. I'd be interested in your comments, as an old pal!

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
ONE HUNDRED FOURTH CONGRESS
B-303 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

June 8, 1995

Congressman Jim McCrery
225 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman McCrery:

We are writing to let you know of our interest, as members of the Banking Committee, in working with you on the Low-Income Housing Preservation Act (H.R. 931).

One of the key issues the Banking Committee faces as it wrestles with ways to restructure the Department of Housing and Urban Development (HUD) is how to treat the large inventory of privately-owned multifamily projects that are insured and assisted by HUD. A number of the projects are aging and at risk. It is perhaps inevitable that the owners of some of these projects will default on their mortgages in response to the variety of other changes we will be making in the HUD programs. The number of such expensive defaults would be reduced, however, if there was a way to attract additional private investment in those projects.

H.R. 931 uses limited tax deductions to encourage investors to purchase the older HUD-assisted projects, and to invest capital in them. At minimal cost to the Treasury, the approach proposed in H.R. 931 would help preserve and improve the stock of aging housing, reduce the number of mortgage defaults that occur, and increase the amount the federal government can recoup in the capital markets when defaults on insured mortgages do occur. By emphasizing enhanced reliance on the private sector, the approach in H.R. 931 provides an important complement to our own efforts to increase the cost effectiveness of our non-subsidized federally-insured multifamily housing programs.

As we continue to review H.R. 931, our staff intends to work with the staff of the Ways and Means Committee to ensure that the legislation is consistent with the changes we will be considering in the Banking Committee. But the overall approach is a promising one that we hope will receive your active support. We thank you for bringing this to our attention.

Sincerely,

Rick Lazio

Congressman Rick Lazio
Chairman, Housing and Community
Opportunity Subcommittee

Richard Baker

Congressman Richard Baker
Chairman, Capital Markets, Securities
and GSEs Subcommittee

Senator MCCONNELL. Mr. Chairman, if I may, I will just indicate to Congressman Bunning that we will have that figure for you later today in terms of the number of people currently participating in Kentucky and submit it for the record, if the Chairman will agree, and get it to your office.

Chairman ARCHER. Thank you. We will be pleased to receive it.

Senator MCCONNELL. Thank you, Mr. Chairman.

[The following was subsequently received:]

Mr. Bunning, it is my understanding that in Kentucky there are 2,137 participants in the Kentucky Educational Savings Plan Trust that was established in 1988. Participants of this plan range in age between 19 to 82 years old. As expected, the largest number of participants are the 40- to 49-year-old age group. It is no surprise since these individuals are parents of children preparing to enter college. In fact, the average age of the Kentucky plan beneficiaries is 9 years old.

I would also like to point out that not only do all age groups contribute, but families from all income groups participate as well. The largest number of participants report an annual gross family income of about $50,000. The lowest income reported by a Kentucky plan participant was just $4,000.

I believe these statistics clearly demonstrate that the Kentucky plan benefits all families who are committed to providing their children an opportunity to receive a college education. I would urge you to keep in mind that these families participate in the plan despite the fact that their contributions receive no Federal tax preference.

With regard to the Committee's question on national participation, I have been informed that those numbers are not currently available. However, prepaid tuition plans operated in Ohio, Florida, Michigan, Alabama, Alaska, Pennsylvania, Wyoming, and Massachusetts report that they represent over 400,000 participants.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Senator McConnell, I want to thank you for appearing here today. You have been a very, very effective advocate of the State systems of prepaid tuition. I agree with you.

My finding, having become involved in the issue, has been that these State programs do not work as effectively as they could in assisting particularly middle-class families in making college affordable and in planning for tuition.

I want to thank you for your efforts and get your comments on some testimony that we had yesterday from the president of the College Savings Bank of Princeton, New Jersey who, as you may know, has initiated a lawsuit against Florida to try to block their program as unfairly competing with the product which he offers in the marketplace. He described in broad terms the kind of tax bill that we have been talking about, and yours and mine differ in a modest way, as tax cuts for the rich, creating a tax advantage that would crowd out the municipal market, and also a tax break that would lead to massive deficits, including a substantial job loss.

Under questioning, he could not quantify that, but could you respond to these claims?

Senator MCCONNELL. Well, there is not any question it is not going to produce massive deficits. The State plans are targeted to meet State educational needs and cooperate with State schools to increase attendance. This is very narrowly targeted. Currently, Congressman, over 32 States operate plans that provide safe and viable investment vehicles for the colleges.

These plans maintain low operating costs to ensure affordability for everyone. Families can open an account with as little as $25 a

month. I mean, if this suggestion is going to be criticized as a break for the rich, then we are all rich.

In addition, the Kentucky plan offers an incentive through the endowment to students who remain in the State. This is clearly a program to benefit people of modest means, to give them a chance to get ahead of the curve and to give their children an opportunity to realize the American dream. I think the criticism is completely wrong-headed.

Mr. ENGLISH. Senator, I appreciate again your being here, and it has made no sense to me that a middle-class family, buying in advance a college credit, would have to pay a capital gains tax on the eventual appreciation of that credit. That is not what Congress had in mind. That may make sense to the green-eyeshade types over at Treasury. But I appreciate very much your involvement in this issue and thank you for coming today.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

Congressman Jefferson, I appreciate your being here today, and I appreciate your testimony. I do have a couple of questions on your proposal.

First of all, one of the things we have seen in low-income type housing is that sometimes, when they get breaks, then people turn around and end up charging higher than market rates in that area.

Are there any assurances in your bill that these tax credits will not go to give people breaks and then later, 3 or 4 years down the line, their rates actually end up not being just for low-income people, but they end up charging higher than market rates?

Mr. JEFFERSON. HUD has rules that govern this whole area of when it will provide insurance, for what types of developments, and what the rent rates ought to be. That is controlled by HUD. It would not be contained within this legislation, but that is a matter of the kinds of units that HUD will insure. I think that that will be protected in that way.

What we say here is that a majority of the units must meet those HUD requirements, so there could be no case where, if HUD were to continue to insure the property, it could get out of line with the low-income housing tenants.

Mr. ENSIGN. I guess the reason why I ask that question is because from talking to various people who were working on some of the HUD reforms, that is one of the problems with HUD currently, that people are either getting around the rules or that they were actually charging higher than market rates, and then when HUD threatened to do something to them, they would say, "Fine, we will just default on our loans."

Well, the Federal Government guaranteed those loans, and those places were not worth as much as the mortgages were. In other words, if they defaulted, the Federal Government would actually lose more money.

What I am asking is whether there is anything in your bill to assure we do not end up with that same scenario?

Mr. JEFFERSON. Let me explain just a little bit about it. What it would mean in this bill is that a new owner who had agreed to come in and make a substantial investment would then be eligible

for the deductions and the depreciation schedule that this bill provides for.

The old owner, the person who now has the property sitting there, maybe with the problems you are talking about, who is now headed toward default and who has done all sorts of machinations just to stay around and stay alive, that person gets removed from the scene and a new owner comes in, and the new owner has to put up his or her real money to attract the incentives of this bill. A majority of the tenants there, although not all of them, have to be eligible on a low-income basis under HUD rules.

While there is nothing in this legislation that says you cannot raise the rents or do this, that, and the other, that is not really what it is designed to do. That comes under Mr. Lazio's Committee and the work he must do to make sure there is no cheating under the low-income rules.

This is just a way of saying we are going to create a market for these properties that does not now exist. This market will drive the revitalization of these areas. It will depend upon private money to leverage the incentives, which is where I think we are headed in this country and in our government. We cannot keep putting money into projects, and it will be privately leveraged. And it will save the government in the end, hopefully, a huge amount of defaults that might otherwise occur.

That is what we are getting at here. I understand the problem you are pointing to, but that is Mr. Lazio's Committee that will have to tighten up that end of it.

Mr. ENSIGN. OK. Just real quickly, the other thing that I am very interested in—and I do not think it is addressed in your bill, and I do not know if there is any way that we can adjust this—home ownership and ownership in these types of units by the individuals themselves is something that I very strongly believe we should somehow encourage similar to "Habitat to Humanity." I would love to work with you on this bill, because the bottom line is that we are obviously trying to help low-income people be able to realize affordable housing, but beyond just paying rent, I would love to see them able to have a stake in the American dream, and if we could somehow coordinate that with your bill, I would like to work with you on that.

Mr. JEFFERSON. Well, thank you. I am very open to whatever suggestions you might make to improve the direction we are trying to head in, and I deeply appreciate your participation.

Mr. ENSIGN. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I want to associate myself with the remarks of Senator McConnell, as well as Mr. English, with regard to the matter that you have brought before us. The gentleman from Florida, Mr. Gibbons, and I have spoken on this on several occasions and are in sympathy with what we are trying to do, and perhaps we will be fortunate enough to make that part of the law this year.

I also want to take this time to tell Mr. Jefferson it is good to see him back in this room. He was certainly a valuable Member of

this Committee, and you look as good sitting there as you looked sitting up here. Welcome back.

Thank you, Mr. Chairman.

Mr. JEFFERSON. Thank you very much.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. One real quick question. Thank you, Mr. Chairman.

On your plan, Senator McConnell—we are talking about saving money for education, and I frankly am a very strong advocate for even a tax-deductible saving education plan to help parents pay for educating their children.

The 1986 tax law effectively got rid of the benefit of the uniform gift to minors because the tax law requires the tax on the income from the uniform gift to be a tax at the parents' rate rather than the child's rate.

Has there been any consideration, or have you considered anything whereby we might be able to change that Uniform Gift to Minors Act back for educational plans? In fact, we have a tax-free accumulation here, but it is only in a State-sponsored plan, and those State-sponsored plans are invested in fixed dollar return rather than the possibilities of taking a little bit more of a risk for a greater return.

Senator MCCONNELL. About the only thing we did in our bill, frankly, due to concerns about revenue loss, was to provide that if the funds were converted by the children to be used for noneducational purposes, the funds would pay taxes at the child's rate instead of the parents'.

Mr. HANCOCK. But as I said, in your analysis of this, have you considered any change in the uniform gift to minors as part of enabling people to accumulate money for their children's education?

Senator MCCONNELL. I have not, but I think that raises a much larger question I assume this Committee is going to address in the context of broader tax reform, and I think your point is extremely well made. We did not consider it in the context of this rather narrowly crafted legislation really designed to promote the use of these 30 some-odd existing State plans.

Mr. HANCOCK. I would like to have it on the record.

Thank you.

Senator MCCONNELL. Thank you, Congressman.

Chairman ARCHER. Thank you again, gentlemen.

Our next witness is a gentleman who is no stranger to this Committee. For a number of years, he was the Ranking Minority Member of the Committee, became President of the World Bank, and now has gone on to other, I am sure, halcyon activities.

We are delighted to have you back, Barber, Hon. Barber Conable, and you are no stranger to the rules of the Committee, so you may proceed at will.

STATEMENT OF HON. BARBER CONABLE, ALEXANDER, NEW YORK; FORMER PRESIDENT, WORLD BANK, AND FORMER MEMBER OF CONGRESS

Mr. CONABLE. Thank you, Mr. Chairman, Member of the Committee. I very much appreciate your holding these hearings.

I am here as an individual citizen in support of H.R. 1401, sponsored by Mr. Gibbons and Mr. Houghton. This measure has been around in one form or another since 1990, looking for a suitable vehicle. I understand the legislation you are considering might be a suitable vehicle, and I commend H.R. 1401 to your attention for that purpose.

Mr. Chairman, I do have a short written statement, and I would appreciate, if it pleases the Committee, that it be included in the record in its entirety.

Chairman ARCHER. Without objection, it will be entered in the record.

Mr. CONABLE. Thank you very much.

This has to do with the taxation of the employees of international institutions that are sited in the United States. The Bretton Woods agreement that set up the IMF and the World Bank in particular provided immunity from taxation in a general way. The courts have held that inheritance tax, however, is subject to taxation as the Congress may specify, and in 1988, in TAMRA, while the president of the World Bank slept, this Committee added some provisions to raise a very small amount of money where arithmetic appeared to be the motive rather than justice. The result was that the nonresident employees of international institutions that had previously not been subject to a punitive tax, as a result of the inheritance tax provisions, suddenly found themselves denied the full spousal marital deduction, found that their exemption was $60,000 rather than $600,000, and found that they were being taxed on the actuarial value of derivative pension benefits.

Let me explain the problem that that caused. If an employee had worked for the World Bank, for instance, for 15 years and was killed in a plane crash or got some exotic tropical disease in Africa, and his widow had derivative pension benefits and was, let us say, 35 years old, those pension benefits could amount to a lot of money. If she died the next day, she would still under TAMRA be taxed the full actuarial value of the pension benefits as of the date of the husband's death, and that could be a very large sum of money.

In any event, these foreign employees working for international institutions have G–4 visas which require them to be out of the country in 60 days. It meant that a spouse of such a deceased World Bank, IMF, or U.N. employee would have to borrow the money to pay the inheritance tax on a substantial assumed actuarial value of the derivative pension and the full appreciated value of any real estate they had purchased while working here in this country, and they had to do it on a pretty much crisis basis because they had only 60 days to get out of the country.

Now, this particular provision is a modest one; it does not change it all back to the way it was previously, but it does increase the spousal benefit for nonresident employees of international institutions from $60,000 to $600,000, thus giving them some reduction on what otherwise could be an almost confiscatory inheritance tax.

I hope the Committee can consider it favorably. It raises very small amounts of money for the Treasury, but it has greatly affected the ability of the World Bank to recruit in Japan and in Europe, and we are supposed to have employee representation on the

Bank staff or on the IMF staff equivalent to the ownership share of that country.

For instance, right now, 25 percent of the employees at the World Bank are American and therefore subject to normal American taxation. It should be only 17 percent, because that is the American ownership of the World Bank. It is very difficult to attract highly skilled, trained Japanese and Europeans to come here and work in Washington when they know in advance that they will be faced with this kind of an inheritance tax problem if something happens to them while they are working here.

Thank you.

[The prepared statement follows:]

Testimony of the Honorable Barber Conable Before the
House Ways and Means Committee of the
House of Representatives, U. S. Congress

Estate Tax Marital Credit For Certain Employees of International Organizations
July 12, 1995

My name is Barber Conable. I was a member of the U.S. House of Representatives from 1964 to 1984, during which time I served on the House Ways and Means Committee. In 1986, I was appointed President of the World Bank, and served in that capacity until September 1991. I remain keenly interested in matters before this Committee which affect the World Bank, other multilateral institutions and their employees, and, in this context, I appear before you today in my individual capacity to discuss certain aspects of U.S. estate tax law which have placed a disproportionate and unfair burden on certain employees of international organizations and their families.

Under its Articles of Agreement, the World Bank is mandated to recruit staff on as wide a geographical basis as possible," subject to "the highest standards of efficiency and technical competence." Consequently, a large number of World Bank employees are citizens of other countries who have come to the United States in order to work for the Bank at its headquarters in Washington while maintaining their citizenship in, and contacts with, their home countries.

In 1988, TAMRA changed the rules governing estate taxes in a way which has had a significant adverse impact on employees of the World Bank, the IMF and other international organizations who are present in the United States for purposes of international organization employment. TAMRA affected surviving spouses who are not U.S. citizens by denying them use of the unlimited marital deduction, which is otherwise available to U.S. spouses, and imposing estate tax on the full value of jointly held property passing to non-U.S. surviving spouses.

Often, the principal source of financial support for a surviving spouse of a World Bank employee will be the spousal benefit paid by the Bank's pension plan. Under the TAMRA amendments, the full actuarial value of the spousal pension benefit, payable over the lifetime of the spouse, may be subject to immediate estate tax even though cash may not be available to pay the tax and the value of the pension may be completely consumed during the remaining lifetime of the surviving spouse. Prior to TAMRA, the U.S. had never imposed estate tax on spousal pension benefits. Moreover, except to the extent that it can be established that the spouse contributed toward the purchase of the family residence, the full appreciated value of the family residence, also a noncash asset, may be subject to estate taxes. Even for modest and illiquid estates, the tax burden imposed on non-U.S. international organization employees may be substantial and much higher than where both spouses are U.S. citizens.

In the case of estates of non-residents, the rate of taxation was increased to nearly the same rate which applies to resident estates. However, for purposes of the unified credit, the exemption equivalent of $60,000 applying to estates of non-residents, compared to the $600,000 exemption equivalent for resident estates, remained unchanged. This change represented a significant tax increase on non-resident estates.

H.R. 1401 contains a provision introduced by Representatives Houghton and Gibbons which would significantly lessen the impact on all but the largest estates of international organization employees who are present in the U.S. on G-4 visas. This would be achieved by adoption of a marital transfer credit against the estate tax for estates of international organization employees and their spouses in an amount up to the equivalent of a $600,000 deduction. I urge the Committee to support this piece of legislation to diminish the unwarranted burden imposed upon international organization employees by TAMRA. Indeed, enacting this provision would be consistent with the United States' obligation, as host to the World Bank and other international organizations, not to place undue burdens on the organizations and their employees.

Chairman ARCHER. Thank you for your testimony. I appreciate your taking the time to explain this issue to the Committee.

Are there any Members who wish to inquire?

Mr. Houghton.

Mr. HOUGHTON. Maybe I should yield first to Mr. Gibbons, if that would be all right.

Chairman ARCHER. Go ahead.

Mr. GIBBONS. Thank you, Mr. Houghton. I am glad that you and I are cosponsoring this, and I am glad that you are the lead sponsor, because maybe now that it has a good lead sponsor, we will pass it. This is a serious piece of mischief that we did back in the eighties to some very fine people who did not deserve the kind of treatment we gave them, those employees who must come here because of the situs of their international job. These are international civil servants, and we have penalized them by the tax provisions that we have put on them.

I want to tell you, Barber, that I recognize every day that I sit in the Barber Conable seat here on the Ways and Means Committee—I feel honored to be in the position that you occupied so distinctively——

Mr. CONABLE. Gently, Sam, gently.

Mr. GIBBONS [continuing]. And with such great honor for so many years. I would ask that God give me the wisdom that he gave you to occupy this seat.

But Barber, I hope we can get it passed. I know that what you are doing is in the best interest of these institutions, and in just plain, simple fairness under our tax laws. I am glad that Amo and I are working together on this, and maybe we can get the Chairman recruited on this one, too.

Mr. CONABLE. Thank you, Mr. Gibbons.

I must say it seems like a modest matter, but recruitment is a very serious problem in international institutions at this point to get the skilled people you need, and quite frankly, the World Bank, to choose only one institution, one that I know something about, contributes a great deal to the Washington economic environment. It has a staff of over 6,000 people, three-quarters of them non-American, and they are very much concerned about the confiscatory nature of the current inheritance tax provisions.

We are not asking that they be put in the same position as American decedents, but only that the penalty on them for having come to work at an international institution be reduced.

Chairman ARCHER. Mr. Houghton.

Mr. HOUGHTON. If I could speak, Mr. Chairman, I would like to follow up on Mr. Gibbons statement. Barber, it is wonderful to have you here; you represent a lot, but one of the things that you do represent is a sensitivity to people's conditions, and I totally agree with you on this. Obviously, my name is associated here. But when we are going to consider ourselves an international nation, a host nation, we must look at the implications of that for the people. Whether it is in expenses, or whether it is in salaries, or whether it is in the beneficiary benefits such as we are talking about here, it makes a great deal of sense.

I am looking at the present law, which was written prior to 1988. This was costed out in 1993 as costing $12 million over a

5-year period. I do not know what it is now, but it is de minimis compared to what you are talking about in being able to attract people. As I understand it, it is not that we can willy nilly attract the people we want; there are certain percentage requirements by the World Bank from foreign countries which we must attract—isn't that right, Barber?

Mr. CONABLE. That is correct. We are supposed to have representation on the Bank staff equivalent to the ownership of the Bank. The United States has a 17-percent share, Japan has a 7-percent share; Britain, Germany, and France have about a 6-percent share each, and we are supposed to have that degree of representation on the staff. It is very difficult to achieve.

I must tell you that when I went there, I was much embarrassed to find that American representation was 8 percent above what it was supposed to be, and that meant that all my friends up here on Capitol Hill, when they sent me their uncles and their cousins and their aunts to be hired, I had to turn them down almost out of hand, simply because we were overrepresented by Americans on the staff at that time.

Mr. HOUGHTON. Just to conclude, Barber, and Mr. Chairman, it makes a great deal of sense; it has far greater implications than the dollars involved, and I think we ought to do it.

I thank you very much.

Chairman ARCHER. Thank you.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Conable, I was not here in 1988, so I will not take any credit or blame for this provision. But what tweaks me is what was the rationale back then, and if you do not know it, maybe Mr. Gibbons does.

Mr. CONABLE. I think the rationale was mathematical. They needed to raise a certain amount of money, and they had an estimate that this would cover that, and people were not concerned about foreigners, inevitably. Here their major concern was local citizens. This appeared to be a politically easy way to raise the money.

Unfortunately, if it had been explained in terms of recruitment potential for institutions that must have skillful people working for them, I think it might have changed the result.

Mr. KLECZKA. Well, the World Bank is one of the entities you indicate that is covered by this. Are there others in a similar situation that are housed in this country?

Mr. CONABLE. No, there are not a lot of international institutions sited in the United States, but there is the United Nations and there is the IMF. These would be covered also by the legislation that is being offered here as a corrective.

Mr. KLECZKA. The last question is, How are American citizens in a similar situation treated in a foreign country? Was reciprocity part of the debate at that point?

Mr. CONABLE. I think that is one of the issues. You see, most of these nationals are also taxed by their own countries. That is why the Bretton Woods Treaty assigned tax exemption generally—I mean, it provided for tax exemption by the United States for those working here temporarily under G–4 visas.

Mr. KLECZKA. That individual would be taxed at his home, his country of origin, and at that rate versus the United States——

Mr. CONABLE. Yes.

Mr. KLECZKA [continuing]. Except for inheritance tax, and we would get them on inheritance tax.

Mr. CONABLE. We get them on inheritance tax at this point, yes. The actual provision of the Bretton Woods Treaty, which was subject to interpretation, is this: "No tax shall be levied on or in respect of salaries and emoluments paid by the Bank to executive directors, alternates, officials, or employees of the Bank who are not local citizens, local subjects, or other local nationals." The courts have held that that does not apply to the inheritance tax, and therefore the inheritance tax is assessed on people, because they have worked here in international institutions over a long period of time. If they become American citizens—and they have the right to permanent residence if they have worked in this country for 15 years—of course, they are subject to American taxes in the same way, or if they become permanent residents, they are subject to American taxes.

We are talking only about those in G–4 visas who remain nationals of other countries and are expecting to return after they have completed their employment here. These people, because they have to get out in 60 days, are really very seriously harassed by an inheritance tax that hits them, requires the sale of their homes, requires the computation of the actuarial value of any derivative pension the spouse has, and the borrowing of money to pay the inheritance tax for it. This proposal simply alleviates that situation and does not correct it.

Mr. KLECZKA. Fine. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Barber, thank you again on behalf of all the Members of the Committee. It is a real pleasure to see you back in this room.

Mr. CONABLE. It is a pleasure to be back, Mr. Chairman.

Chairman ARCHER. We wish you well. We hope you are happy in your life and that you are pursuing, as usual, constructive goals. Mr. Ford.

Mr. FORD. Mr. Chairman, I just wanted to take this opportunity to welcome Barber back to the Ways and Means Committee. I am glad to see you.

Mr. CONABLE. Thank you, Harold. My best to Tennessee.

Chairman ARCHER. Thank you, Barber.

The Chair announces for the benefit of the Committee that we will continue to work through this vote, so that Members can proceed to vote and come back as they wish.

Chairman ARCHER. Our next panel includes Edgar Spears, Dr. William Conway, William Taylor, and J. Michael Keeling, if you would all come forward to the witness table, please.

Mr. Spears, if you would identify yourself for the record, and after that identification, you may proceed.

STATEMENT OF EDGAR SPEARS, SENIOR DIRECTOR, HUMAN RESOURCES OPERATIONS, LOWE'S COMPANIES, INC., NORTH WILKESBORO, NORTH CAROLINA

Mr. SPEARS. Thank you, Mr. Chairman.

My name is Edgar Spears. I am senior director for Human Resources Operations at Lowe's Companies, Inc. I appreciate the opportunity to testify before this Committee today in support of a proposal to repeal the current 15-percent penalty tax on excess distributions from retirement plans.

We believe this tax is an inappropriate penalty on workers who have planned wisely and saved for their retirement, and that it discourages younger workers from saving for their retirement. We strongly support repeal of this penalty tax.

Lowe's Companies, Inc., is one of America's top 30 retailers, serving the home improvement and home construction markets. Lowe's 346 stores employ over 45,000 dedicated workers and serve customers in 22 States, principally in the South Atlantic and South Central regions.

Lowe's provides both a 401(k) plan and a combination stock bonus and money purchase plan for its employees. The company has made contributions to the stock bonus money purchase plan equal to 13 percent of earnings for all eligible employees for each of the past 10 years. Employees save their own money enthusiastically through our 401(k) plan, and the company matches those savings at an average of more than 50 percent. Through these plans, participants have seen their retirement accounts grow dramatically.

Unfortunately, when the 15-percent excess distribution tax is added to the current income tax structure, the total tax burden has the potential to wipe out over one-half of a retiree's accumulation.

The Tax Reform Act of 1986 imposed the 15-percent excise tax on aggregate distributions from retirement plans, tax-sheltered annuities, and IRAs to the extent they exceed $150,000 in any calendar year. At the same time, the act reduced individual income tax rates to 15 and 28 percent.

The 15-percent penalty presumably was intended to be a proxy for the tax benefit enjoyed by retirees on distributions over $150,000. But as personal income tax rates have risen, that benefit no longer exists.

Similar penalties apply to post-death distributions from retirement plans. In lieu of the annual penalty tax, an additional estate tax equal to 15 percent of the decedent's excess retirement accumulation is imposed. This surtax is particularly onerous when added to the tax due for an estate possibly subject to the top rate of 55 percent.

In light of the increases in individual tax rates since 1986, the reinstatement of the 55-percent top estate tax rate in 1993, and the low savings rate in America in general, it is appropriate to reexamine and eliminate this penalty tax on savings.

The 15-percent penalty tax affects far more than just chief executive officers and other highly paid executives in this country. Of Lowe's 579 fully vested retirees in 1994, 268, fully 46 percent, could be subject to this tax. Many of our retirees use a portion of their retirement benefits to reinvest in new startup businesses. To penalize individuals who save wisely and who seek to remain productive in their later years is contrary to this company's need for savings, for investment, and for creative, entrepreneurial, job-generating businesses.

Therefore, on behalf of our employees, I strongly urge this Committee to repeal this onerous penalty.

Mr. Chairman, that concludes my statement. Thank you for this opportunity to testify.

[The prepared statement follows:]

STATEMENT OF EDGAR SPEARS,
SENIOR DIRECTOR FOR HUMAN RESOURCES OPERATIONS,
LOWE'S COMPANIES, INC.
NORTH WILKESBORO, NORTH CAROLINA
BEFORE THE COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
WASHINGTON, D.C.
WEDNESDAY, JULY 12, 1995

Good morning. My name is Edgar Spears, and I am Senior Director for Human Resources Operations, Lowe's Companies, Inc. I appreciate the opportunity to testify before this Committee today in support of a proposal to repeal the current 15-percent penalty tax on excess distributions from retirement plans. We believe this tax is an inappropriate penalty on those workers who have planned wisely for their retirement years and discourages young workers from saving adequately for their future retirement. We strongly support the repeal of this penalty tax.

Background on Lowe's Companies

Lowe's Companies, Inc. ("Lowe's" or the "Company") is one of America's top thirty retailers, serving the do-it-yourself home improvement, home decor, home electronics and home construction markets. Lowe's 346 stores serve customers in 22 states located mainly in the South Atlantic and South Central regions, with 45,500 dedicated employees.

Lowe's provides two long-term retirement benefit plans for its associates: a 401(k) plan and a combination stock bonus and money purchase plan. The Company has made contributions equal to 13 percent of earnings for all eligible employees for each of the past 10 years. Employees save enthusiastically through the 401(k) plan, and the Company matches those savings at an average rate of 50 percent. During that time, participants have seen dramatic growth in the value of their accounts, principally due to growth in the stock of their company.

Unfortunately, when the 15-percent excess distribution tax is added to the current income tax structure, the total tax burden is confiscatory and punitive-- penalizing workers who have saved wisely and successfully for their retirement.

Background on the 15-percent excess distribution penalty tax

Under present law, a 15-percent excise tax is imposed on aggregate distributions from retirement plans, tax-sheltered annuities and IRAs to the extent that they exceed the greater of $150,000 or $112,500 (indexed for inflation) in any calendar year (Code sec. 4980A). Under certain circumstances, retirees may be able to exempt as much as $750,000 from this penalty tax, but only if taken as a lump-sum distribution and taxed in full in a single year.

Special rules are applied to post-death distributions from retirement plans. In lieu of subjecting post-death distributions to the annual penalty tax on excess distributions, an additional estate tax equal to 15 percent of the decedent's excess retirement accumulation is imposed. The tax may not be offset by any credits against the estate tax, including the unified credit.

A distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid, except to the extent the amount distributed represents the employee's investment in the contract, (that is, his basis in the contract). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

The Tax Reform Act of 1986 (P.L. 99-514)(the "Act") added this excise tax as a substitute for a combined limit on contributions to tax-favored retirement plans, including IRAs, and to account for appreciation in defined contribution plans (sec. 1133 of the Act). At the same time, the Act reduced individual income tax rates to 15 and 28 percent.

The 15-percent amount presumably was intended to be a proxy for the tax benefit enjoyed by the individual on amounts in excess of $150,000 because of the tax-favored treatment of the plans and the contributions made to them. However, it does not appear to capture the savings precisely, nor can it fairly account for, or predict, appreciation in plan accounts.

The estate tax surtax is particularly onerous when added to the tax due from an estate subject to the top rate of 55 percent, and taking into account the potential state and local transfer or inheritance taxes that may be applicable to such an estate.

Moreover, individual income tax rates are currently 15, 28, 31, 36 and 39.6 percent. These rates are considerably higher than they were in 1986 when the penalty tax was enacted. Estate and gift tax rates range from 18 to 55 percent, which is also a 5 percent increase at the top end.

In light of the increases in individual tax rates since 1986, the reinstatement of the 55 and 53 percent top estate tax rates in 1993, and the persistently low rate of savings in America in general, it is appropriate to reexamine and eliminate this penalty tax on savings.

The excess distribution penalty tax should be repealed.

Ideally, the excess distribution penalty should be repealed. At a minimum, it should be reduced to 5 percent with respect to lifetime distributions, and to zero in the case of post-death distributions, to reflect the increase in individual and estate tax rates and to provide an incentive for Americans to save adequately for retirement.

Repeal of the excess distribution tax will help primarily middle-income employees.

The 15-percent excess distribution penalty tax affects far more individuals than just chief executive officers and other high-paid executives in this country. A review of the 579 fully vested employees who retired from Lowe's (the "Company") in 1994 (a "1994 Company retiree") reveals that 268 (or approximately 46 percent) would be subject to the excess distribution penalty tax.

Most of these individuals retired as middle-income employees, with an average annual salary of $38,000. However, they had served many years with the Company (the median is 17 years) and thus were able to benefit from the Company's growth, increased productivity, and the concomitant appreciation in stock value.

Moreover, even after many years of service, the median age of a 1994 Company retiree who faces this penalty is 45. Only six 1994 retirees were in their 60s. Because of the relative youth of our retirees, many use a portion of their retirement earnings to reinvest in new, start-up businesses.

To penalize those individuals who have saved wisely for their future and are attempting to remain productive in their later years is contrary to this country's need for savings, investment, and creative, entrepreneurial, jobs-generating businesses. Therefore, on behalf of our employees, I strongly urge this Committee to repeal this onerous penalty.

Mr. Chairman, that concludes my statement. Thank you for this opportunity to testify.

Chairman ARCHER. Thank you, Mr. Spears.

With the Committee's indulgence, the Committee will be in recess for a very short period of time, because I have got to run over and vote on the floor. We will be back very quickly, so please keep your seats and be patient; it will only be a couple of minutes.

[Recess.]

Mr. CRANE [presiding]. If you folks will please take your seats, we will resume.

Mr. Taylor, please.

STATEMENT OF R. WILLIAM TAYLOR, PRESIDENT, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

Mr. TAYLOR. Thank you, Congressman Crane. I thank you for the opportunity of testifying today.

I am going to speak very briefly on three issues. First, we want to support H.R. 1161 which Representative Camp has introduced. Second, we want to ask that 401(k) opportunities again be available to employees of nonprofit organizations. Third, we want to express concern about IRS attempts to tax membership dues of nonprofit organizations. I will be brief; the written record contains most of what I need to tell you.

Just a brief word about the ASAE, American Society of Association Executives. My name is Bill Taylor, and I am president of that organization. We have over 23,000 members. Approximately one-third of them work for (c)(3) organizations. The remaining two-thirds manage professional societies and trade associations, 501(c)(6) organizations for the most part. And these are all types of organizations, about 11,000 organizations in ASAE, national, State, local, international, and so forth. They serve over 200 million Americans.

Let me tell you first of our concern about the taxing of associate member dues. ASAE and the association community have been dueling with IRS for the past couple of years over their attempt to reverse their previous position and to dramatically expand the attempted taxation of dues commonly referred to as associate member dues. In short, the IRS, through revenue procedures, technical advice memoranda, litigation, audit instructions, and public speeches, has been attempting to tax dues received from those who have fewer rights and benefits in the organization than others.

This enforcement initiative is not supported by the unrelated business income tax laws. It is a complete reversal of many years of regulatory and judicial precedent. With no change in the law to justify this change, it poses a serious threat to the ability of associations to carry out their nonprofit mission, and certainly it is an affront to association self-governance.

Membership organizations are tax exempt for good reasons. They perform a wide variety of invaluable functions such as self-regulation, standard-setting, public education, public service, to name a few—things that government itself has decided not to do. And membership organizations have various classes of membership with various rights and responsibilities, also for good reason.

For example, in many situations, there are antitrust laws that preclude certain classes of competitors from establishing policies affecting entire industries.

Take the student membership category in the ABA, American Bar Association, for example, and the right of the practitioner to suggest a law student could not be a member of the ABA and has no stake in furthering that particular profession is ludicrous Yet, it is reasonable for ABA not to give student members voting rights in sophisticated policy debates. There are reasons why everybody does not have voting rights.

Certainly, taxation of dues is appropriate where a certain class of members might join an organization solely to receive one or more benefits or services that are unrelated to the tax status and purpose of the organization. Also, we know that income from unrelated benefits and services to any class of members is already taxable, so the member dues income issue is what we are concerned about at this time.

ASAE proposes that the Congress enact legislation to clarify what Congress has authorized the IRS to do under unrelated business income taxation laws.

In short, we want to ensure that all forthcoming guidance issued by the IRS in this area reflects the principle that association membership dues are to remain exempt from taxation unless it is clear that members join the tax-exempt organization for no other bona fide reason than to receive one or more unrelated benefits or services.

Representative Camp has introduced H.R. 783, and that is a good start in this direction, but it is very limited in scope and substance. Among other limitations of H.R. 783 is that it benefits only 501(c)(5) farm organizations, and the bill needs to be significantly broadened to be fair and effective, both in terms of to whom it applies and the terms of standards it sets. This is an issue affecting all organizations, not just farm organizations.

To finalize on this subject, ASAE hopes that you will consider legislation that will, first, clarify the provision that unrelated benefits to a class of association members will not cause the dues paid by such members to be taxable unless these benefits constitute the principal purpose for the organization to have such a class of members; second, if the existence of a class of members helps to significantly further one of the organization's tax-exempt purposes, then the dues paid by the class of members will not be taxable; third, any income directly resulting from the provision of unrelated benefits or services will continue to be taxed according to the current law; fourth, the existence of different categories of members will not make some members more bona fide than others and thus more or less subject to taxation; fifth, the abilities to vote and hold office in an organization are not the deciding issues on who is a bona fide member; and sixth and finally, no one factor shall be fatal to the tax-exempt status of dues income.

We would welcome the opportunity to work with the Committee on this issue because we do think it is an important issue.

Next, very briefly, 401(k) eligibility retirement for employees of nonprofits. Through some mistake, back in 1986, the ability of people employed by nonprofit organizations to have 401(k)s was taken away. This is an issue that we have faced many times. The House of Representatives has four times passed legislation to reinstate 401(k)s for employees of tax-exempt organizations. It has passed

the Senate twice. It has been vetoed by President Bush twice as part of larger tax bills. The time has come for the Congress to reinstate 401(k) plan eligibility for all employees, providing the same incentives for employees of tax-exempt organizations as other American workers.

Finally, we would like to endorse the bill by Representative Camp, H.R. 1161, on corporate sponsorship payments. They should not be taxed as unrelated business income where events merely recognize the contributions of sponsors and where there is no expectation that the sponsor will receive any substantial return benefit.

We thank you for the opportunity to testify, sir.

[The prepared statement follows:]

STATEMENT OF R. WILLIAM TAYLOR, PRESIDENT AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

Good afternoon, Mr. Chairman and members of the Committee. My name is R. William Taylor, CAE.[1] I am president of the American Society of Association Executives (ASAE). ASAE is a not-for-profit, tax-exempt, umbrella organization organized to serve and represent associations. Its membership includes approximately 22,300 association executives and staff, as well as suppliers of goods and services to the association community. Approximately one-third of the association executives and staff manage charitable and philanthropic organizations; the remaining two-thirds manage professional societies and trade associations. The more than 10,700 organizations managed by ASAE members include international, national, regional, state, and local groups, as well as multi-tiered federations and coalitions. ASAE is testifying today on behalf of the organizations it represents, all of whom have a strong interest in these issues.

Specifically, I would like to discuss three pieces of proposed legislation — bills concerning the tax treatment of associate member dues income, the reinstatement of 401(k) plan eligibility for tax-exempt organizations, and the tax treatment of corporate sponsorship income. I will begin with the associate member dues issue.

I. TAXING ASSOCIATE MEMBER DUES

As the Committee may know, ASAE and the association community have been dueling with the IRS for the past couple of years over the IRS' attempts to reverse its previous position on, and dramatically expand its attempted taxation of, a class of dues income received by membership associations commonly referred to as "associate member dues." In short, the IRS — through a Revenue Procedure, technical advice memoranda, litigation, audit instructions, and public speeches — has been attempting to greatly increase its taxation of dues received from certain classes of association members, specifically, those who have lesser rights and benefits in an organization than others.

This enforcement initiative is wholly unsupported by the unrelated business income tax (UBIT) laws which purportedly give the IRS its authority in this area. In addition, it is a complete reversal of many years of regulatory and judicial precedent – with no change in the law to justify such action – and poses a serious and dangerous threat to the ability of associations to carry out their nonprofit missions. Finally, it is, above all else, an affront to the principles of association self-governance.

By way of context, this Committee should be aware that membership organizations — for good reason — often have various classes of members with varying rights, responsibilities and benefits in the organization. The mere existence of these categories does not make some classes of members more *bona fide* than others, although the IRS' briefs in a recently-decided U.S. Tax Court case (*National League of Postmasters v. Commissioner*), which it won, certainly make such an implication — implying that "members" with less than full rights and privileges in an organization are generally not *bona fide* members, and as such, their dues should be taxed. Associations have sound policy reasons for distinguishing between different classes of members and providing them with different rights in the organization. For example, the antitrust laws may play a role in precluding certain classes of competitors from establishing policies affecting entire industries. Similarly, student membership may legitimately reflect a different relationship with

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[1] Certified Association Executive

the association's governing structure. To suggest, for example, that a law student member of the American Bar Association (ABA) has no stake in furthering the tax-exempt purposes of the Association is ludicrous, yet, clearly, it is reasonable for the ABA not to give student members voting rights in sophisticated policy debates.

It is undisputed that, in the egregious situations where a certain class of members joins an organization *solely* to receive one or more benefits or services which are unrelated to that organization's tax-exempt purpose, dues from that class of members should be taxable as unrelated business income (UBI). What is of great dispute, however, is the IRS' recent attempts to tax the dues of classes of members who *do* have rights and benefits which are substantially related to the organization's tax-exempt purposes. This lies at the root of ASAE's concerns.

With the exception of a few "bad apples" (which the IRS has and should continue to pursue), membership organizations are tax-exempt for good reason. They perform a wide variety of invaluable functions (such as industry self-regulation, standard-setting, public education, and public service, to name a few) which the government has chosen not to conduct itself. Taxing the dues of members who receive unrelated benefits — *in addition to* related benefits — would do enormous financial damage to nonprofit organizations, and would greatly hinder (and, in some cases, eliminate) their ability to carry out their nonprofit missions. Income *directly* flowing into an association from its provision of unrelated benefits or services to *any* class of members is *already* taxable as UBI; it is the member *dues* income which is at issue. Such dues taxation is not warranted or authorized by the UBIT statutes.

As such, ASAE proposes that Congress enact legislation to clarify what Congress has authorized the IRS to do under the UBIT laws — in short, to ensure that any and all forthcoming guidance issued by the IRS in this area reflects the principle that **association membership dues are to remain exempt from taxation unless it is clear that members join the tax-exempt organization for *no other* bona fide *reason* than to receive one or more unrelated benefits or services.** While the bill introduced by Rep. Dave Camp, H.R. 783, is a good start, it is limited in both scope and substance. At present, H.R. 783 benefits only 501(c)(5) farm organizations. The bill needs to be significantly broadened — both in terms of to whom it applies and in terms of the standards it sets — in order to be fair and effective. This is an issue which, as the IRS has already recognized, has application across the whole universe of tax-exempt membership organizations.

In this regard, ASAE proposes legislation which would, beyond codifying the previously-stated principle, also clarify that:

1) the provision of unrelated benefits to a class(es) of association members will not cause the dues paid by such members to be taxable unless the receipt of such benefits is the *principal purpose* for the organization to have such a class(es) of members;

2) if the existence of a class of members helps to significantly further one of the organization's tax-exempt purposes — as defined in the organization's articles of incorporation and application for tax exemption — then dues paid by that class of members will not be taxable;

3) any income *directly* resulting from the provision of unrelated benefits or services will continue to be taxable according to current law;

4) the existence of different categories of members will not make some members more *bona fide* than others, and thus more or less subject to taxation;

5) the abilities to vote and hold office in an organization are *not* dispositive factors when deciding who is a *bona fide* member; and

6) no *one* factor in this highly factual determination shall be "fatal" to the tax-exempt status of dues income.

Background

By way of background, the associate member dues issue first came onto the association community's radar screen by way of two 1993 IRS rulings — one issued to a 501(c)(6) professional society and the other to a 501(c)(5) farm organization — concluding that dues paid by the associate members of those organizations were really not tax-exempt dues, but rather were taxable unrelated business income. (Note that the term "associate" member has acquired a generic meaning, and is used as such by the IRS to describe any class of members with less than full rights and privileges in an organization.) In the 501(c)(6) case (TAM 9345004), the IRS said the supplier member dues were essentially purchasing "advertising" (an unrelated activity), and not much more; in the 501(c)(5) case (TAM 9416002), the IRS held that the dues of non-farmer associate members were purchasing access to insurance programs (an unrelated activity), and not much more. (See below for more on these TAMs.) In both cases, the dues were thus deemed to be taxable.

Numerous public speeches by IRS officials following the 1993 rulings confirmed that the rulings indeed represented a significant change from prior IRS enforcement in this area, and that the IRS would now be aggressively scrutinizing dues paid by "less than full members" to determine if they were not *bona fide* members, but rather joined the association primarily to receive one or more unrelated benefits (*e.g.*, advertising, access to insurance, etc.). If so, the IRS would tax such dues as UBI.

On March 23, 1995, the IRS continued down this path by issuing its first "precedential" guidance in this area, in the form of a Revenue Procedure (95-21). The Rev. Proc. establishes a *principal purpose* test for determining whether a class of dues income will be subject to unrelated business income tax.

Specifically, it says that if an associate member category has been *formed* or *availed of* for the *principal purpose* of producing unrelated business income, then dues from associate members will be taxed. The Rev. Proc. defines unrelated business income, for these purposes, as income from the sale of, or the provision of access to, goods or services produced by an activity which constitutes a trade or business, is regularly carried on, and is not substantially related to the organization's tax-exempt purposes. Finally, the Rev. Proc. says that in applying this standard, the IRS will look to the purposes and activities of the *organization* rather than of its *members*.

Speaking at an ASAE-sponsored legal conference in April, IRS Exempt Organizations Division Director Marcus S. Owens elaborated on the scope and significance of the Rev. Proc. He said that while the guidance technically only applies to 501(c)(5)s (labor unions and agricultural organizations), it is a statement of IRS policy in this area generally, and will be

applied to all classes of 501(c) organizations. Owens went on to say that the objective of the IRS in issuing the Rev. Proc. was to spell out the general legal standard the IRS will apply in these cases, as well as to clarify that there will be no *allocation* of dues between related and unrelated purposes (*i.e.*, associate member dues will either completely taxable or completely tax-free). He said that the Rev. Proc. is simply a reiteration of the policy reflected in the 1993 IRS rulings, and acknowledged that it does not provide much useful guidance to associations attempting to minimize their potential tax exposure. Owens added that this broad policy statement will likely be followed up later this year with proposed audit guidelines which will spell out specific factors IRS auditors should consider when determining whether a given class of members is truly a *bona fide* class, or whether their dues are merely (taxable) "access" charges to gain one or more unrelated benefits.

Finally, Owens said that as part of his annual training of his revenue agents this year, he will be including a session on the tax treatment of associate member dues. As a result, Owens said, associations should expect increased IRS audit activity in this area.

Departure from Prior IRS Policy

Rev. Proc. 95-21, the two 1993 TAMs and Marcus Owens' public comments all represent a significant departure from past IRS enforcement in this area.

Under the UBIT rules, if a trade or business is regularly carried on and is not substantially related to the organization's exempt purposes, then any income derived from that activity will be treated as UBI. In the two 1993 TAMs, for example, the unrelated activities were advertising and providing access to insurance, respectively. Both advertising and insurance are historically unrelated activities, and income *directly* attributable to them (even when received from *bona fide* members) has always been treated as UBI (*e.g.*, advertising revenue, insurance premiums, fees received for sponsoring and administering insurance programs, etc.).

The difference here, however, is that dues (historically tax-exempt income) from associate members are also being attributed to these activities — something that, except in egregious circumstances, has never happened before. The IRS is now saying that when associate members receive unrelated services or benefits, if it cannot be established that they are *bona fide* members, then all dues received from them will be taxed as UBI (in addition to the prior taxation of fees and other payments directly attributable to these services and benefits).

Who Is a Member?

The question of who is a *bona fide* member is thus the central question in this analysis. A variety of definitions of an association "member" have been adopted in recent years — by the IRS, the Supreme Court, the U.S. Tax Court, the Federal Election Commission (FEC), state legislatures, and others. Which definition takes precedence? Unfortunately, there is, to date, no definitive answer as to what constitutes a *bona fide* member.

In TAM 9345004, the IRS acknowledged that associations often have several classes of members, but that associate members in this case would not be treated as members under non-profit

corporation law standards. While state non-profit corporation laws vary on this issue, it is noteworthy that section 1.40(21) of the ***Revised Model Non-Profit Corporation Act*** (1987) defines a member as "any person or persons who on more than one occasion, pursuant to a provision of a corporation's articles or bylaws, have the right to vote for the election of a director or directors."

In TAM 8834006, the IRS said, "The term 'member,' at the least, denotes a formal relationship in which a person, whether specifically described as a member or not, has specified rights and obligations in relation to an organization. In addition, 'membership' assumes some right to participate in the organization's direction as well as an obligation to help support the organization through regular financial contributions." The TAM goes on to say that "most importantly," *[bona fide]* members "have voting rights and have a voice in the administration and direction" of the organization. It therefore concludes, "Where the payment of dues is the only requirement of membership and where 'members' have no right to participate in the direction of the organization, these individuals will not be deemed *[bona fide]* 'members.'"

In *FEC v. National Right to Work Committee*, 459 U.S. 197 (1982), the U.S. Supreme Court considered whether certain individuals constituted members of a tax-exempt organization for purposes of the *Federal Election Campaign Act.* Relying on the *Act's* brief legislative history, the Court determined that members of non-stock corporations (*i.e.*, non-profit corporations) should be defined, at least in part, by analogy to stockholders of business corporations and members of labor unions. As stated by the Court, viewing this question from this perspective means that "some relatively enduring and independently significant financial *or* organizational attachment is required to be a 'member'" under the statute. *Id.* at 204. In holding that the National Right to Work Committee's (NRWC) purported "members" did not meet this test, the Court noted, "Members play no part in the operation or administration of the corporation; they elect no corporate officials...There is no indication that NRWC's asserted members exercise any control over the expenditure of their contributions." *Id.* at 206.

In (belated) response to the *National Right to Work Committee* decision, on August 30, 1993, the FEC issued final regulations which, among other things, define what constitutes a "member" of a membership association. (The regulations are codified at 11 C.F.R. §§ 100.8(b)(4)(iv), 114.1(e) and 114.7(k).) Under the new rules, a "member" must meet one of the following four tests: (1) "Have some significant financial attachment to the membership association, such as a significant investment or ownership stake (but not merely the payment of dues);" (2) "Are required to pay on a regular basis a specific amount of dues that is predetermined by the association *and* are entitled to vote directly either for at least one member who has full participatory and voting rights on the highest governing body, or for those who select at least one member of those on the highest governing body of the membership association;" (3) "Are entitled to vote directly for *all* of those on the highest governing body of the membership association;" or (4) On a "case by case" basis for those who do not fit the precise definition of the general rule. 11 C.F.R. § 114.1(e).

In *Hunt v. Washington Apple Advertising Commission*, 432 U.S. 333 (1977), the U.S. Supreme Court held that certain persons should be treated as members of a Commission for standing purposes where such persons alone elected the members of the Commission, served on the Commission, and financed its activities through assessments levied on them. *Id.* at 344.

The U.S. Tax Court has applied the holdings of these cases in determining whether individuals were members of an association within the meaning of section 1.512(a)(3)-a(f)(3)(iii) and (iv) of the unrelated business income tax advertising regulations. *National Association of Life Underwriters v. Commissioner,* __ T.C.M. __ (1993). The Court held that certain individuals were not members of a trade association because: (1) the association's articles and bylaws did not constitute them as members; (2) the individuals had no "rights or obligations" in the association; (3) the individuals did not pay dues to the association; and (4) the individuals had no voting ("representation") rights in the association. *Id.* at 388-389.

As can be seen by this brief survey of the law in this area, there is, as of yet, no definitive "bright line" definition of a *bona fide* member. The IRS has promised audit guidelines on this issue, but has noted that any such guidelines will only contain a list of "factors" to be considered in making such a determination (in the same way that the often-confusing IRS determination is now made as to whether someone is an employee or an independent contractor). A clear, bright-line standard, such as that proposed by ASAE above, is acutely needed.

Prior IRS Rulings Say Associate Member Dues Are Not Taxable

If the Committee needs any evidence that the evolving IRS enforcement policy on taxing associate member dues is nothing short of a complete reversal in policy, it need look no further than three prior TAMs (8302009, 8302010 and 9128002), all of which held that associate member dues are *not* taxable as UBI.

In the two 1983 TAMs, in circumstances strikingly similar to those in TAM 9416002, the IRS concluded that associate member dues were not taxable because although the payment of dues gave associate members the right to participate in the insurance programs, the IRS was "unable to identify a nexus to that portion of non-earmarked dues" allocable to the insurance programs.

Interestingly, the IRS pointed to the fact that associate members received other benefits besides the ability to participate in the insurance plans, including legislative advocacy on issues of concern to both regular and associate members, educational lectures and seminars, and various publications including a newsletter providing free classified advertising for members. The associate members in these TAMs had *no* voting rights or ability to serve on the board. Yet, the IRS still said, "These benefits indicate that dues paid by [associate members]...provide more than the right to participate in [the insurance programs]," and therefore are not subject to tax.

In the 1991 TAM (9128002), the associate members were suppliers of goods and services to the regular members, the dues paid by associate members were higher than those paid by regular members, and the associate members had no rights to vote or hold office. Yet, unlike the more recent TAM 9345004, the IRS held that the dues paid by associate members were *not* taxable. The facts were as follows: The organization was comprised principally of two classes of members — active and associate members. The organization had 75 active and 44 associate members. Active members were defined as those engaged in the management of a particular type of business. Associate members were defined as anyone who represents a company that provides or offers products or services to that type of business. Associate members were comprised primarily of sales

and marketing personnel of hotels and conference centers. Active members paid annual dues of $110, while associate members paid $185 annually to be members. Associate members received the same rights and benefits as active members except they could not vote or hold office.

In concluding that the dues paid by associate members were not taxable as UBI, TAM 9128002 held, "The term 'unrelated trade or business' includes activities carried on for the production of income from the sale of goods or performance of services. Factually, it cannot be concluded that the admission of associate members under a graduated dues structure is the performance of a service or a sale of goods. That is, merely permitting admittance of a limited number of associate members does not rise to the level of carrying on a trade or business. In essence, there is not the degree of activity nor the typical *quid pro quo* found in ordinary commercial transactions. Furthermore, the collection of such dues does not place the organization in competition with taxable organizations. Consequently, the taxation of dues paid by associate members would not eliminate a source of unfair competition."

TAM 9128002 went on to say, "In addition, the collection of dues is ordinary income from a related activity. Although the associate members pay greater dues, they receive all the ordinary benefits without the responsibility of the organization's operations. To the extent that the organization can demonstrate a reasonable basis for the greater dues paid by the associate members, the Service will not second guess the necessity of disproportionate dues; however, if the amount or the basis is not reasonable, the Service will consider the likelihood that a commercial reason underlies the graduated dues structure. Because of the foregoing, we conclude that dues paid by the associate members of the organization do not constitute unrelated business income to it."

Considering that the benefits and rights (and lack thereof) received by associate members in these three TAMs are very similar to those in the two 1993 rulings (the most recent ones in this area), yet the outcomes are completely apposite, it is difficult not to conclude that IRS policy on this issue has been deliberately and significantly reversed — a reversal which is completely unwarranted and flies in the face of the existing UBIT statutes. The IRS appears to be completely ignoring its previous rulings in this area, as well as the statutorily-supported reasoning that accompanied them.

Conclusion

This issue has tremendous consequences for many associations. The need for clear and reasonable direction from Congress is more acute than ever. ASAE would welcome the opportunity to work with this Committee to ensure that the IRS does not continue to usurp the authority of Congress by writing new and dangerous law which attacks the very basis of association self-governance. The IRS has overstepped the authority granted to it by Congress, and this abuse of power poses a critical threat to the ability of the association community to carry out its many nonprofit missions.

II. SECTION 401(K) PLAN ELIGIBILITY REINSTATEMENT

ASAE strongly urges Congress to extend the availability of Section 401(k) retirement plans to all tax-exempt organizations. This is a matter of fairness to hundreds of thousands of

association employees. ASAE believes that employees of trade and professional associations and other tax-exempt employers are entitled to the same opportunity to save for their retirement on a tax-favored basis as employees of charitable and educational organizations, federal, state and local governments, and the private sector. It is unfair and discriminatory to prevent one type of employer from being able to offer to its employees a particular type of employee benefit that is available in one form or another to employers in every other sector of the economy. It is ultimately the employees of those employers whose ability to save for retirement is being restricted.

Many of ASAE's members work for associations which employ less than 10 employees. Approximately two-thirds of ASAE's members represent trade and professional associations exempt from taxation under Internal Revenue Code (IRC) section 501(c)(6). Many of ASAE's member associations either sponsor or are contemplating sponsoring some form of qualified retirement plan, including 401(k) plans, if they would be permitted by law.

As this Committee is aware, most employers may establish programs that allow their employees to save for retirement on a tax-favored basis. For-profit employers may offer their employees the opportunity to participate in 401(k) plans, and, if employing less than 25 employees, salary reduction simplified employee pensions ("SEPs"). Organizations exempt under IRC section 501(c)(3) and certain educational organizations may offer their employees tax-sheltered annuities under IRC section 403(b). Employees of state and local governments may participate in an eligible deferred compensation plan under IRC section 457 (457 plans). And, within the past few years, even the federal government has provided its employees with a tax-deductible salary reduction retirement savings program.

Only tax-exempt organizations, other than those described in IRC section 501(c)(3), are unable to provide all of their employees with an opportunity to save for their retirement on a tax-favored basis. To further compound the problem, many individuals may no longer make tax-deductible contributions to individual retirement accounts after the passage of *Tax Reform Act of 1986*.

During the *Tax Reform Act of 1986* debates, many incorrectly believed that tax-sheltered annuities under IRC Section 403(b) were available to employees of *all* tax-exempt organizations. In fact, they are available only to employees of organizations exempt from taxation under IRC Section 501(c)(3). Another misconception was that the extension of eligible deferred compensation plans under IRC Section 457 to all tax-exempt organizations would provide tax-deductible salary reduction retirement arrangements to all employees of those organizations. In fact, since ERISA requires that pension and other retirement plans of non-highly compensated employees be funded, and since IRC Section 457 prohibits funding, these eligible deferred compensation plans are available only to highly compensated or management employees of tax-exempt organizations. "Rank and file" employees may not participate. Therefore, it is important that 401(k) plans be extended to employees of all nongovernmental, tax-exempt organizations for the following reasons:

1. It is unfair to prohibit a single group of employees in a particular community of organizations from participating in tax-deductible salary reduction retirement savings programs.
2. The national push for international competitiveness requires that employees and employers be able to respond to the shifting needs of the economy. It is difficult for nongovernmental, tax-exempt organizations that do not currently have 401(k) plans to attract and retain qualified employees if they are the only employers that cannot provide tax-deductible salary reduction retirement savings programs to their employees.
3. Congress and the federal government are increasingly shifting the responsibility for retirement income security from the public sector to the private sector. Personal tax savings are an important part of any retirement savings program. Therefore, it is important that employees of nongovernmental, tax-exempt organizations be encouraged to save for their retirement on a tax-deductible basis. All other employees in the economy are permitted to save for their retirement on a tax-deductible basis, including the employees of the federal government.

Many members of Congress continue to fight against the inequity of this situation, and have sought to rectify it during the 102nd and 103rd Congresses. Sen. David Pryor had included language in the *Employee Benefits Simplification and Expansion Act of 1991*, S. 1364, that would reinstate 401(k) plans. In May 1991, Reps. Sander Levin and Bill Archer introduced H.R. 2327, which would have allowed all tax-exempt organizations to have access to 401(k) retirement plans. This bill had strong bipartisan support with 98 cosponsors, including 10 from the Ways and Means Committee.

In February 1991, former Sen. Steve Symms introduced a similar bill which also had strong bipartisan support with 25 co-sponsors, including nine members of the Senate Finance Committee. In addition, the language from H.R. 2327 was included in two major pension simplification bills: Former House Ways and Means Committee Chairman Dan Rostenkowski's bill, H.R. 2730, and Rep. Ben Cardin's bill, H.R. 2742.

At the close of the 102nd Congress, when Congress and the President began work in earnest on a tax bill, members of the 401(k)s for 501(c)s Coalition, headed by ASAE, worked to ensure that 401(k) reinstatement would be included in any tax legislation passed by Congress. ASAE was successful when the tax measure which passed the House and Senate (H.R. 11) included 401(k) reinstatement. Unfortunately, due to other provisions in the bill, President Bush vetoed the measure.

In the 103rd Congress, ASAE once again lobbied to restore 401(k) eligibility to all exempt organizations. As Congress convened in the first week of January, one of the first bills introduced, the *Tax Simplification and Technical Corrections Act of 1993* (H.R. 3419), included the reinstatement of 401(k) plans for all 501(c) organizations. In addition, 401(k) reinstatement was included in the *Pension Simplification Act of 1993* (S. 862), introduced by Sen. Pryor.

In May 1994, the House of Representatives passed by voice vote the *Tax Simplification and Technical Corrections Act of 1994*, H.R. 3419. This bill included reinstatement of Section

401(k) plans for all 501(c) organizations. Although passed by the House, the *Act* died a quiet death by inaction in the Senate.

In the 104th Congress, Sen. Pryor has included Section 401(k) reinstatement in the *Pension Simplification Act of 1995*, S. 1006. Additionally, President Clinton has included Section 401(k) reinstatement in his pension reform plan, which has yet to be formally introduced in Congress.

III. CORPORATE SPONSORSHIP INCOME

In 1993, the Internal Revenue Service issued proposed regulations concerning corporate sponsorship payments to tax-exempt organizations. The IRS has yet to finalize these proposed rules – over two and a half years after their issuance, and, at present, the IRS has no plans to do so.

The IRS' proposed regulations (EE-74-92) attempt to clarify the tax status of corporate-sponsored events hosted by tax-exempt organizations. Under the proposed rules, an exempt organization generally will not have to pay unrelated business income tax on payments from a sponsor for displaying a sponsoring corporation's logo and/or distributing samples of its products. The proposed regulations reflect the fact that in such circumstances, the exempt organization is merely "acknowledging" the sponsor(s) of the event. The proposed rules also define "advertising" activities which may result in UBIT.

In addition, the proposed regulations do not apply to the sale of advertising in exempt organization periodicals; all types of sponsorship activity involving broadcast, print and other forms of corporate acknowledgment are subject to the rules; and distribution of samples of a sponsor's product constitutes an "acknowledgment" rather than "advertising."

While the IRS' proposed rules answer a number of questions posed by associations, ASAE supports the efforts of Rep. Camp and his legislation, H.R. 1161. Corporate sponsorship payments should not be treated as UBIT where events merely recognize the contributions of sponsors, and such recognition is only incidental to the contribution and there is no expectation that the sponsor will receive any substantial return benefit. The mere use of the sponsor's name or logo, and/or the furnishing of facilities or services, should not generate UBIT.

Thank you for this opportunity to testify. I would welcome any questions members of the Committee may have at this time.

Mr. CRANE. Thank you, Mr. Taylor.
Dr. Conway.

STATEMENT OF WILLIAM A. CONWAY, M.D., VICE CHAIRMAN, HENRY FORD HEALTH SYSTEM, DETROIT, MICHIGAN; ON BEHALF OF AMERICAN GROUP PRACTICE ASSOCIATION, MEMBER, BOARD OF TRUSTEES

Dr. CONWAY. Thank you for the opportunity to testify.

I am Dr. Bill Conway, vice chairman of the Henry Ford Medical Group, which is part of the Henry Ford Health System in Detroit, Michigan. We are a nonprofit organization that provides the full spectrum of health care services through a staff of 1,000 employee physicians.

Today I am pleased to testify on behalf of the AGPA, American Group Practice Association, as a member of its board of trustees. The association is composed of about 250 group practices, with more than 25,000 physicians nationwide.

Although there are only a few nonprofit medical group practices in our country today, their size and impact are enormous. Many of these are icons of American medicine. Among them are Mayo, Leahy, Cleveland, Geisinger, Virginia Mason, and Henry Ford.

In addition to having an international reputation for excellence, these practices provide significant charity care. They offer some of the world's best medical education and training. They are leaders in medical research and quality improvement. And, most importantly, they are sincerely devoted to community service.

One of the bipartisan issues in the debate on health care reform has been the need for access to quality health care for millions of Americans in inner cities and rural areas. These group practices are serving these vulnerable communities.

Continuing quality health care for these underserved communities is going to depend on the ability of these community-based nonprofit organizations remaining viable and able to attract and keep highly qualified professionals.

Before describing the details of our issue, I would like to thank Congresswoman Dunn for her recognition of our issue and her leadership in developing a solution. I would also like to thank Congressman Camp from my own State of Michigan and Congressman Portman of Ohio for their understanding and active support.

Using some data from the Henry Ford Medical Group as an example of this issue in group practices across the country, I would like to explain that the average salary for an employed physician in our group is $135,000. Comparable physicians in the for-profit sector average $40,000 to $50,000 more per year in direct compensation. That gap has always been there, and we have been able to compete despite it.

In the past couple of years, as a result of the decrease in the salary cap on qualified retirement plans, 20 percent of our medical staff at Henry Ford lost 25 to 35 percent of their retirement benefits that would have accrued by age 65. Because of other options for retirement, this did not affect for-profit enterprises as much as our staff.

Because of this increasing gap in total compensation possibilities and its impact on our recruiting and retention capabilities, we are

seeking an amendment to the Internal Revenue Code. This would provide a limited exemption from IRC section 457 to eligible nonprofit group practices. First, it would increase the dollar limitations for employees of nonprofit integrated health systems. Second, it would index the deferral amount for inflation. Third, it would create an exemption from the limitations of section 457(c).

We believe there are sound reasons why a change in the law is good public policy, and I would like to outline these briefly.

The first is to support effective reform of the health care system. Many Members of Congress and the private sector look to integrated health care systems as the model best able to achieve cost containment with continued high quality care. In many instances, a nonprofit salaried physician group is at the core of these systems that are forming today. Without adjustments to the Tax Code, existing and forming physician groups are encouraged to avoid or abandon nonprofit status.

The second reason is the availability of quality physicians where most needed. Under current tax law, employers who retain nonprofit status are at a significant disadvantage in recruiting and retaining the brightest physicians. Many of these professionals, as I pointed out earlier, are serving millions of inner city and rural residents.

The third reason is tax equity and simplicity. The recent reduction of the salary cap from $235,000 to $150,000 has made it difficult for tax-exempt employers to provide competitive retirement packages. Taxable employers deal with this problem through more generous salary increases and nonqualified plans. Tax-exempt employers are limited by rules governing private inurement and limits on nonqualified plans and have fewer options.

To restore balance to the system, tax-exempt organizations need more flexibility to offer reasonable and competitive retirement benefits.

Finally, our medical professionals in these nonprofit group practices forego substantial benefits in order to serve their communities. To compel them to deepen that sacrifice compared with their for profit colleagues is unrealistic and unfair. We are concerned that, if the competitive disadvantage created by the recent Tax Code change continues, it will have a serious adverse effect on our unique medical institutions. The ultimate loss will be to the community and patients, and the diversity of the American health care system.

Mr. Chairman, on behalf of the AGPA's 25,000 physicians, I wish to thank you for hearing us on this critical issue today.

[The prepared statement follows:]

STATEMENT OF WILLIAM A. CONWAY, M.D.
VICE CHAIRMAN, HENRY FORD HEALTH SYSTEM
ON BEHALF OF AMERICAN GROUP PRACTICE ASSOCIATION

Mr. Chairman, thank you for the opportunity to testify. I am William A. Conway, M.D., Vice Chairman of Henry Ford Medical Group, which is part of the Henry Ford Health System in Detroit, Michigan. We are a non-profit organization that includes virtually the entire continuum of health care services.

I am pleased to submit testimony on behalf of the American Group Practice Association, where I serve as a member of the Board of Trustees. AGPA is the only physician-governed organization representing the needs of integrated, multispecialty group practices in the country. AGPA membership is comprised of integrated multi-specialty group practices which are committed to providing the highest quality, most cost-effective care to their patients under both managed care and fee-for-service arrangements. AGPA is dedicated to the continuous improvement of clinical practice and cost performance. With approximately 250 member groups, AGPA represents more than 25,000 physicians nation-wide.

We are asking the Committee to consider an equity provision that would allow us the ability to offer our professionals reasonable deferred compensation packages, in a manner comparable to those allowed for profit groups under the tax code.

Congress and the private sector look to integrated health systems as models best able to achieve cost-containment with continued, high-quality care. In many instances, the non-profit salaried physician group is the optimal foundation for creating the kind of managed care plans that promise true delivery-system reform for Americans of all ages and income status. Without adjustments to the tax code, physician groups are encouraged to avoid non-profit status. Groups that remain non-profit are at a great disadvantage in recruiting top-flight talent. This is movement in the opposite direction from where health care should be going.

On behalf of our members, I want to thank Congresswoman Jennifer Dunn, not only for her recognition of this as an important health policy problem, but also thank her for her leadership in developing a solution. I want to thank Congressman Dave Camp of our own state of Michigan, and Congressman Rob Portman of Ohio for their understanding and active support.

There are only a few non-profit medical group practices in our country today, but their impact on health care is enormous. Their names constitute a "Hall of Fame" in medicine, among them: Mayo, Lahey, Cleveland, Virginia Mason, and Henry Ford. In addition to a well-deserved, international reputation for medical excellence, the non-profit group practices have several other characteristics in common.

- They provide significant charity care and other uncompensated care.
- They offer some of the finest medical education and training in the world.
- They are acknowledged leaders in medical research and quality improvement.
- And perhaps most important, they are devoted to community service and participate significantly in the economic viability of their community.

An issue stressed by both Republicans and Democrats in the debate on health care, Medicare and Medicaid is that of access to quality health care for millions of Americans who live in inner cities and rural areas. In the future, Quality health care for under-served communities will depend almost entirely on the ability of the community-based, non-profit organizations to come together as health plans and to attract and keep highly qualified professionals.

Currently, coverage for inner-city and rural populations is a combination of Medicaid, Medicare and charity care in clinics and hospital emergency rooms, where the need for physicians is particularly high. Government payment rates and malpractice insurance costs have already driven many of the private physician providers to higher income areas. The hospitals and non-profit health systems are hiring physicians to fill the gaps.

These health care professionals often are attracted to these non-profit settings by teaching and research opportunities. They will serve part or all of their professionals careers in the non-profit setting out of a deep sense of social obligation. They often are part of a multi-specialty group which accepts risk for an enrolled population through various HMO arrangements, which effectively eliminates their ability to improve personal income through referrals or increased visits.

At the Henry Ford Health System in Detroit, patients receive their care from both the Henry Ford Medical Group, comprised of about 1,000 salaried physicians, as well as 1,200 private practice physicians connected to the Henry Ford Health System through network arrangements with our own H.M.O., Health Alliance Plan of Michigan, with 425,000 enrolled members. We are a pluralistic medical model, like many of the other large multi-specialty group practice organizations throughout the country.

We serve more than 40,000 Medicaid and 50,000 Medicare patients under both enrolled and fee-for-service arrangements--again similar to the diversity your will find in the other large medical groups. We own and operate four community hospitals and 36 ambulatory centers throughout Southeast Michigan. And like many of the other large medical groups--including Mayo in Minnesota, Cleveland Clinic in Ohio, and Lahey Clinic in New England--teaching and research are central to our mission. Charity care runs about $38 million per year for Henry Ford Health System, with an additional $40 million in other uncompensated care, particularly through the Medicaid Program, which pays about 35 cents on the dollar in Michigan for physician services.

Our preferred clinical approach is patient-focused managed care -- irrespective of the type of health insurance coverage the patient has.

At the Henry Ford System, the average salary of an employed physician is $135,000, whereas it is about $150,000 for the other large groups. In contrast, physicians in the for-profit sector average $50,000 more per year in compensation. About one-third of our physicians are affected by the tax code limitations we want to fix. Nationally, we estimate that about 20,000 salaried physicians in non-profit health care organizations were adversely affected by the 1993 changes in the tax code. As a result of the salary cap, twenty percent of our medical staff at Henry Ford lost 25 to 35 percent in retirement benefits at age 65.

We are seeking an amendment to the Internal Revenue Code which would provide a limited exemption from IRC Section 457 to eligible non-profit group medical practices. It would:

- increase the dollar limitations for employees of non-profit integrated health systems;
- index the deferral amount for inflation; and
- create an exemption from the limitations of Section 457 (c)(2).

There are sound reasons why a change in the law is good public policy. I will summarize these briefly:

1. The first is <u>**Availability of Quality Physicians Where Most Needed**</u>. Under current tax law, non-profit employers are at a significant disadvantage in recruiting and retaining the best and brightest physicians. Many salaried professionals are on the front lines, delivering primary care and related services to millions of inner city and rural residents. Because IRC Section 457 (e)(1)(B) limits the ability of non-profits to offer attractive and competitive compensation packages, such medical practices lose out in the national and local competition for top physicians and other health professionals to the for-profit entities which are able to offer more favorable retirement alternatives.

2. The second reason is <u>**Availability of Critical Medical Institutions**</u>. An important way to maintain high quality and availability is to affirmatively encourage physician groups and other medical professionals to continue to organize in a non-profit status. Current law provides incentives to abandon non-profit status and discourage health institutions and professionals who would collaborate and consolidate themselves under non-profit coverage agreements for Medicare, Medicaid or private practice.

3. The third reason is **Effective Reform of the Total Health Care System**. The evolving health care system will rely on physicians and other care providers working together in integrated health care networks. Instead of expediting the formation of such integrated networks, current law regarding deferred compensation acts as a serious barrier. Groups of physicians and other medical professionals who might join together with hospitals and other non-profit entities to form cost-efficient integrated networks are reticent because of the significant retirement benefits they lose. An exemption to IRC Section 457 will remove an important barrier to the formation of integrated health care delivery networks.

4. The fourth and final reason is **Tax Equity and Simplicity**. Professional compensation usually includes a combination of employer-paid and employee-paid retirement plans. Rules governing these retirement arrangements are spelled out in several parts of the tax code. IRC Section 457 governs deferred compensation arrangements between non-profit organizations and their employees. The recent reduction of the salary cap from $235,000 to $150,000, combined with other limits, has made it difficult for many employers to provide adequate and competitive retirement packages. Taxable employers have been able to deal with this problem through their non-qualified deferred compensation plans. Tax-exempt employers do not have similar options, as compensation is limited by rules governing private inurement and community benefits. To restore some balance to the system, tax-exempt organizations should be allowed the flexibility to offer reasonable benefits.

Congress has begun to recognize the inequities of current law and this Committee recently approved legislation exempting state and local governments from the dollar limitations contained in IRC Section 457 (b)(2) and Section 457 (c)(1). The Tax Simplification and Technical Corrections Act of 1993 (H.R. 3419) amends Sections 415 and 457 to provide that excess benefit arrangements of government entities will not be subject to IRC Section 457 (b)(2) and Section 457 (c)(1) limits. As a matter of fairness, as well as good health care and tax policy, non-profit group practices should be accorded similar treatment.

Toward the end of the 103rd Congress, the Senate Finance Committee began to take such action. It reported a provision, as part of the "Health Security Act," which would have removed the current cap on deferred compensation plans for certain medical group practices. The bi-partisan Senate "Mainstream Group" adopted a similar provision.

Our intent with this legislation is not a total balance between for-profit and non-profit organizations. We recognize that non-profit organizations have certain beneficial and inherent advantages. The tax code and other laws are designed to take this into account. However, the realities of a competitive marketplace, with intense cost pressures and performance pressures do create a disadvantage for us in recruiting professional staff and in our efforts to consolidate into integrated systems. The remedy in Congresswoman Dunn's bill is designed to bring the laws for non-profits to a reasonable standard -- to restore a better balance between what we can offer highly qualified and productive staff and what they find available from the for-profit companies.

Medical professionals in tax-exempt group medical practices already forego substantial, personal economic benefits in order to serve their communities. To compel them to deepen that sacrifice, compared with those made by their for-profit colleagues, is both unrealistic and unfair. The ultimate loss in such circumstances is to the community and the patients, who have a right to expect the best, most cost-efficient health care America's medical profession can provide.

Mr. Chairman, on behalf of AGPA's 25,000 members, I thank you and the members of your Committee for hearing us on this critical issue.

Mr. CRANE. Thank you, Dr. Conway.
Mr. Keeling.

STATEMENT OF J. MICHAEL KEELING, PRESIDENT, EMPLOYEE STOCK OPTION PLAN ASSOCIATION

Mr. KEELING. My name is Michael Keeling, and I am the president of the ESOP, Employee Stock Option Plan Association. Today, I comment on five proposals before the Committee.

Proposal one would permit a subchapter S corporation to sponsor an ESOP. Proposal two would modify rules relating to deferral of gain on certain sales to an ESOP under code section 1042. Proposal three would permit an ESOP to be a beneficiary of a charitable or remainder trust. Proposal four would permit a closely held corporation to pay estate tax if stock were transferred to an ESOP. And proposal five would alter the treatment of certain dividends on stock in an ESOP transferred from a terminated defined benefit plan.

You should appreciate that the ESOP community believes employee ownership will improve American competitiveness, increase productivity through greater employee participation in the workplace, strengthen our free enterprise economy, create a broader distribution of wealth, and will maximize human potential, enhancing self-worth, dignity, and the well-being of our people. These beliefs form the core of our vision for America.

Of the five proposals before you, four will increase to a very small extent employee ownership in America and thus align with our vision. Therefore, we ask the Committee to include these four proposals, one, two, three, and four, in any bill you send to the floor of the Congress.

But let me make it clear that if the majority of this Committee does not accept as real the power of employee ownership, then you should not go forward with any of these proposals. May I state that I personally believe that a majority of this Committee does believe in the positive and powerful aspects that employee ownership can have in America, as set forth in the vision.

My evidence for this statement is not just my 14 years representing ESOP advocates before Congress, but by the fact that of the four proposals, three were included in H.R. 2088 introduced by Congressmen Ballenger and Rohrabacher in the last Congress. Ten Members of this Committee sponsored that legislation. By their actions, these Members earned the accolade from the ESOP community as ESOP champions. And we thank Congresswoman Johnson, Congressmen Bunning, Houghton, Herger, McCrery, Hancock, Camp, Ramstad, Johnson, and Payne.

Joining your Committee Members in sponsoring this legislation were 105 Members of the 103d Congress, including people with names such as Gingrich, Armey, DeLay, Paxon, Molinari, McCollum—and the list goes on. Obviously, I am dropping names to bolster my case, and I do so without shame.

Mr. Chairman and Members of the Committee, let me say this. If there is any problem, any consideration of the revenue impact that these proposals may have, the ESOP community stands ready to work with you and your Committee staff to ensure that the pro-

posals meet the definitions that you have set forth—that these be miscellaneous tax proposals.

You must obviously consider their impact on the underlying provisions of law and their impact in terms of the revenue impact on the Federal Treasury. We will work to make sure that most of them are scored at $1 million a year, $5 million a year, and so forth.

But let me go back, Mr. Chairman, in conclusion, to the basic premise of my statement. If you feel that employee ownership is good for America, then in all likelihood, you will want to include at least four of the five proposals commented on in any tax bill. But I, Michael Keeling, do not speak of the power of employee ownership, nor do the former owners that have transferred stock to the ESOP. The employee owners speak for ESOPs in your districts and in towns and communities across America.

In 1988 Congressman Rangel told the ESOP community to prove the value of employee ownership through the voices of employee owners—not the paid lobbyists, not the top executives. We have taken his advice to heart, and today ESOP participants actively engage in all of our government relations activities, including meeting face-to-face with the President and his advisors.

While the rather technical nature of today's ESOP discussion has no direct impact on the employee owners of the year who have come with me today to stand up for ESOPs before the Ways and Means Committee, I would like Doreen Eng, 1995 Minnesota Employee Owner of the Year, Emilia Podkowiak, 1995 New England Employer Owner of the Year, and Darrel Tackett, 1995 Ohio and the National Employee Owner of the Year, to stand for just 1 second so that you may see them.

If you wish to know the value of our belief or whether our belief has validity in the real world, take the time to talk to these men and women and to the employee owners in your district.

Yes, I am more than pleased to engage you and your staff and your Committee staff over the nuances of ESOP law and even its bigger impact; but the true witnesses for our statement today are Doreen, Emilia, Darrel, and their millions of colleagues across America.

I thank you for having us.

[The prepared statement follows:]

STATEMENT OF J. MICHAEL KEELING, PRESIDENT EMPLOYEE STOCK OPTION PLAN ASSOCIATION

INTRODUCTION: On behalf of The ESOP Association, a 501(c)(6) entity with nearly 1,200 U.S. corporations sponsoring Employee Ownership Plans, or ESOPs, and their nearly 1 million employee owners, I thank Chairman Archer, the Ways and Means Committee members, and its staff for permitting me to visit briefly with you today on several proposals before the Committee that fall into the category of "miscellaneous" tax proposals.

My name is J. Michael Keeling, and I am the President and Chief Staff Officer of The ESOP Association, headquartered here in Washington. I have held this position for over four years, and have worked with the ESOP and employee ownership community for nearly 14 years. In the past four years I have visited with the management and non-management employee owners in over 250 companies from our borders with Canada, to rural areas of Hawaii, southern Florida, to southern California, and many points inbetween.

Although it sounds like bragging, I am proud of these facts as I feel it qualifies me to speak openly and objectively about the status of the employee ownership movement in America today.

Today, I make a statement to you on five proposals pending before your Committee.

Proposal One, would permit a Subchapter S corporation to have its stock held by a trust meeting the requirements of what we refer to as "ERISA", which in turn means that a Subchapter S corporation may sponsor an ESOP.

Proposal Two, would modify rules relating to deferral of gain on certain sales of stock to an ESOP, under Code section 1042.

Proposal Three, would permit an ESOP to be a beneficiary of a charitable remainder trust.

Proposal Four, would permit a closely-held corporation to pay estate taxes if stock were transferred to an ESOP, as set forth in former Code section 2210.

And, **Proposal Five**, would alter the treatment of certain securities transferred to an ESOP from a terminated defined benefit.

But before I comment on these five proposals before you, I wish to explain my recommendation to you that you follow a "two" step analysis in reviewing these proposals, which I believe will permit you and your staff to come to closure as to whether you wish any, or all, to be included in any recommendation you make to the full House for passage of a 1995 Miscellaneous revenue bill.

STEP ONE: Your Step One analysis should recognize that the ESOP community believes that employee ownership will improve American competitiveness...that it will increase productivity through greater employee participation in the workplace...that it will strengthen our free enterprise economy and create a broader distribution of wealth...and that it will maximize human potential by enhancing the self-worth, dignity, and well-being of our people.

Because we sincerely believe these things, this belief forms the core of The ESOP Association's Vision for America, and from this Vision, we analyze everything.

Of the five proposals before you, four will increase employee ownership in America, and thus align with our Vision.

But, let me make it clear, if you, or the majority of the Committee do not accept the belief that I just gave as to the power of employee ownership, then you should not go forward with consideration of these four proposals as part of any 1995

Miscellaneous Tax bill.

Your Step One analysis must also recognize that if the four proposals I am speaking of do become law, they will not increase employee ownership in America to any significant extent. If they would, Congressman Ballenger, who submitted three of the four to you, and Congressmen Hancock and Johnson, who each submitted one, would not have done so because they obviously would not be "miscellaneous", as defined by Mr. Archer.

May I state that I personally believe that most members, even a majority, of this Committee, do generally, and I emphasize generally, believe in the same positive, and powerful, impact employee ownership can have on America as do ESOP advocates, as set forth in our Vision statement.

My evidence for this statement is not just my fourteen years of representing ESOP advocates before Congress, and mainly before this Committee, but by the fact that of the five proposals, three were included in H.R. 2088, introduced by Congressmen Ballenger and Rohrabacher last Congress. Ten members of this Committee co-sponsored that legislation, and thus these three provisions.

By their action, these members earned the accolade from the ESOP community as "ESOP Champions", and we thank Congresswoman Johnson, and Congressmen Bunning, Houghton, Herger, McCrey, Hancock, Camp, Ramstad, Johnson, and Payne.

Joining your Committee members in sponsoring this legislation were 105 other members of the 103rd Congress, including people with names such as Gingrich, Armey, DeLay, Boehner, Paxon, Molinari, McCollum, and the list could go on.

Obviously I am dropping names to bolster any Step One analysis, but I do so without shame.

In all candor, to both you, and ESOP advocates, I must note that while this Step One analysis is necessary, again these are minor ESOP proposals. The ESOP community has developed them over the years, beginning in 1990, in order to make some common-sense changes in existing ESOP law, and to have a few more encouragements for ESOP creation that do not affect the revenue stream to the Federal Treasury to any significant extent.

But again, before you bother with a Step Two analysis, think to yourself on my Step One recommendation. Ask yourself if you generally accept the view that employee ownership will improve American competitiveness...that it will increase productivity through greater employee participation in the workplace...that it will strengthen our free enterprise economy and create a broader distribution of wealth...and that it will maximize human potential by enhancing the self-worth, dignity, and well-being of our people.

STEP TWO: If you reach Step Two, then you must engage in the more traditional analysis of the five proposals on which I comment today. In Step Two, you will examine whether the proposals are truly "miscellaneous" with minor, or no revenue impact, whether the proposals are fair and equitable, and whether they alter to any significant degree the underlying provision of the tax law they amend.

Frankly, it is just like the management of a well-run employee-owned company--your Congressional colleagues have delegated to you, or as we say "empowered" you to decide on the details about these proposals. If my Step One comments are correct, and the majority of your colleagues do wish to have more and better employee ownership in America, this does not mean that they consider themselves "expert" or "with the obligation" to look at the details on these ESOP proposals--they trust you to make the best decision.

And, unfortunately for those who like to deal with "Vision" and the "Big" picture, you meet your obligation only by looking at each one of the five proposals one by one, in some detail.

Thus, I provide the ESOP communities' comments on:

PROPOSAL ONE: The Chairman's press release announcing these hearings included what is generally known as the Subchapter S reform legislation, which has garnered significant support from the small business community, and professional groups such as the American Bar Association and the American Institute of Certified Public Accountants. These reform proposals contain one section that relates directly to ESOPs, and is an expansion of a provision proposed first by a former member of this Committee, Beryl Anthony when he introduced pro-ESOP legislation in 1990, with Congressmen Ballenger and Rohrabacher.

This provision would permit a Subchapter S corporation to sponsor an ESOP, and thus make employees of a Subchapter S employee owners through an ESOP.

I will not take a great deal of time explaining this proposal, except to note that the Sub S reform proposal before you permits any ERISA plan, not just an ESOP, to hold the stock of the Sub S sponsor.

The ESOP community has no objection of the expansion of the original Anthony-Ballenger-Rohrabacher ESOP-only proposal to all ERISA plans.

We proudly note that when the House Committee on Small Business, Subcommittee on Procurement, Taxation, and Tourism, held hearings on the 103rd Congress version of the Sub S reform legislation, nearly all of the small business witnesses, representing a variety of business entities, specifically noted the importance of permitting Sub Chapter S corporations to sponsor ESOPs, and cited this provision as one of the major reasons Congress should pass Sub S reform.

Clearly, I do not speak to the other ten to twelve Sub S reform ideas embodied in the overall Sub S package, as I am not qualified to do so.

I do state that America's experience with employee ownership the past twenty years does demonstrate that the use of the ESOP in a closely-held business culture, is particularly impressive and powerful.

As to revenue impact, I cannot say as at the time this testimony was being prepared, we had no estimate from the Joint Committee on Taxation.

The proposal permits that portion of the Sub S's taxable income allocable to the ERISA trust's ownership share of the corporation, to be subject to the unrelated business income tax, which is imposed at the corporate rate. Whereas before recent tax law changes this UBIT tax rate was higher than the individual rate and one could make the case that the change proposed in 1990 was a revenue raiser--i.e. shifting income from a lower tax bracket to a higher bracket--now the individual rate is higher than the UBIT, or corporate rate.

In looking at this particular revenue impact of the Sub S proposal, it probably must be placed in the context of the overall package, not just the so-called ESOP part.

But, if there is a need to massage the ESOP piece, or even the ERISA piece of the Sub S reforms to meet some revenue considerations, the ESOP community stands ready to work with the Committee in a constructive manner.

In sum, The ESOP Association strongly endorses permitting Subchapter S corporations sponsoring ESOPs and employee ownership.

PROPOSAL TWO: The second ESOP proposal is probably the most technical of the group, and perhaps the most difficult to explain in plain English. As background, I.R.C. Section 1042 permits the seller of closely-held stock to defer the capital gains tax on proceeds from sale of his/her stock to a corporation's ESOP if the seller reinvests the proceeds in qualified replacement property, which means securities of an U.S. operating corporation, within a certain period of time, and if the ESOP holds at least 30% of the corporate sponsors highest class of stock, or equivalent, after the sale. If the seller sells any or all of the replacement property, he/she pays a gains tax based on the basis of the original stock sold to the ESOP, not the basis of the replacement property.

There are many restrictions and complex rules governing a so-called 1042 transaction, and the operation of the ESOP that obtained stock in a 1042 transaction. Despite these restrictions and complexities, it is estimated that since 1989, 60 to 70% of the approximate 500 ESOP transactions a year involve 1042 transactions.

But two restrictions contained in the original 1042 law enacted in 1984 have created problems for ESOP creation and operation.

To explain one restriction, 1042 (c)(1)(B)(ii) does not permit 1042 treatment for any stock the seller acquired as 1. his/her current compensation, 2. that he/she purchased at fair market value, or 3. that he/she acquired from an exercise of a stock option, which he/she had when employed by the sponsor of the ESOP. In tax law lingo, this stock, which an employer holds directly is known as Section 83 stock, which governs the tax treatment of stock acquired directly by an employee as a result of his/her employment.

In sum: the IRS interprets, partially correct, partially incorrect, in my view, section 1042 (c)(1)(B)(ii) to prohibit Section 83 stock from receiving section 1042 treatment.

And, in plain English, the proposed change before you would alter that prohibition and provide "yes, Section 83 stock is eligible for 1042 treatment."

As background ESOP advocates, particularly those who had direct knowledge of the drafting of 1042 in 1984, which includes yours truly, always understood that this provision was added to the 1984 bill in order to prevent a taxpayer from escaping all tax on gain when exercising a tax-qualified stock option at the same time the employer who issued the option took a tax deduction for the value of the exercised option. Note that tax incentives for stock options were changed in the late 80's, thus negating some of the reasons for the 1984 restrictions.

In the late 80's the IRS issued letter rulings that held that the 1042 restriction applied not only to stock acquired in a tax incentive stock option, but also to stock that an employee paid fair market value for, and to stock that the employee was paid as compensation! In both instances there is no tax advantage to the employee--if he/she pays fair market value for stock, then the taxpayer is like any other investor in the company, who should clearly be eligible for 1042 treatment. If the employee gets stock as current compensation, the value of the stock is income to the employee and he/she pays current income tax on the value of the stock. For this employee to sell to an ESOP later under 1042 creates no unique tax advantage other than the one clearly intended by 1042. In other words, the IRS position set forth in these letter rulings does not address any so-called "double" tax avoidance scheme.

As for Section 83 stock acquired as part of a stock option, the proposal denies a corporation a deduction for the value of the option if the employee sells to an ESOP within 60 days of getting the stock. This denial of an immediate corporate deduction should actually cause a revenue increase or at least revenue neutrality. Now if the stock option is part of an incentive stock option plan, the deferral through a 1042 transaction is nearly the same as the current law: no tax on the gain of the stock until realized by the taxpayer.

The problem with the current IRS interpretation of the 1042 restriction is that employees who obtained stock as a result of their employment are treated unfairly compared to the owner-founders and the outside investors. In many companies, stock ownership schemes outside an ESOP are not as attractive because this stock is not eligible for the incentives to have it become more broadly distributed through an ESOP.

The revenue impact of this expansion of 1042 cannot be significant--in fact a case may be made that it might even raise revenue as the immediate loss of the corporate compensation deduction when a non-qualified stock option is exercised, which are the most common stock options, might be greater than the loss of the time-value of money on the expansion of 1042, plus the delayed corporate deduction for the contribution of the stock to an ESOP.

But even if the proposal does not increase revenue, the impact should not be significant. For example, at no time in the history of 1042 since 1984 has this provision ever been estimated to lower individual income taxes by more than $50 million per year. (1042 is a tax deferral advantage available to individuals, and is thus scored in the tax expenditures tables under the individual tax column.)

So, to expand 1042 to a subset of an existing universe never more than $50 million, leads one to speculate that it has to be less than the entire $50 million universe by a substantial degree, probably, single digit.

Clearly, if the seller holds the replacement property until death, and heirs get the stepped up basis, the loss of the corporate deduction may be less than the final loss to the Treasury. This loss, however, might not be in the five year window that is used to calculate revenue estimates, and again becomes rather small for revenue estimating purposes.

But permit me to reiterate, if you find a significant revenue problem we in the ESOP community did not anticipate, we pledge to work to eliminate that problems.

The second part of Proposal Two contains another technical 1042 fix that is even more technical than that discussed above, and is even more insignificant in terms of potential revenue impact, as it presents a problem to only a few existing ESOPs.

Among the many restrictions related to 1042 is the restriction that "25% owners" and relatives may not participate in allocations of ESOP stock acquired with in a 1042 transaction.

Throughout the tax code are certain restrictions on 25% owners of a business in terms of tax breaks, etc. In nearly most instances, including a variety of areas applying to ESOPs, a 25% owner is defined as someone holding securities in the company that equals at least 25% or more value of the entire corporation, or at least 25% of the voting power of the corporation.

But I.R.C. Section 409(n)(1)(B)(i) sets forth an unusual definition of a 25% owner be defining him/her as someone who owns 25% of "any" class of stock. (Code section 409(n) sets forth restrictions on ESOP stock and allocations of that stock if

obtained in a 1042 transaction.

How is this definition a problem? Let's assume that we have a corporation valued at $10 million dollars. Let's assume that 100% of the highest common stock is owned by one person, and it is valued at $7.5 million. Let's assume that in the life of this corporation, one time the owner needed an infusion of capital, and issued an outside investor a preferred stock with a preferred dividend, and this stock is valued at $2 million. Now let's assume that the owner has created a third class of stock that has a dividend preference, but one lower than the outside investor's preferred. He has compensated some of his senior managers with this third class of stock as a performance incentive. Assume that this stock is worth $500,000.

Assume that two senior managers each has $250,000 of this preferred stock. In value they own only 2.5% of the corporation, and have no voting stock.

But under the current unusual definition of 25% owners as set forth in 409(n), these two men are 25% owners, and cannot participate in an ESOP with 1042 stock.

The second part of ESOP Proposal Two would amend 409(n) to conform its definition of 25% owner with the more commonly-used tax code definition--it would be any person owning 25% or more of the value of the corporation, or any person owning stock with 25% or more of the voting power of the corporations' stock.

The expansion here is really minor. It would permit a few more people to participate in an ESOP. Since it is possible for these people to participate in other tax qualified deferred compensation plans, putting these people in an ESOP with 1042 stock should not expand the number of persons participating in a tax qualified deferred compensation plan. If it does, it cannot do so be much.

In sum, this second ESOP proposal corrects some unfair technicalities currently found in the most popular ESOP tax law incentive Code Section 1042, and is in essence, technical corrections as opposed to a true "miscellaneous" tax law amendment.

PROPOSAL THREE: This proposal was not included in those submitted to the Committee by Congressman Ballenger, but it is one that The ESOP Association has reviewed, and has noted that its revenue impact, as estimated by the Joint Committee, is negligible, (less than $1 million per year.) In fact, Congressman Ballenger is considering including this proposal in any new pro-ESOP legislation he is considering for the 104th Congress.

Based on its description, we believe the proposal is the same as H.R. 1962, which was introduced by your colleague Congressman Sam Johnson, one of our ESOP champions. It appears to be the same as H.R. 1807, as well, by former Congressman Mike Andrews on which the former Subcommittee on Select Revenue Measures held hearings on June 17, 1993, among other bills. That hearing record contains basic information about this proposal, and there is no need to reinvent, or waste your time reading the old testimony to you.

Briefly, the proposal would allow a deduction in determining Federal estate tax for employer securities transferred to an ESOP in a "qualified gratuitous transfer". For a transfer to qualify, certain requirements would have to be met. The stock would have to have been first transferred from an estate to a trust. In addition, after the remainder interest vests in the ESOP, allocations of stock under the employee stock ownership plan could not be made to any family member of the decedent or to employees owning more than five percent of the shares outside the plan. A transfer would be qualified gratuities transfer to the extent that:

1. the securities were received by a trust from a decedent's estate.

2. no deduction under section 404 (relating to the income tax deduction allowed employers for contributions to tax-qualified pension plans) is allowed with respect to the transfer,

3. the ESOP provides that the securities are allocated to plan participants in manner that does not discriminate in favor of highly compensated employees,

4. the ESOP treats the securities as attributable to employer contributions (except that no employer income tax deduction is allowed),

5. the securities cannot be allocated, directly or indirectly, to any family members of the decedent or to any employees owning five percent or more of the issuing corporation's stock outside the plan,

6. the securities cannot be traded on an established securities market, and

7. certain other requirements are met with respect to the allocation of the securities to plan participants.

While the ESOP community would love to see Congress permit a deduction for the transfer of any employer securities from an estate to an ESOP, we realize that the limited approach recommended here is more realistic in that the revenue impact is very minor since the underlying requirement is that the stock either go to charity or an ESOP--i.e. there will be a deduction in any respect.

PROPOSAL FOUR: This proposal, part of H.R. 2088, and one of the three proposals submitted to you by Congressman Ballenger, would put back into the Tax Code Section 2210, which Congress repealed in the 1989 tax law changes as part of an overall overhaul of tax incentives for ESOP creation and operation.

Important things first--when this provision was law between 1984 and 1989, at no time did it have a revenue impact greater than $5 million per year. A July 29, 1991, revenue estimate from the Joint Committee for a forerunner of H.R. 2088, confirmed this number of less than $5 million.

As to operation, former Code Section 2210 permitted an ESOP to assume federal estate tax liabilities to the extent that the ESOP acquires employer securities from a deceased shareholder or his/her estate. If the stock constituted more than 35% of the decedent's adjusted gross estate and is stock of a "closely-held" corporation, the ESOP may be eligible for special installment payments of the tax liability (over as long as 14 years). The ESOP obligation to pay the estate tax must be guaranteed by the employer.

Estate tax experts will recognize that the special payment rules track rules under Code section 6166, and ESOP experts will note that the scheme follows what a corporation does when it engages in a leveraged ESOP transaction--the corporation has to guarantee payment of the debt. Given the economic reality of perfecting a 2210 transaction, nearly all corporations taking advantage would be Section 6166 corporations, as others assuming the estate tax would have to pay a big lump sum payment.

There is an element of fairness to restoring Code Section 2210. Its repeal was part of a 1989 Ways and Means Committee amendment offered by ESOP Champion Anthony as a counter to more major cutbacks in ESOP law proposed by former Chairman of the Committee Mr. Rostenkowski. Mr. Anthony, as a tactical matter, included this repeal of the less than $5 million provision with a

repeal of a more significant ESOP tax incentive involving a straight tax deduction for an estate transferring stock to an ESOP that saved nearly $300 million per year. The view at the time was both were estate tax-related ESOP incentives, and to win the day it would be better not to try to distinguish the two.

But, we have a few reports of some people writing wills between 1984 and 1989 to take advantage of Code Section 2210,and the Committee action in 1989 sort of pulled the rug out from under their plans if they did not die in that timeframe.

Again, The ESOP Association urges the restoration of former Code Section 2210 as a modest way to strengthen the use of ESOP as a estate planning and business succession tool.

PROPOSAL FIVE: Of the proposals before the Committee, this one does not create more ESOPs, and thus does not necessarily need to undergo Step One analysis. Instead, it would ease the operation of a small number of ESOPs that took advantage of a provision of law that existed between 1986 and 1989.

This provision permitted the sponsor of terminated defined benefit plan to escape the "penalty" tax imposed on the sponsor's recapture of the surplus monies of a terminated defined benefit plan if the surplus was transferred to an ESOP. During this time frame, the tax was 10%.

This provision of law expired at year end 1988, and no attempt has ever been made to restore this incentive. In fact, the policy of Congress has become even more harsh towards the use of defined benefit plan surplus by the sponsoring employer by imposing an effective 100% tax on the surplus.

The former law made the taxpayer who utilized the provision to allocate the employer securities acquired with the defined benefit surplus within seven years.

It is our understanding that mechanics of that requirement have created some administration problems co-ordinating allocations from the ESOP funded with the defined benefit surplus, other ESOPs in the corporate mix, and other plans under ERISA.

In candor, we have not studied this proposal in detail; and while we have no reason to believe that it is anything but equitable, and with little revenue impact, we would have to work with staff to obtain more details about this proposal's impact and its need before providing an unqualified statement that we urge its enactment.

CONCLUSION: Mr. Chairman, and members of the Committee, in conclusion, I would like to again go back to the basic premise of my statement--if you feel that employee ownership is good for America, based on its historical performance, then in all likelihood you will want to include at least four of the five proposals commented upon in any 1995 miscellaneous tax bill.

But, I do not speak of the power of employee ownership--nor do the former owners of employee-owned companies that have transferred stock to an ESOP.

The employee owners speak for ESOPs in your district and in town and communities across America.

In 1989, Congressman Rangel told the ESOP community to prove the value of employee ownership through the voices of the employee owners--not the paid lobbyist, not the top executives. Although he may not realize this, we have taken his advice to heart, and today have ESOP participants actively engaged in all of our government relations activities, including meeting face-to-face with the President and his advisors.

And while the rather technical nature of today's ESOP discussion has no direct impact on the Employee Owners of the Year who have come with me today to stand up for ESOPs, I would like Doreen Eng, Minnesota Employee Owner of the Year, Emilia Podkowiak, New England Employee Owner of the Year, and Darrel Tackett, Ohio and the National Employee Owner of the Year to stand for just one second so that you may see them.

If you wish to know the value of our belief, or whether our belief has validity in the real world, take the time to talk to these men and women, or to the employer owners of your communities.

Yes, I am more than pleased to engage you, your staff, and your committee staff over the nuances of ESOP law, and even its bigger impact; but the true witnesses for our statement today are Doreen, Emilia, and Darrel, and their millions of colleagues across America. They are here today all day for any conversation you might wish to have with them.

Again, I thank you for having us.

Mr. CRANE. We thank you for your testimony.

Are there any questions that Members have?

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman, and welcome, gentlemen.

I do have a couple of questions for Dr. Conway on his legislation, with which I am familiar and heartily support and urge my colleagues to support.

The Henry Ford Health System, Dr. Conway, where you serve as vice chairman, like the Virginia Mason Clinic in Seattle, which is in my part of the country, is one of the top medical facilities in the Nation. Why would institutions like these have any real difficulty in attracting qualified medical personnel, and how do limits on nonqualified plans like the one that you have discussed, section 457, have a bearing on this problem?

Dr. CONWAY. I think it is true—our reputation and our education and research programs provide recruitment attraction potential. That is true, and that is what has made up for the base salary gap between these nonprofit group practices and the for-profit sector.

In the last couple of years, the retirement benefit opportunity has increased the economic gap between different kinds of organizations, and we are afraid that even our reputation and our education and research programs are not going to be able to make up for the economic gap. Today, we have graduates and young physicians with large medical school bills; they have families, and they need to begin looking forward to retirement, and a total retirement program that has a 25- to 30-percent gap compared to the for-profit sector is something that is very hard to overcome.

Ms. DUNN. Thank you, Dr. Conway. Also, could you spend 1 minute with us, giving us your point of view on how current law, specifically with regard to IRC section 457, provides disincentives for integrated health care systems that involve for-profit and not-for-profit institutions?

Dr. CONWAY. Increasingly, as people are attempting to form integrated health care systems around the country, they are hearing today from their physician components that they should be organized in a for-profit entity, in part because of these pension differences.

As you are attempting to organize an integrated entity, one of the things you want to accomplish is alignment of incentives, and if the whole entity is for-profit, then you are all aligned around the same mission incentive, which is to make a profit. If the entity is a nonprofit entity, you want alignment around mission and a different set of values. And if the physician component of that entity has to be for-profit, and the overall entity is not-for-profit, it creates internal dissension and lack of alignment.

Ms. DUNN. Thank you, Dr. Conway.

Thank you, Mr. Chairman.

Mr. CRANE. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman, and I thank all of the witnesses for being here today, and Dr. Conway particularly, thank you for being here.

I just have one brief question. Have you had a Joint Tax Committee estimate of your proposal or the proposal that you are interested in, that you know of?

Dr. CONWAY. We do not have that yet. We look forward to an opportunity to submit something in writing at a future date.

Mr. CAMP. I would be very interested in that. If, when you get it, you could make sure I see a copy of that as well, I would appreciate it.

Thank you very much.

Mr. CRANE. Mr. Coyne.

Mr. COYNE. No questions.

Mr. CRANE. Mr. Neal.

Mr. NEAL. No questions.

Mr. CRANE. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Taylor, in your testimony, you made numerous references to unrelated benefits or services to an organization's tax-exempt purpose. Could you give me several examples of what you mean by unrelated benefits or services?

Mr. TAYLOR. Yes. Every tax-exempt organization was given tax exemption for carrying out certain activities related to the exempt purpose of the organization, and anything that is unrelated to the basic purpose of the organization is taxable at this time. I was talking about related activities versus unrelated activities, saying unrelated activities already are taxed; unrelated business income activities are taxable and are currently taxed. Related to the tax-exempt purpose, those are not taxed. And I was trying to draw the distinction in associate member dues that dues are considered related income, related to the tax-exempt purpose, as long as the members who pay those dues are joining for the purpose of taking advantage of what the association does.

Mr. LAUGHLIN. Using the bar association as an example, could you give us a couple of examples of the unrelated services if the bar association indeed provides those?

Mr. TAYLOR. I do not know a whole lot about the bar association.

Mr. LAUGHLIN. Well, pick another association.

Mr. TAYLOR. Advertising in the bar association journal, for example, would be taxable as nonrelated business income. If they rented any space in the bar association building, that would be unrelated business income. If they carried out executive search activities or things of that nature, it might be considered unrelated business income.

The IRS and Congress have set aside certain areas which are unrelated to the tax-exempt purpose and taxable.

Mr. LAUGHLIN. But if it were a continuing legal education program, then it would not be taxable.

Mr. TAYLOR. That would be related to the exempt purpose.

Mr. LAUGHLIN. Now, under your proposal, do we gain or lose revenue?

Mr. TAYLOR. On associate member dues, we are asking you to prevent IRS from imposing this tax, and so there is no revenue to be lost there.

Mr. LAUGHLIN. Thank you very much.

Thank you, Mr. Chairman.

Mr. CRANE. Thank you.

Are there any other Members who wish to inquire?

[No response.]

Mr. CRANE. If not, we thank the panel for its participation today.

We now ask the panel of Harold Adrion, Stanley Ruchelman, Letitia Chambers, and Robert Blair to please come to the witness table.

We will open with you, Mr. Adrion.

Mr. RUCHELMAN. Mr. Chairman, Mr. Adrion and I are presenting together, and I would like to speak first, if possible.

Mr. CRANE. Fine.

STATEMENT OF STANLEY C. RUCHELMAN AND HAROLD L. ADRION, NEW YORK, NEW YORK

Mr. RUCHELMAN. Mr. Chairman and Members of the Committee, my name is Stanley Ruchelman. I am an attorney practicing in New York City, and I am accompanied today by my colleague, Mr. Adrion.

We are here to testify on one aspect of the miscellaneous tax reforms now being considered by the Committee, and we wish to thank you for this opportunity.

We are here because we believe that the exemption allowed to foreign persons for interest on items of portfolio and indebtedness should be continued in U.S. law. We believe it serves a valid function for a wide range of taxpayers in the United States.

The exemption allows for U.S. business to have access to overseas funds in an efficient manner which does not run afoul of any international tax policy of the U.S. Government. In addition, we believe that a repeal of the exemption may not be consistent with proposals designed to significantly restructure U.S. tax law that are currently being considered by the Congress at this time.

To put our comments in perspective, ordinarily the payment of interest to a foreign person attracts a 30-percent withholding tax. This tax is waived if the interest is paid on an item of portfolio debt. The exemption is currently fashioned so that large institutional taxpayers may raise funds in the Eurodollar market through the issuance of bearer securities that are targeted to foreign investors. These are instruments that meet stringent requirements designed to prevent them from being acquired by U.S. investors.

According to statistics prepared by the Federal Reserve, the $300 billion level was exceeded several years ago, which means that there is a significant amount of this type of instrument outstanding abroad, and a significant amount of money has flown into the United States.

At the same time, the exemption is broad enough so that small private companies may raise funds from private sources abroad through a relatively simple method of issuing a registered instrument and obtaining a certificate of foreign status on a form W–8. In our experience, companies owned by naturalized citizens and resident aliens whose country of birth does not have in effect an income tax treaty with the United States frequently utilize this procedure to borrow from persons still resident in that country.

Certain foreign persons do not qualify for the exemption. Most importantly, foreign banks do not qualify with regard to interest

received on the extension of credit arising from a loan agreement entered into in the ordinary course of business. Exemptions are provided for U.S. Government debt.

Foreign persons who are the 10-percent shareholders of the borrower do not qualify for the exemption, and controlled foreign corporations controlled by U.S. shareholders do not qualify with regard to interest arising from loans to a related person, including the 10-percent or greater U.S. shareholder.

It is important to note that this exemption is provided under the domestic law of the United States and not under an income tax treaty which might eliminate U.S. withholding tax on the payment of interest. As a result, there is no incentive on the part of a foreign investor or the U.S. borrower to construct a web of international companies in order to "borrow" the benefits of an income tax treaty. That was the situation that existed prior to 1984 when the exemption was first enacted.

The exemption is thus consistent with the existing tax treaty policy of the United States, which is to limit treaty benefits to qualified residents of the United States and its treaty partner. This policy appears in limitations on benefits provisions of recent income tax treaties concluded by the United States, certain aspects of the branch profits tax that appear in code section 884, and also in code section 7701(l), which authorizes the IRS to issue regulations that recharacterize conduit financing transactions where appropriate to prevent U.S. tax avoidance.

If the exemption is repealed, U.S. borrowers will either attempt to structure borrowings in a manner that will borrow a tax benefit from an income tax treaty or will absorb the investors' withholding tax liability. In either event, the administrative cost and additional cost to the U.S. borrower will be significantly increased.

To illustrate, the absorption of a 30-percent withholding tax by a borrower in the United States will increase its interest expense by 43 percent. Presumably, taxable income and tax will be reduced by the added cost.

We also believe that the proposal to repeal the exemption is inconsistent with the restructuring proposals that are currently under consideration by the Congress.

Mr. CRANE. Thank you.

Mr. Adrion.

Mr. ADRION. Thank you, Mr. Chairman.

One of the principal arguments made for imposing a withholding tax on interest paid to foreigners is that the borrower is allowed to deduct interest that is paid abroad, thereby reducing domestic tax liability. If the interest is not subject to tax in the hands of the recipient, there is most likely no offsetting increase in the tax base of the United States or any other jurisdiction.

The tax system is out of balance. The result likely will not occur under the major restructuring proposals currently being considered by Congress. In general, those proposals do not allow businesses to deduct interest. In the absence of a deduction at the level of the borrower, the system is not eroded by the absence of tax at the level of the recipient of the interest.

We recognize that one could ask why the restructuring proposals being considered by Congress do not render meaningless many of

the proposed modifications to the international provisions that are now being reviewed in these hearings. Under this view, the portfolio interest exemption is properly subject to modification or repeal.

However, a meaningful difference exists between the exemption and the other provisions. The other provisions are intended to modify U.S. law to comport with economic practices or transactions that were not in existence at the time the various code provisions were first enacted.

An example is the treatment of member countries of the European Union for purposes of subpart F of the Code. In comparison, the proposed repeal of the portfolio interest exemption at this time is not premised on any such purpose.

The restructuring proposals that are currently in existence I believe are generally designed to encourage U.S. businesses to be able to compete abroad. The portfolio interest exemption has a similar premise in that it enables U.S. companies to compete with foreign companies in the capital markets.

One could argue that fairness demands that foreign recipients of interest income should be treated in a manner that is similar to domestic recipients of interest. However, the issue is not one of fairness to U.S. lenders; rather, the issue relates to the availability of capital to fund expansion of U.S. businesses.

It is interesting to note that with respect to a number of U.S. holders of debt instruments, they are exempt from tax, so that the disequilibrium is not quite as significant as has traditionally been noted.

Mr. Chairman, we have tried to note the highlights of our points, and if you would like, we would be happy to submit other written testimony on these points.

Thank you.

[The joint statement follows:]

RETENTION OF PORTFOLIO INTEREST EXEMPTION

Testimony Presented to the Committee on Ways and Means
U.S. House of Representatives
by
Harold L. Adrion, Esq.
Stanley C. Ruchelman, Esq.

July 12, 1995

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, thank you for this opportunity of testifying on a specific aspect of miscellaneous tax reforms now being considered by the Committee. We are here because we believe that the exemption allowed to foreign persons by the Internal Revenue Code for interest on items of portfolio indebtedness should be continued. It serves a valid function for a wide range of taxpayers in the U.S. The exemption allows U.S. business to have access to overseas funds in an efficient manner which does not run afoul of any international policy of the U.S. Government. In addition, we believe that a repeal of the exemption may not be consistent with proposals designed to significantly restructure U.S. tax law.

The exemption is currently fashioned so that large institutional taxpayers may raise funds in the Eurodollar market through the issuance of bearer securities that are targeted to foreign investors. These instruments must meet stringent requirements that are designed to prevent them from being acquired by U.S. investors.

At the same time, the exemption is broad enough so that small private companies may raise funds from private sources abroad through a relatively simple method of issuing a registered instrument and obtaining a certificate of foreign status on Form W-8. In our experience, naturalized citizens and resident aliens whose country of birth does not have in effect an income tax treaty with the U.S. utilize this procedure to borrow from persons still resident in that country.

Certain foreign persons do not qualify for the exemption. Most importantly, foreign banks do not qualify with regard to interest received on the extension of credit arising from a loan agreement entered into in the ordinary course of business, with the exception of interest paid on an obligation of the U.S. Foreign persons who are 10% shareholders of the borrower do not qualify for the exemption. And controlled foreign corporations do not qualify with regard to interest arising from loans to a related person, including a 10% or greater U.S. shareholder.

The exemption is provided under the domestic law of the U.S. and not under an income tax treaty. As a result, there is no incentive on the part of the foreign investor or the U.S. borrower to construct a web of international companies in order to "borrow" the benefits of an income tax treaty. The exemption is consistent with the existing tax treaty policy of the U.S., which is to limit treaty benefits to qualified residents of the contracting states. This policy appears in the limitations on benefits article in recent income tax treaties negotiated by the U.S. and in Section 7701(l) which authorizes the I.R.S. to issue regulations to recharacterize any multiple-party financing transaction where appropriate to prevent U.S. tax avoidance. Regulations were proposed in October 1994.

If the exemption of interest on items of portfolio indebtedness is repealed, U.S. borrowers will either attempt to structure borrowings in a manner that will benefit from an income tax treaty or will absorb the investor's withholding tax liability. In either event the administrative cost to the U.S. borrower will be increased. Alternatively, foreign sources of debt capital will be eliminated.

We also believe that the proposal to repeal the exemption of interest on items of portfolio indebtedness is inconsistent with the restructuring proposals that are currently under consideration by Congress.

One of the principal arguments made for imposing a withholding tax on interest paid to foreigners is that the borrower is allowed to deduct the interest that is paid abroad, thereby reducing domestic tax liability. If the interest is not subject to tax in the hands of the recipient, there is most likely no offsetting increase in the tax base of the U.S. or any other jurisdiction. The tax system is out of balance. This result likely will not occur under the major restructuring proposals currently being considered by Congress. In general, those proposals do not allow business borrowers to deduct interest expense. In the absence of a deduction at the level of the borrower, the system is not eroded by the absence of tax at the level of the recipient of the interest.

We recognize that one could ask why the restructuring proposals being considered by Congress do not render meaningless many of proposed modifications to the international provisions of the Code now being reviewed in these hearings. Under this view, the portfolio interest exemption is properly subject to modification or repeal. However, a meaningful difference exists between the exemption and the other provisions. The other provisions are intended to modify U.S. law to comport with economic practices or transactions that were not in existence at the time the various Code provisions were first enacted. An example is the treatment of member countries of the European Union for purposes of Subpart F of the Code. In comparison, the proposed repeal of the portfolio interest exemption at this time is not premised on any such purpose.

One could argue that fairness demands that foreign recipients of interest income should be treated in a manner that is similar to domestic recipients of interest. However, the issue is not one of fairness to U.S. lenders. Rather, the issue relates to the availability of capital to fund expansion of U.S. business. If it is in the economic interest of the U.S. to attract foreign capital in the form of a non-equity instrument, current law should not be changed. Stanley C. Ruchelman can be reached at (212) 843-8822. Harold L. Adrion can be reached at (212) 559-0715.

Mr. CRANE. Thank you.
Dr. Chambers.

STATEMENT OF LETITIA CHAMBERS, PRESIDENT, COALITION OF PUBLICLY TRADED PARTNERSHIPS

Ms. CHAMBERS. I appreciate this opportunity to testify, Mr. Chairman, on behalf of the Coalition of Publicly Traded Partnerships. PTPs, publicly traded partnerships, are limited partnerships whose ownership shares are traded on public exchanges and are regulated by the SEC.

As its first priority, the Coalition urges the Committee to enact H.R. 1686, which was introduced by Congressman Houghton and cosponsored by 11 other Members of the Committee. This would extend the permanent partnership treatment to the 27 publicly traded partnerships which do not meet the qualifying income test imposed by the 1987 Tax Act and which are nearing the end of the 10-year grandfather period. This proposal has been described in detail for the record by Mr. Houghton and will be covered at length in written statements to be submitted by the Coalition.

There are several problems with the current tax law which hinder capital formation for PTPs. The Coalition strongly supports the large partnership simplification provisions and believes that it is essential that these provisions be enacted. Understanding the items on a K–1 and entering them in the proper spaces on a tax return is complex and difficult even for those who are most sophisticated in tax matters. The system should be simplified so that it no longer penalizes investors. The provisions address complexity by establishing a simplified reporting system and also reporting on a simplified form. The proposed simplification provisions actually originated within the Treasury Department based on audit concerns. The concerns of the IRS are addressed by a new audit system which provide for adjustments determined after an audit to be made in the current year.

These provisions enjoy broad bipartisan support and are an effective response to a significant problem. The Committee would like to propose that two additional changes be incorporated into the large partnership simplification which will remove significant and unwarranted complexities from the Tax Code.

Under UBIT, the unrelated business income tax rules, a tax-exempt organization investing in a partnership is considered to be engaged in that partnership's trade or business, and the organization's share of PTP income is taxed as unrelated business income unless it falls within a special exemption or is below a $1,000 threshold. This rule creates great complexity for pension funds, IRAs, and other tax-exempt entities investing in partnerships.

In the case of PTPs, this complexity serves no purpose whatsoever, certainly not the purpose for which the UBIT, unrelated business income tax, rules were intended. The purpose of UBIT is intended to prevent tax-exempt organizations from using their tax-exempt status to engage in unfair competition with taxable businesses. In the case of publicly traded partnerships, an individual partner is only one of tens or hundreds of thousands of investors. The partner is not engaging in or managing the PTP's business, but is only providing a small portion of its capital.

We would propose that a de minimis rule be added to partnership simplification which exempts from UBIT investments representing less than 5 percent interest in a partnership's capital and also to allow 10 percent investment for a PTP's own employee pension plan.

A similar problem exists for mutual funds. Under the RIC, Regulated Investment Co., rules, mutual funds must receive 90 percent of their gross income from specified sources. Income from PTPs or other partnerships do not qualify. These rules force mutual funds investing in PTPs to monitor their investments to ensure that they do not exceed 10 percent of their gross income. This complexity is unnecessary. It may have made sense to omit partnerships from the list of qualifying income sources when the RIC rules were conceived because at that time, there was no such thing as publicly traded partnerships, partnerships that were regulated fully by the SEC. That is not the case today. PTPs are as appropriate an investment for a mutual fund as any other publicly traded SEC-regulated security.

In conclusion, the Coalition strongly supports extension of the grandfather period for the few PTPs to which it applies, enactment of large partnership simplification, a de minimis rule for partnership holdings by tax-exempt investors, and removing barriers to investments in publicly traded partnerships by mutual funds.

Mr. Chairman, I will be happy to answer any questions. I also want to note that I am accompanied today by executives of publicly traded partnerships who are in the audience and who would be happy to meet with any Committee Members or staff who have questions concerning the provisions that I have discussed.

[The prepared statement and attachment follow:]

**TESTIMONY OF LETITIA CHAMBERS
PRESIDENT OF CHAMBERS ASSOCIATES
AND
PRESIDENT OF THE COALITION OF PUBLICLY TRADED PARTNERSHIPS
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
July 12, 1995**

Mr. Chairman and members of the Committee, I appreciate the opportunity to submit testimony to the Committee today on issues of concern to publicly traded partnerships. My name is Letitia Chambers, and I am the President of the Coalition of Publicly Traded Partnerships. The Coalition is a trade association representing PTPs and the accounting, law, and service firms who work with them.

Publicly traded partnerships, as you know, are limited partnerships whose ownership shares are traded as "units" on public securities exchanges. PTPs, most of which operate in the energy, natural resources, and real estate sectors, are regulated by the SEC comparably to other publicly traded securities. The relative safety, liquidity, and competitive yields of PTPs make them potentially attractive investment options not only for individuals, their primary purchasers, but also for pension funds, IRAs, and other tax-exempt entities, as well as for mutual funds. PTPs also allow the natural resource and real estate industries to tap new pools of investors and thus promote capital formation in those industries.

The Coalition urges the enactment of H.R. 1686, the legislation introduced by Congressman Houghton and co-sponsored by nine other members of the Committee, that would extend permanent partnership treatment to the 27 PTPs which are nearing the end of the ten-year grandfather period imposed by the Omnibus Reconciliation Act of 1987. As this proposal has been described in detail for the record by Mr. Houghton, and will be covered at length in written statements to be submitted by the Coalition and other members of the PTP community, I will not go into any further detail here. Because this issue is so time sensitive, however, it is the highest legislative priority of the Coalition.

There are other problems with the current tax law which hinder PTPs' potential as investment and capital formation vehicles and make investment in PTPs more difficult and complex than is necessary. The Coalition believes that these problems could be addressed by adopting, with two amendments that I will describe, the simplification provisions for large partnerships in H.R. 3419 that are described in the announcement for this hearing.

Large Partnership Simplification

The publicly traded partnership community strongly supports the large partnership simplification provisions and believes that it is essential that these provisions be enacted. One of the major problems that PTPs and other large partnerships encounter in trying to attract investors is the sheer complexity of accounting for the investment when income tax season arrives. Understanding the items on a K-1 and entering them in the proper places on a tax return is difficult even for those who are sophisticated in tax matters; for average investors it is a headache that they are sorely tempted to do without. The tax code should be simplified so that it no longer penalizes investors of modest means.

It is not only large partnerships and their investors that need the simplification provisions. These provisions actually originated within the Treasury Department based on two concerns: first, that the nature of the current K-1 prevented the IRS from matching this return to partners' individual returns to check for compliance, and second, the extreme difficulty of collecting additional tax owed after an audit from the hundreds or thousands of individual partners that comprise today's large partnerships. These concerns were reinforced in a study of widely held partnerships undertaken by Treasury at Congress' direction, which found that the current reporting and audit system, which was developed with smaller partnerships in mind, does not work well for large partnerships.

The proposed simplification provisions, a response to that study, were developed jointly by Treasury, the IRS, the staff of the Congressional tax writing committees, the Coalition of Publicly

Traded Partnerships, and other representatives of the partnership community. The provisions address the complexity faced by partnership investors by establishing a simplified reporting system under which various items of partnership income, gain, loss, deductions, and credits are combined at the partnership level and reported on a simplified form. The concerns of the IRS are addressed by a new audit system which provides for adjustments to tax determined after an audit to simply be added to (or subtracted from) the partnership's income in the year in which the adjustment takes effect.

The large partnership simplification provisions enjoy broad bipartisan support and were actually passed twice by Congress in 1992, as part of larger tax bills that were ultimately vetoed. The provisions are an effective response to a significant problem faced by both the industry and federal tax officials, and Congress should move expeditiously to enact them.

The Coalition would like to propose that two additional changes be incorporated into the large partnership provisions which we believe will remove significant, unnecessary complexities from the tax code and make it easier for a variety of investors to realize the benefits offered by PTPs. The first change concerns the treatment of PTPs under the unrelated business income tax (UBIT) rules.

Unrelated Business Income Tax

Under the UBIT rules (Code section 512(c)), a tax-exempt organization investing in a PTP (or any partnership) is considered to be engaged in that partnership's trade or business. The organization's share of PTP income is thus taxed as unrelated business income unless it falls within one of the special exceptions in section 512(b): interest, dividends, rents, royalties. If the PTP holds debt-financed property, the income may be subject to UBIT even if it falls into one of the exempted categories. Partnership investors may benefit from the $1,000 deduction provided in section 512(b)(12).

This rule creates great complexity for pension funds, IRAs, and any other tax-exempt entity wishing to invest in a PTP -- including PTPs' own employee plans. The entity must carefully monitor its share of income from the PTP, along with income from any other investments subject to UBIT, to ensure that such income does not, in aggregate, exceed the $1,000 threshold. If it does, a form 990 must be filed. This requirement is especially onerous for individuals investing in PTPs through their IRAs, who may not even be aware that the income could become taxable if it exceeds the $1,000 threshold. Needless to say, this complexity is a significant deterrent to investment in PTPs.

The critical point is that at least as far as PTPs are concerned, this complexity serves no purpose--certainly not the purpose for which the UBIT rules were created. The purpose of the unrelated business income tax is to prevent tax-exempt organizations from using their exempt status to engage in businesses that would compete unfairly with taxable businesses. Income from PTPs and other partnerships is subject to UBIT because of the flow-through nature of a partnership: since there is no separate entity, the partners, including tax-exempt partners, are considered collectively to be engaging in the partnership's business. In the case of a publicly traded partnership, however, an individual partner is only one of tens or hundreds of thousands of investors. The partner is not really engaging in or managing the PTP's business but is only providing a small portion of its capital.

The amendment that the Coalition proposes to add to the simplification bill recognizes these facts by providing a *de minimis* rule which excludes from unrelated business income a tax-exempt organization's share of income and deductions from partnership interests it holds which represents less than a 5% interest in the partnership's capital. A PTP's employee retirement plan could hold up to 10% of the partnership's capital. Such a limited interest would also be exempted from the restrictions related to acquisition indebtedness. The amendment also amends an ERISA provision which allows only employee retirement plans of PTPs existing as of December 17, 1987, to hold employer securities. The amendment would allow retirement plans of all PTPs to hold employer securities.

This simplification proposal by the Coalition is a needed and appropriate addition to the large partnership provisions in H.R. 3419.

Mutual Funds

A similar problem exists with regard to mutual funds, another important segment of the capital markets which could benefit from access to PTP investment. Under the Regulated Investment Company (RIC) rules in Code section 851, mutual funds must receive 90 percent of their gross income from specified sources. Income received from a PTP or other partnership does not qualify. Thus, a mutual fund cannot invest in a PTP or other partnership unless it is certain that the income it receives from that partnership, together with all other nonqualifying income sources, will not exceed 10 percent of its gross income.

These rules force mutual funds choosing to invest in PTPs to carefully monitor their income from those investments to ensure that it does not exceed the 10 percent threshold. The consequences of failure are severe: loss of its passthrough status as a regulated investment company. The Coalition knows of one mutual fund which came close to having this happen because a PTP in which it had invested had an unexpectedly profitable year and was allocating income to the fund at a rate which nearly brought it over the limit.

This complexity is completely unnecessary and serves to needlessly deprive PTPs of investment capital. It may have made sense to omit partnerships from the list of qualifying income sources when the RIC rules were originally conceived, as there were no *publicly traded* partnerships then. Partnership investments at that time were always illiquid and often risky, and it was understandable that Congress would deem them not to be an appropriate investment for a mutual fund. PTPs, however, are as appropriate an investment for a mutual fund as any other publicly traded security. Mutual funds are an increasingly important part of the capital market, and it is unfair to deny PTPs access to them on the basis of rules that have no current policy justification.

The Coalition proposes to enhance capital formation for those doing business as PTPs by adding to the simplification provisions an amendment to the RIC rules in Code section 851(b) to include income from publicly traded partnerships as qualifying income for mutual funds. The Coalition's proposal would accomplish this by treating such income as a dividend solely for the purpose of the gross income test in section 851(b).

Conclusion

The Coalition of Publicly Traded Partnerships commends the Ways and Means Committee for returning tax simplification to the Congressional agenda. We believe that these provisions have languished for far too long and look forward to seeing action on them this year. The Coalition urges that in its consideration of simplification, the Committee take the following actions:

- Retain the large partnership simplifications now in the bill in their entirety.
- Improve upon large partnership simplification by adding provisions that would:
    - Eliminate unnecessary complexity for pension funds, IRAs, and other tax-exempt investors by exempting from UBIT any investment representing less than 5% of the partnership's capital; and
    - Eliminate unnecessary complexity for mutual funds wishing to invest in PTPs by making PTPs a qualifying source of income under the RIC rules.

On behalf of the Coalition of Publicly Traded Partnerships, I thank the Committee for its attention to and consideration of our views.

Coalition of

Publicly
Traded
Partnerships

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**TESTIMONY OF
THE COALITION OF PUBLICLY TRADED PARTNERSHIPS
SUBMITTED FOR THE WRITTEN RECORD OF
THE HOUSE COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISCELLANEOUS TAX BILLS
July 11-12, 1995**

The Coalition of Publicly Traded Partnerships appreciates the opportunity provided by the Committee to offer these additional comments to the testimony we provided orally at the hearing on the issues which are of concern to its members. The Coalition is a trade association representing publicly traded partnerships (PTPs) and the accounting, law, and service firms that work with them.

The oral testimony delivered to the Committee by Letitia Chambers, President of the Coalition, at the July 12 hearing covered four legislative provisions which the publicly traded partnership community wishes to see enacted in the near future, including H.R. 1686, sponsored by Congressman Amo Houghton and nine other Committee members, which provides a permanent extension of partnership treatment for "grandfathered" PTPs not meeting the qualifying income test enacted in 1987. This statement will expand on that testimony with regard to the grandfather extension, which is the first priority of the Coalition in the 104th Congress.

Background

The current status of the "grandfathered" PTPs derives from section 10211 of the Omnibus Reconciliation Act of 1987 ("the 1987 Act"), which placed restrictions on the types of PTPs which could enjoy partnership status. These provisions were the result of concerns of the Committee leadership at the time that if no restrictions were placed on publicly traded partnerships, the corporate revenue base would be seriously eroded as corporations adopted the PTP form to avoid the corporate income tax.

The Coalition argued at the time that these fears were highly overblown, and still believes that to be true. In the first place, the repeal of the *General Utilities* doctrine in 1986 had ensured that there would be no further corporate conversions by making the tax consequences prohibitively expensive. In addition, the PTP form is suitable only to certain types of businesses, primarily those generating a substantial cash flow which is available for distribution to investors. The businesses themselves are in a better position than Congress to know whether a PTP makes economic sense. Nevertheless, the concern was strong enough to prompt the Ways and Means Committee, and ultimately Congress, to take action.

Section 10211 of the 1987 Act created section 7704 of the Internal Revenue Code, which states that a PTP will be accorded partnership tax status only if 90 percent of its gross income comes from specified sources (primarily natural resource and real estate activities). PTPs meeting the test, including those PTPs formed since the Act, can continue to operate indefinitely as partnerships. PTPs not meeting this test are taxed as corporations. Section 10211(c) provided a transition rule under which PTPs in existence at the time of enactment would retain their partnership status through December 31, 1997, regardless of whether they met the gross income test, as long as they did not enter a substantial new line of business.

At the time this legislation was enacted, there were about thirty-five PTPs with the "wrong" kinds of income. Since then, the number has been reduced as PTPs have been acquired by other companies, have reincorporated (for reasons unrelated to their grandfathered status), or for other

reasons have ceased to be traded partnerships. There are now twenty-seven grandfathered PTPs remaining (see attached list). They are in a variety of businesses, and have hundreds of thousands of employees and unitholders in states across the nation.

The Legislation

H.R. 1686 simply removes the 1997 sunset date from the transition rule and gives this small group of PTPs the option of continuing their partnership status as long as they wish. It does not change the substantive rule of section 7704, nor the restriction on entering new lines of business, nor in any way alter the policy of Congress with regard to the taxation of publicly traded partnerships. It simply maintains the status quo.

This legislation has solid bipartisan support. The ten cosponsors include six Republicans and four Democrats. In the 103rd Congress, the bill was also introduced with a bipartisan group of sponsors led by Representative Mike Andrews. On the Senate side, where the legislation was introduced in the 103rd Congress by Finance Committee Chairman Packwood, it will also be introduced by a bipartisan group of cosponsors.

Enactment of the Grandfather Extension is Appropriate and Fair

A permanent grandfather is appropriate tax policy.

It is a long established principle of tax policy that legislation changing the tax law should be prospective in application. This principle recognizes that it is unfair to penalize taxpayers which have entered into transactions in reliance on the tax law existing at the time. Thus tax legislation routinely provides taxpayers who have entered or made a binding commitment to a transaction before a certain date with a transition rule allowing them to continue using the tax law on which they had relied with regard to that transaction. It is also quite routine for such a transition rule to be indefinite in term, allowing the taxpayer the benefit of previous tax law until the contract or transaction to which it applies has run its natural course.

Thus, the ten-year transition rule which was given to PTPs that were already trading or in registration at the time of the 1987 Act was not a special benefit. What was unusual was the limited term of the transition rule. It would have been more usual for the existing PTPs to be grandfathered for as long as they continued to operate. The legislative history of the 1987 Act offers no policy justification for limiting the grandfather in this way

There is in fact no policy justification for requiring the grandfathered status of these PTPs to sunset at the end of 1997. The policy goal of the PTP provisions of the 1987 Act, to strictly limit the use of the PTP form in order to ensure that it was not used for large-scale evasion of the corporate income tax, was met by the establishment of the gross income test in section 7704. New PTPs can now be formed only by a few industries, and only a few new PTP issues come on the market each year. No more PTPs with nonqualifying income will be formed. The concerns about the growth of PTPs have been addressed.

Moreover, looking at the larger picture, allowing the grandfather to expire would result in exactly the type of government interference with business and capital formation that the 104th Congress is trying to reduce. These companies chose the business structure that they felt would work best for them and for their investors and made a sizeable investment in that structure. Their investors showed their faith in this decision by purchasing partnership units and providing the companies with hundreds of millions of dollars in new capital. The desire of these companies to continue in partnership form shows that the decision has worked. Why should Congress force these companies to abandon a structure that is working well for them and to incur enormous conversion costs in the process?

Failure to extend the grandfather will impose unnecessary costs on PTPs and investors.

There is thus no reason to force the few remaining grandfathered PTPs into an unwanted corporate conversion, and many reasons not to. If the grandfather is not extended, the affected PTPs cannot simply go about their business as partnerships through December 31, 1997 and then continue on as corporations on January 1, 1998. There is an extraordinary amount of planning and work involved in developing the "exit strategy" that will best meet the needs of the company, in shepherding investors through the conversion process, in doing all the things necessary to comply with securities law, and in anticipating and planning for the tax consequences. To the extent that the company is focused on these matters, it is not engaging in productive activities that could contribute to profit, employment, and growth. This is a loss both to the company itself and to the economy as a whole.

The forced conversion will impose enormous costs on the PTPs and their investors. For the PTPs the costs will include legal, accounting, and other service fees; staff time; and opportunity costs, as resources that could be more productively employed in furthering the business of the company are diverted to the conversion. The investors, predominantly middle class individuals who bought their units with no expectation that the nature of their investment would be greatly changed, face the tax consequences of the various steps in the conversion (depending on how it is structured, the conversion may trigger recapture of tax benefits, realization of gain, etc.), as well as a drop in the value of their units caused both by the market reaction to the forced conversion and the diversion of resources away from activities producing profit and growth. In fact, many grandfathered PTPs feel that the pending sunset date is already be affecting the price of PTP units and depriving their investors of value. In return for all this, the federal government would gain only $68 million in additional revenue between now and the year 2000, according to the Joint Committee on Taxation.

A permanent grandfather is fair.

Besides imposing a large amount of cost and effort on these companies for no particular reason, failing to extend the grandfather would be simply unfair. The affected PTPs, no less than those that happened to have "qualifying" income when the law changed in 1987, were formed in good faith (and after the expenditure of considerable time and expense) under a tax code that provided them with partnership tax treatment. Like the qualifying PTPs, they did nothing more or less than what the law allowed them to do. It is unfair to force them to convert because they were not sufficiently clairvoyant to know at the time they were formed that their business' income would fall on the wrong side of a qualifying line that would be imposed at some future date.

An issue that is sometimes raised in this connection is the fairness of the grandfather extension to other companies in the same industries as the grandfathered PTPs which cannot avail themselves of PTP status. It should be remembered that these other companies had exactly the same opportunity that the grandfathered PTPs did before the law changed in 1987. They, too, could have structured all or part of their operations in PTP form. Presumably they did not do so because they decided that this was not the option that best met the needs of their company. If that has changed, it is unfortunate that the tax law no longer allows them this option, but it is not unfair. Having passed up an opportunity of which others availed themselves is a very different thing from having incurred the costs involved in structuring or restructuring a business in reliance on existing law and then facing the prospect of having to restructure again because the law has changed.

Why the grandfather needs to be extended this year

There are a little over two years left before the grandfather provision sunsets. As discussed above, the conversion, if it must occur, will require extensive planning and preparation. Coalition members have indicated that a two-year lead time is not unusual when it comes to planning something on this scale. It is therefore essential that the matter be resolved now, rather than in the final months before the sunset date.

In addition, there are indications that the pending expiration of the grandfather is already depressing the market price of the units for these PTPs. Even PTPs that are not subject to the

grandfather may be affected, as many people may be under the belief that *all* PTPs will undergo a forced conversion at the end of 1997.[1] It is in the interest of the tens of thousands of middle class investors who own PTP units to remove this drag on the value of their investment.

Conclusion

In the overall scheme of the policy issues with which Congress must deal this year, the extension of the grandfather provision for twenty-seven publicly traded partnership is a very small matter. For the PTPs that are affected, however, it is an issue of enormous consequence, affecting every business decision that they will make for the next two years. The Coalition of Publicly Traded Partnerships strongly urges that H.R. 1686, Congressman Houghton's bill providing a permanent extension, be included in the Committee's next tax bill. The reasons for doing so are clear:

- A permanent grandfather is appropriate tax policy, and serves the larger goals of this Congress.

- Allowing the grandfather to sunset would impose substantial costs on the affected companies and their investors for no good policy reason.

- Allowing the grandfather to sunset would be unfair to the grandfathered PTPs and their investors, as it would penalize companies that chose their business structure on the basis of the tax law in existence at the time and those that backed that choice with their capital.

- Extending the grandfather this year will allow the affected PTPs to plan for the future and remove the shadow that the sunset has cast over their long-term business planning and the value of their units in the marketplace.

The Coalition appreciates the Committee's attention to this issue and stands ready to provide whatever information and assistance might be needed.

[1]Several people who have called the Coalition for information on PTPs have had this impression.

GRANDFATHERED PUBLICLY TRADED PARTNERSHIPS

Hotels and Motels

1. AIRCOA Hotel Partners -- Denver, Colorado
2. PSH Master I -- Dublin, Ohio
3. Red Lion Inns -- Vancouver, Washington

Investment Advisors

4. Alliance Capital Management, L.P. -- New York City
5. New England Investment Company -- Boston, Massachusetts
6. Oppenheimer Capital, L.P. -- New York City
7. Pacific Investment Management Co. -- Newport Beach, California; Stamford, Connecticut

Cable TV

8. Falcon Cable Systems -- Pasadena, California
9. Galaxy Cablevision, L.P. -- Sikeston, Missouri
10. Jones Intercable Investors, L.P. -- Englewood, Colorado

Health Care/Nursing Homes

11. Forum Retirement Partners -- Indianapolis, Indiana
12. Integrated Health Care Facilities -- Milwaukee, WI
13. National HealthCorp, L.P. -- Murfreesboro, Tennessee

Restaurants

14. American Restaurant Partners -- Wichita, Kansas
15. Perkins Family Restaurants -- Memphis, Tennessee

Leasing

16. Airlease, Ltd. -- San Francisco, California
17. PLM Equipment Growth Fund -- San Francisco, California

Others

18. Borden Chemicals and Plastics -- Geismar, Louisiana
19. Boston Celtics, L.P. -- Boston, Massachusetts
20. Cedar Fair, L.P. -- Sandusky, Ohio
21. FFP Partners, L.P. -- Fort Worth, Texas
22. Los Angeles Athletic Club -- Los Angeles, California
23. The Marina, L.P. -- Noblesville, Indiana
24. Mauna Loa Macadamia Partners, L.P. -- Honolulu, Hawaii
25. ServiceMaster, L.P. -- Downers Grove, Illinois
26. Sun Distributors, L.P. -- Philadelphia, Pennsylvania
27. TENERA, L.P. -- Berkeley, California

Mr. CRANE. Thank you, Dr. Chambers.
Mr. Blair.

STATEMENT OF ROBERT A. BLAIR, CHAIRMAN, S-CORPORATION REFORM PROJECT

Mr. BLAIR. Thank you, Mr. Chairman. My name is Robert Blair, and I am chairman of the S–Corporation Reform Project, a coalition of approximately 40,000 companies nationwide. I am here today to talk about apple pie, motherhood, and the American way.

When you talk about tax reform and tax issues, you tend to talk about technical provisions, and there are a ton of technical provisions in the S corporation reform legislation that has been pending before the Congress off and on for a number of years. The important thing is not to lose sight of what these technical provisions do for the American economy and the American people.

I would also quickly like to thank you, Mr. Chairman. You are an original cosponsor of legislation about to be introduced by Mr. Shaw, and I thank you for your willingness to go on this legislation this year.

What are S corporations? S corporations are about 1.9 million strong; they are by definition closely held companies; they are the vehicle of choice for many family businesses—in fact, until the arrival and the advent of the LLC, limited liability corporation, the S corporation was the way to go. It is still the way to go for those who have chosen that method—1.9 million companies. They have been the job-creating machines of the United States. In this era of big companies downsizing, laying off, trying to figure out how to squeeze another dollar out of the bottom line, who has been taking up the slack? That slack has been taken up by a number of small corporations, but S corporations being the vehicle of choice for so many families and "mom and pop" operations, I say it is the vehicle for the job creation here in the United States.

Why are we talking about apple pie, motherhood, and the American way, and why is S corporation reform legislation needed? It is because of the success that Congress helped to create in 1958 and in successive legislation in 1982 and other amending provisions over time.

Why the success? The success occurred because you permitted companies to go out, to have limited liability, while taking the calculated risk; that is, the amount of money they put up in order to start businesses. And these businesses are across the spectrum. I talked about the 40,000 companies in S corporations. They are everything from pet crematoriums to trucking companies to rent-a-car companies to travel agents. You name it, they do it.

Particularly among families, since S corporation legislation was created in 1958, you now have second and third generations of families who are part of these companies. It is wonderful; it is terrific. Families, making money together, bringing in the sons and daughters, the grandsons and granddaughters. That is the success. That is also the problem.

The problem is that the rules that you so wisely passed in 1958 and amended in 1982 need further revision. Success breeds more success. What are the problems that these rules today foster and create?

One is the problem of limited access to capital. If you are a company and you are trying to expand into new horizons, if you are attempting to hire more people, if you are trying to take more risk, you have got to have access to capital. It is a problem.

What happens when these companies go to their favorite lender, the bank, and ask for money to expand? I will give you the example that one gentleman, Brad Barney, found in Utah. He went to the bank and asked for $1 million to expand. The bank said, We will lend it to you provided you put up $1 million in the bank, on deposit, and by the way, we will charge you a 4.5-percent spread for the use of that money.

As Mr. Barney so appropriately said: In other words, they will loan me my own money for 4.5 percent. Not exactly a fair deal. He needs to raise capital, however, because he wants to diversify and move into other arenas. He did not take the deal that was offered, so that diversification, that expansion did not occur.

Other areas include the limited number of shareholders. Only 35 shareholders are permitted with S corporations. If you need capital, how do you get it? You have got to go out and get shareholders to put money into your company. Many of these families, many of these operations have expanded to the point of being at 32, 33, 34 shareholders. Where do you get the capital? You cannot do it if you cannot have more shareholders.

S corporations also cannot have a wholly owned subsidiary. If you have developed, as one father did with his company—he is now in his seventies, and he had a great business—you may be hindered from expansion opportunities. That father's son comes along, for example, and wants to expand into a more risky business. The father says no, because he does not want to put at risk all of his capital that he has earned and held onto over these years. Well, a wholly owned subsidiary would permit the father's company to go out and diversify, expand, create more jobs, continue the good story that is there.

There is a bill on the Senate side, S. 758, with 29 bipartisan cosponsors, which solves many of these problems. On the House side, Congressmen Shaw, Matsui, and Portman will be introducing legislation, I was told, just before this hearing, within the next day or two, to help solve these problems.

There are 25 original cosponsors of the draft House legislation, including 20 Members of this Committee, and I am sure that that number will grow because everybody wants to be part of a success story, apple pie, motherhood, and the American way.

I urge this Committee to please act on this legislation as soon as possible after its introduction.

Thank you, Mr. Chairman.

[The prepared statement follows:]

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STATEMENT OF ROBERT A. BLAIR
CHAIRMAN
THE S CORPORATION REFORM PROJECT

HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
OF THE U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.
JULY 12, 1995

Mr. Chairman and Members of the Committee, thank you for taking time to address the concerns of America's entrepreneurs related to capital access, improving operating efficiency and overcoming the obstacles associated with managing family businesses from one generation to the next. It is my hope that, though the efforts of this Committee, real legislative answers can be found for these very real problems affecting productivity and growth for S corporations, which are an increasingly critical part of the economy.

My name is Robert A. Blair, and I am the founder and chairman of a coalition called the S Corporation Reform Project, known as S-CORP. We are the only organization devoted exclusively to addressing the federal policy concerns of America's 1.9 million S corporations. S-CORP was formed in 1993 by several dozen S corporations which sought to improve the legislative environment governing their business operations. Nearly two years later, through our members, affiliates and trade association affiliations, we speak on behalf of more than 40,000 S corporations nationwide.

Who Are America's S Corporations?

The latest Treasury Department statistics available indicate that there are more than 1.9 million S corporations in America today. These businesses are not concentrated in any geographic region, nor are they aggregated in a particular industry. Rather, they are evenly spread across the industrial base, with about a third operating in the service sector, a third in the retail trade and financial sectors, and a third in manufacturing, mining, agriculture and other traditionally "heavier" industries.

Because the S corporation structure has been well-suited for closely held and managed companies, the S corporation structure is very common among family businesses. Because a growing number of U.S. companies are operated as closely-held or family-owned companies, moreover, S corporations have become an increasingly important segment of American industry. While in 1978, S corporations made up only about 20 percent of U.S. corporations, they now account for almost 50 percent of all corporations in this country. S corporations also account for about 40 percent of the U.S. corporate tax base. From these statistics, we can tell that S corporations are an integral part of the U.S. economy, and that they tend to be most prevalent among small- and medium-sized businesses. In fact, a report issued in May by the Joint Committee on Taxation noted that S corporations hold a relatively small share of corporate assets in America despite their large numbers nationwide. Thus, the report concludes, S corporations are mostly small businesses.

The Restrictive Legislative Environment for S Corporations

S corporations share some other important features: The rules governing their operations severely limit their capital access, their ability to grow and streamline their businesses, their ability to manage family operations from one generation to the next, and thus their ability to maximize productivity and long-term competitiveness.

I do not believe that Congress intended to set productivity traps for S corporations when it originally created the rules for these businesses as part of the Technical Amendments Act of 1958. In fact, I would argue that, in the nearly four decades that have passed since the S corporation provisions of the Internal Revenue Code were enacted, Congressional efforts to promote entrepreneurship have been highly successful. Indeed, by creating this special corporate structure, Congress has encouraged literally millions of Americans to form new businesses. Given the quadrupling in the number of S corporations from 1978, when there were fewer than half a million of these businesses, to today, when more than 1.9 million exist, I would submit that much of what Congress has done has worked

Unfortunately, many of the rules governing S corporations are no longer appropriate. The S corporations that were established a twenty or thirty years ago have matured. The generation responsible for the S corporations that emerged in the 1960s and 1970s has brought its children, nieces and nephews in to run and, hopefully, to grow their businesses. The operations of these companies, as they have added new facilities across the United States and, in some cases, across the globe, are naturally more complex than ever before. As a result of the maturation and growth of these companies, together with the significant changes that have occurred in the global business environment over the past 40 years, many of the S corporations rules implemented in 1958 to encourage entrepreneurship now serve to restrict the growth of these companies instead.

Congress certainly did not set out to hinder or impede the growth of S corporations in subsequent years, when S corporation rules were amended and modified. Instead, many of the current burdens on S corporations are the by-products of other legislative efforts A glaring example of this was the 1993 increase in top personal tax rates, which rose from 31 percent to 39.6 percent. Since S corporation shareholders pay taxes at rates which apply to individuals, the rate increase exacerbated disproportionately the tax burden borne by S corporations relative to all other corporations.

Although my task today is not specifically to argue for rate relief, I nevertheless must point out to this Committee that S corporations have suffered a far higher increase in their tax burden than any other type of corporate entity, since the 1993 Budget Reconciliation Act pushed up the top corporate rate by only one percentage point, while the personal rate -- which is applied to S corporations -- rose by almost nine times that amount. More troubling is that the increase in rates paid by S corporations does not distinguish between the earnings distributed to S corporation shareholders and the funds that are reinvested in these businesses for upkeep and growth. As a direct result, S corporation shareholders pay higher taxes on their own take-home earnings and on their pro rata share of corporate reinvestment.

The unintended result of this tax policy is easily illustrated. Let us assume that an S corporation owner's "share" of her company's earnings in a given year is $250,000. Of that amount, she takes home $125,000 in wages and distributions, and invests the remaining $125,000 to purchase a new machine and hire new workers. According to current law, the owner must pay taxes on the full $250,000 as if it were her own income. Thus, at the end of the year, she will pay federal income taxes at an astonishing rate of 64 percent of her actual take-home pay. **More importantly, she will pay the same tax bill as another business owner who took home $250,000 in salary and distributions and chose to reinvest nothing in his business.** I cannot conceive of a greater disincentive for growth.

It should not be surprising, therefore, that many S corporations are now scaling back investment in their operations. This trend is nothing short of alarming, given the importance

of S corporations to the national economy and their longstanding role as job-creators and engines of productivity growth.

The lesson to be learned from this, I believe, is that any broad-based national economic policy is likely to have some effect on S corporations, and that policymakers must therefore take these companies and their unique corporate structure into consideration when developing major new initiatives -- from tax policy to health care reform to the establishment of new estate planning rules. A blind eye to the needs of S corporations is something akin to building a national highway system whose entry ramps are too narrow to accommodate almost half the cars getting on. In the competitive national and international economy, access and opportunity are critical.

Hindered Capital Access

When burdens are placed on the capital of S corporations, it is important that alternative and accessible forms of capital be made available to these companies. Without accessible and reasonably-priced capital, a company's short- and long-term plans for growth can be severely restricted.

Unfortunately for S corporations, there are many restrictions on capital which hinder their ability to grow. These restrictions range from limitations on the type of debt and equity an S corporation may have to limitations on the number and type of shareholders which can invest in an S corporation. Capital is thus available only from a limited number of equity participants, or from bank debt, which can itself be scarce. The troubling result for too many S corporations -- regardless of their creditworthiness, their performance history or their promise -- is that their cost of capital is often extremely high, and their ability to compete is proportionately diminished.

I recently learned, in fact, that one of our members who owns a successful trucking company was asked to pay 9 percent to borrow short-term funds from his local bank. The cost of these funds certainly didn't take into account his company's considerable track record over more than four decades, the fact that the funds were required for a customer-driven expansion, the fact that his company had provided much of the bank's local business for decades, or the fact that the bank required that this businessman keep as much cash in an account with them as he take out in the form of a loan. Of course, the latter requirement defeated the purpose of seeking the loan in the first place.

What the price of capital reflected was the fact that bank debt was the only outside capital source available to this extremely desirable borrower. The truth is that such situations are all too common for S corporations in search of funding today.

<u>Debt and Equity Restrictions</u>. S corporations are very restricted in capital access because they are permitted to have only one class of shareholders. This prohibits these companies from having, among other things, a two-tiered equity structure, or from issuing debt that can be converted to equity.

Without the ability to have multiple classes of equity, S corporations are forced to trade off voting rights, and often the management of their businesses, in return for any new equity capital. Moreover, this rule, as well as the prohibition on any type of convertible debt, generally makes S corporations ineligible for funding from the many types of investors and lenders who prefer to be sheltered from the direct risk associated with holding the common stock of a small or closely held business. Such preferences are typical among venture capitalists and other similar private equity investor groups, which might -- absent current limitations -- otherwise play an important role in fueling the continued growth of S corporations.

<u>Limits on Shareholder Number and Type</u>. Current law also limits an S corporation to 35 shareholders, and prohibits many types of shareholders -- including most trusts and all taxexempt

entities -- from owning S corporation stock. These restrictions result in both capital and operating difficulties for S corporations.

As a result of the numerical limitation on S corporation shareholders, family businesses which are run by more than one family or by several generations of a single family will eventually be disqualified as S corporations when they surpass the shareholder limit; it is simply a matter of time. Consequently, participation in a family's business may have to be denied to important family members -- either senior members who know the business best, or junior members who hold the most promise for the business' future. Either way, the business suffers.

The limitations on the type of permissible S corporation shareholders raise even further problems. S corporations are not currently allowed to include many types of important institutional shareholders -- like "multiple beneficiary" trusts, spray trusts, and charitable institutions -- which are common among shareholders in C corporations, partnerships and limited liability companies ("LLCs"). By limiting the type of entity that can invest in an S corporation, the company is further limited in its capital sources. Frequently, moreover, these rules lock out many employees from participating in their companies directly, and thus benefiting from their own hard work.

By disallowing multiple beneficiary trusts as S corporation shareholders, for example, current law effectively prohibits S corporations from having employee stock ownership programs, or ESOPs. It is widely accepted that ESOPs provide an important productivity incentive for a company's workers, and that they are immensely valuable as a means of rewarding many years of service by long-time employees. ESOPs also provide an important means for some business owners to obtain new sources of reliable capital without forcing them to turn "outside the company" for these funds.

Unique Operating Burdens

The disallowance of other multiple beneficiary trusts, like those which would "spray" benefits among a business owners heirs depending on the needs and circumstances of each potential beneficiary, raise additional, operating problems for S corporations. The ineligibility of S corporation "spray" trusts, for instance, forces S corporation owners to spend thousands of extra dollars -- sometimes tens of thousands -- to create separate trusts for each of their separate beneficiaries. When an S corporation has more than one owner, which is common, this rule can be extremely burdensome to the owners and the company.

Several other, often more serious operating difficulties exist for S corporations. One of the most onerous of these is the inability of S corporations to own and operate wholly owned subsidiaries. Without being able to have a subsidiary, an S corporation is often forced to grow in inefficient fits and spurts, or create complicated organizational structures to get around the problem. This prohibition frequently limits an S corporation from expanding into new areas of business, new geographic regions, or both. The restriction on operating flexibility inherently limits an S corporation's ability to compete with other types of businesses in the same industry, and as a result, frequently curtails long-term growth.

Other difficulties arise because of the excessive and unnecessary administrative burdens placed on S corporation tax planning, additional statutory complexities related to estate planning, and the proliferation of unnecessary and obsolete tax traps which serve only to "catch" the unwary S corporation tax planner. Separately and together, these prohibitions seriously restrict the growth of the sizeable American S corporation community.

Legislative Solutions Are Within Reach

Fortunately for 1.9 million companies, there are legislative solutions to these issues well within reach. In the Senate, S. 758, or the "S Corporation Reform Act of 1995," was introduced May 4 by Senators Orrin Hatch and David Pryor to alleviate many of the burdens which unnecessarily plague S corporations and limit their growth. Companion legislation will soon be introduced in the House, thanks to the considerable efforts of Congressmen Clay Shaw, Robert Matsui, Rob Portman and their staff. S-CORP strongly supports this measure, and extends its appreciation to the leaders of S Corporation Reform legislation for their hard work to improve the financial and operating environment for America's S corporations.

The Shaw-Matsui-Portman bill would grant S corporations access to important types of capital which are presently unavailable. New classes of debt and equity could be issued, and the limits on the number and type of permissible shareholders would be expanded to 75 from the current limit of 35. Companies would be able to create ESOPs and have other multiple beneficiary trusts, and would be able to have many types of institutional shareholders. S corporations would be able to have wholly owned C corporation subsidiaries as well as S corporation subsidiaries, thereby permitting these companies to grow through acquisitions as well as start-ups.

Efforts to pass family businesses from one generation to the next would be enhanced through improvements to estate planning and the reclassification of all family members as a single shareholder of the company. The bill would also simplify S corporation taxes by eliminating many of the obsolete tax traps which continue to plague S corporation owners and managers.

This legislation makes good business sense for S corporations, their employees, the communities in which they operate, and the national economy. It represents a pro-active legislative approach to solving real business problems with real and realistic solutions.

Some have raised the notion that while legislation such as the S Corporation Reform Act would vastly improve the competitive playing field for S corporations, it may be unnecessary due to the recent spread of limited liability companies, or LLCs. While I agree that the advent of the LLC is indeed important and positive for American entrepreneurs, I would nevertheless argue that the LLC format is not an economically feasible option for entrenched S corporations, due to the very high "toll charge" these companies would pay as a result of switching over from S corporation status to LLC status.

At the time of such a switch, the S corporation would have to pay a severe tax penalty on accounting gains -- a penalty that is generally so high that it will never be economic to convert to and then operate as an LLC. Given the very low likelihood that significant numbers of S corporations will convert to LLCs, we can count on the fact that most of these 1.9 million businesses will continue to require legislative solutions to the serious capital and operating issues I have raised today. The value of the S Corporation Reform legislation about to be introduced by Congressmen Shaw, Matsui and Portman is, and will remain, considerable.

I should reiterate at this junction that, while not all S corporations are small businesses, the vast majority of them are. Therefore, the lion's share of the benefits of the proposed legislation will accrue to these companies, though some medium-sized and larger S corporations will also be helped by this important legislation. This result is, I believe, as it should be: Reform legislation should address the difficulties faced by any company operating as an S corporation, because these obstacles affect these companies equally, regardless of their size. Moreover, this legislation should encourage and facilitate long-term growth, and not limit it by being narrowly applied to only a subset of the S corporation community.

I believe that the S Corporation Reform Act of 1995 will measurably improve the competitiveness of America's S corporations. And I do not believe that our coalition is alone

in that belief: I am profoundly encouraged by the wide acceptance and support this legislation has gained since its very recent introduction in this Congress. Since it was introduced in the Senate only 10 weeks ago, 29 Senators have cosponsored this measure, including seven Members of the Finance Committee. More relevant to this Committee -- and perhaps even more impressive -- is that, even before this bill is introduced in the House, 24 Members of this Chamber, including an impressive 20 Members of this Committee, have endorsed the Shaw-Matsui-Portman companion bill. In both the House and the Senate, furthermore, support for this legislation is strongly bipartisan.

Not surprisingly, strong support for this legislation has also emerged from American industry. In fact, the S Corporation Reform Project (S-CORP) is working closely with 22 associations and coalitions in a wide variety of industries to pass this legislation this year. I have included a list of the supporting trade groups with my testimony today.

I believe that the proposed legislation is so widely embraced because it represents fairness and real simplification, and is intended not to benefit any particular sector or region, but rather to help American entrepreneurs broadly. The legislation recognizes the economic value that S corporations have long created, as well as the economic potential that matured and growing S corporations hold on a national scale. Finally, it represents a critical opportunity for a true cross-section of the U.S. industrial base and the American populace.

I thank the Chairman for his foresight in addressing some of the central concerns of S corporations, and for calling this hearing today. I very much appreciate the hard work and commitment from Congressmen Shaw, Matsui and Portman, whose leadership and determination can make a significant difference to the competitiveness of 1.9 million companies across America. I hope that others on this Committee will follow the important and admirable leadership of the Chairman and the sponsors of S corporation reform legislation, and help to make S corporation reform a reality in 1995. Thank you.

ORGANIZATIONS WHICH SUPPORT THE S CORPORATION REFORM ACT OF 1995

American Consulting Engineers Council
American Institute of Certified Public Accountants
American Vintners Association
Associated Builders and Contractors
Associated General Contractors of America
Association for Advanced Life Underwriting
BDO Seidman, Washington, D.C.
Independent Insurance Agents of America
Information Technology Association of America
National Accounting and Finance Council of the American Trucking Association
National Association of Life Underwriters
National Association of Private Enterprise
National Association of Realtors
National Association of Wholesaler-Distributors
National Automobile Dealers Association
National Business Owners Association
National Small Business United
National Society of Public Accountants
S Corporation Reform Project
S Corporation Coalition
Sheet Metal and Air Conditioning Contractors' National Association, Inc.
Steel Service Center Institute
United States Chamber of Commerce

Mr. CRANE. Thank you, Mr. Blair.

Mr. McCrery, do you have any questions of the witnesses?

Mr. MCCRERY. No questions.

Mr. CRANE. Mr. Collins, do you have any questions?

Mr. COLLINS. No questions.

Mr. CRANE. Mr. Christensen.

Mr. CHRISTENSEN. No questions.

Mr. CRANE. Mr. Hancock.

Mr. HANCOCK. Thank you very much.

I would like to question Mr. Blair for just a moment on this LLC as a substitute in many cases for S corporations. I was recently visiting with some legal people, and in many cases, they are saying the LLC is so new that there are different State laws, and they are saying be extremely careful with the limited liability corporation. Have you been hearing that also?

Mr. BLAIR. Indeed, you have got to look State to State, and even as to the State to State differences, there is another trick bag for S corporations that exists today, Mr. Hancock. That is that if you are already an S corporation, you could not convert to an LLC anyway, without paying a terrible tax penalty.

Mr. HANCOCK. I understand that, but for a small company—say, in my district, for instance, or in my area—doing business in four States, which would be Missouri, Arkansas, Oklahoma, and Kansas, the only alternative is an S corporation. Even though the LLC appears to be a good vehicle, it is so new that we need to—I would just like to get on the record that we need to fix the S corporation before we start looking at these other things. Would you agree with that?

Mr. BLAIR. I couldn't agree more with that, Mr. Hancock.

In fact, the LLC is not a new vehicle in the world. They have been in Europe for many years. I remember back in 1975 researching an issue of a Saudi SARL, which is equivalent to an LLC here in the United States, but the differences between Saudi Arabia, Lebanon, France, and so forth as to those LLCs caused people to look at different vehicles, and they had to be very careful about how they did that.

I agree with you. If you are going particularly into multi-States, and different States have different laws, one must be very careful how one goes about that.

The beauty of the S corporation is that it is a federally created opportunity to limit your liability, and the Federal rules are there. They are straightforward; you just have to abide by them. As I suggested, they are a little limited today, and we need to broaden them.

Mr. HANCOCK. Well, that is true enough, but there are also some problems of having to pay 40 percent taxes on your profits on money that you need to leave in the business. That is another area that we need to address on S corporations.

Mr. BLAIR. Would you permit me to make a comment on that? That was in my written remarks, but I ran over and didn't have the chance to address this issue before, so I apologize. Something that a lot of folks up on Capitol Hill do not understand is that when you went from a 31- to 39.6-percent tax rate, whether you agreed or disagreed with that, whether you voted for it or against

it, it took a massive toll on S corporations which are pass-through entities. Many of these S corporations self-capitalize. What that 39.6 percent tax did to these S corporations is it made them distribute money to the shareholders to pay the higher taxes to the U.S. Treasury, therefore creating part of this capital access problem, because if you do not make money in the business and keep it and reinvest it, you have got to get it from somewhere, or you do not expand, and indeed, in some respects, S corporations have had to hold back some, retrench from their expansion.

Maybe the 39.6 percent was good for some. I submit, for S corporations, it bordered on a disaster.

Mr. HANCOCK. Well, I happened to have been a businessman before I came into the Congress, and last year, as a matter of record, the profits of the company, which the company cannot pay me—I cannot put it in my bank account—I have had to pay 45.6 percent income tax on the money that I cannot receive and cannot get. That 45.6, if they could just cut that down to the regular corporate tax of 35, would make it a little bit more reasonable, anyway.

Mr. BLAIR. Indeed.

Mr. HANCOCK. Anyway, thank you for your testimony.

Mr. BLAIR. Thank you.

Mr. CRANE. Mr. Portman.

Mr. PORTMAN. I thank the Chairman, and I appreciate the testimony here today.

Mr. Blair, I guess I have just one question for you. I am very supportive of everything you said with regard to encouraging sub S corporations, family businesses. In the Senate hearings, there was a discussion as to whether this legislation should be limited as to the size of sub S corporations. I think the Treasury Department proposed that the reforms were a good idea, but that they should be applied to sub S corporations that were "small"—perhaps below a certain annual revenue figure or a certain number of employees figure.

Can you comment on that? Sub-S corporations for the most part are small businesses, but some of them would be classified as midsize businesses. Does it make any sense to have an arbitrary cutoff in terms of the size of the company that would receive these necessary reforms and benefits?

Mr. BLAIR. Well, if you look at what Treasury said—and I was at that hearing and was frankly disturbed to hear the comment—if you are successful as an S corporation, that is, if you are able to generate revenues, if you are able to hire people, if you are able to expand your business, then the Treasury position, it would necessarily follow, is that if you are successful, you do not get the benefits of reform, and you are the one who really needs the benefits. You need a higher number of shareholders because you are expanding, you are bringing in family members, you are bringing in other capital, or you are looking to venture capitalists who do not want to come in as a common shareholder, but they want to come in in some preferred position—for example, preferred stock, not permitted under current S corporation rules. Treasury's suggestion flies in the face of the success of S corporations.

Maybe Treasury does not understand the success story that is out there, but every small S corporation that forms today—and I

think this is the beauty of America; you go out and talk to somebody who has just set up an S corporation, and that person is going to be the king or the queen of the hill in 5 years, and they want to grow, they want to get there—terrific. Give them the benefit. But do not take it away from those who have taken the risk, have attained success, and now need to continue to expand and move forward.

Mr. PORTMAN. I would just make one comment. I would concur with that. I do not think it makes any sense to have an arbitrary cutoff. In fact, I think it does create a disincentive to growth. I would also say that one of the reasons why there has been an interest in narrowing the legislation as to its application is because of the revenue impact. I think we have done a good job in the last couple of months of taking this legislation and narrowing the legislation itself, particularly with regard to the health care benefit, to come up with a revenue estimate that is much less than last year and which I think will be consistent with what this Committee, and Congress as a whole, is trying to do with regard to the budget deficit.

I think we have done our work to narrow this down and to make a responsible effort, and I think that is reflected in the fact that we have 20 Members of this Committee as cosponsors.

Thank you for your testimony.

Thank you, Mr. Chairman.

Mr. BLAIR. May I make one comment, Mr. Chairman, on that?

Mr. CRANE. Certainly.

Mr. BLAIR. Because there is a question—there is not a bill yet on the House side, and therefore, there is not a revenue estimate yet. But I do know that when they did some projections a couple of years ago, the provision that was stripped from this year's bill that you are about to be a lead on, Mr. Portman, is the fringe benefit deduction, which was estimated to be 60-plus percent of any revenue loss that the bill would have caused.

The 30 percent of the cost was some arbitrary figure, 30 of the 100 percent, that a number of C corporations would convert to S corporations, I think you have done the job of stripping this back to make it as clean and as revenue-neutral as possible.

Mr. CRANE. Mr. Coyne.

Mr. COYNE. No questions.

Mr. CRANE. Mr. Jacobs.

Mr. JACOBS. Mr. Chairman, I want to observe for the record on this portfolio exemption from taxation for foreign nationals that what it boils down to is that Uncle Sam in effect is paying higher interest rates to foreign nationals than he pays to his own nieces and nephews. It came about in 1984, as the witness said, and I will go so far as to say that the problem faced by people who anted to get reelected that year was that interest rates were rising rapidly because of the enormous borrowing by the Federal Government and pressures on money markets in the United States.

Here is how the reasoning went: We have to stop putting pressure on the money markets in the United States. How can we do that? We will borrow on foreign money markets? Well, why would the foreigners lend us any more than they already have? Because we will pay them higher interest rates. Well, if we do that, every-

body in the United States will think there is something wrong if they buy a bond and get a certain interest rate, and the foreign national buys a bond and gets a higher interest rate. That does not sound fair to the average person. Yes, but we can do it in the following way—we will make it tax free to foreigners whereas it is taxable to American citizens.

That is the origin. That is the motivation of it. It was applied to all portfolio investments in the first instance. The following year, certain people wanted to narrow it down just to government obligations, and that never got off the ground.

I simply say that for the record so the other side can be read.

Mr. SHAW [presiding]. Thank you.

Mr. Blair, I want to thank you for your comments. I have a copy of your written statement. The companion bill to the Senate bill that you refer to regarding S corporations now has 20 cosponsors on this Committee. It is moving ahead, and it seems to have a lot of support, and it certainly has a lot of common sense behind it.

If there are no other Members seeking recognition, we will dismiss this panel. Thank you very much for being here.

The Committee will resume at 1 p.m. this afternoon.

[Whereupon, at 11:52 a.m., the Committee was recessed, to reconvene at 1 p.m. this same day.

Chairman ARCHER. The Committee will come to order.

We are now ready to receive testimony from our last panel of the day, which includes Mr. Threadgill, Mr. Bannister, Mr. Dumbacher, and Mr. Enochs.

I would first like to recognize Mr. Threadgill. If you would identify yourself for the record and, having done so, you may proceed. Your entire printed statement will be entered into the record without objection, and we would like for you, if you could, to summarize verbally in 5 minutes or less.

Mr. Threadgill.

STATEMENT OF DELMER R. THREADGILL, VICE PRESIDENT AND DIRECTOR OF TAX, J.C. PENNEY CO., INC., DALLAS, TEXAS, ON BEHALF OF THE NATIONAL RETAIL FEDERATION

Mr. THREADGILL. Thank you, Mr. Chairman.

My name is Del Threadgill, and I am vice president and director of tax for the J.C. Penney Co. I am also the current chairman of the NRF, National Retail Federation's Committee on Taxation, and on behalf of that federation and its members, I am pleased to appear before you today to briefly address three issues that are before the Committee.

As you indicated, my written statement has been entered, and I will be as brief as possible.

First, NRF urges the Committee to enact the proposal to allow taxpayers to estimate the deduction for shrinkage used in accounting for inventories. Current law allows retailers a deduction for shrinkage, shrinkage being missing inventory due to theft, breakage, bookkeeping errors, and so on.

The Internal Revenue Service maintains that shrinkage is only deductible if it has been verified by a physical count of the inventory at the end of the year. For valid business reasons, many retailers and other taxpayers cannot or do not take a physical inventory

count at the end of their tax year. They do take a physical count, but it is at some other time during the year. Shrinkage is verified at that time and recorded on their books, but from the point in time of the physical count to the end of the year, retailers and other taxpayers calculate and deduct an estimated shrinkage amount using a reference to historical shrinkage patterns as a percentage of sales.

In many cases, the IRS has chosen to litigate this issue and in the only decision thus far, the Tax Court in 1993 ruled in favor of a retailer, stating that an estimate of inventory shrinkage may be used in computing year-end inventory so long as it clearly reflects income.

Although the NRF has attempted to engage the IRS in developing a shrinkage methodology that would be acceptable to the industry and the Service, the IRS has chosen to litigate this issue on a case-by-case basis. Therefore, to avoid the continued waste of both taxpayer and government resources on these controversies and to help eliminate and simplify these kinds of problems, the NRF asks the Congress to enact legislation that would prescribe acceptable methodologies for calculating shrinkage.

As to the second proposal we wish to comment on, the NRF urges the Committee to act on legislation to create a new, 10-year depreciable life for qualified commercial improvement property, such as improvements made by retailer owners and lessors to improve their retail space. Currently, additions of this type are forced into the same 39-year life as buildings, and this treatment grossly overstates the economic useful life of these retail improvements.

Successful retailers generally need to remodel their stores as often as every 5 to 7 years to reflect changes in customer tastes and needs. Commercial improvements will be changed out, several times before the end of any 39-year life.

There are other proposals, including one that is before the Committee in these sessions, that deal with the depreciable treatment for leasehold improvements. They deal, however, only with assets in leased property and do not address the situation where an owner of a building makes the same type of improvements to the interior space that they use for their own retail establishment. The decision to lease or own space should have no impact on the depreciable treatment of subsequent renovations.

Thus, the NRF requests the Committee to include in its legislation a provision creating a new, economically appropriate, 10-year class life for all qualified commercial improvement property whether leased or owned.

Finally, the NRF urges the Committee to act on legislation to modify penalties associated with certain errors in complying with the requirements for qualified employer pension and profitsharing plans. The IRS is currently very active in auditing large employer plans, and while the IRS at times can be very reasonable, the present rules call for a disqualification even when a very small percentage of inadvertent errors is found. An aggressive application by the IRS has also resulted in penalties being assessed in amounts that are far in excess of the cost of correcting these violations.

The NRF asks that the Committee consider the proposal to modify—certainly not do away with, but modify—the sanctions for inadvertent and de minimis errors in satisfying the qualification requirements in order that the level of punishment would better fit the level of the crime. As an example, one proposal would be to limit the amount of the penalty to 100 percent of the cost of the errors that were found and corrected.

Mr. Chairman, that concludes my remarks. Thank you.

[The prepared statement follows:]

STATEMENT
on
INVENTORY SHRINKAGE
and
COMMERCIAL IMPROVEMENTS
and
SANCTIONS WITH RESPECT TO QUALIFIED PLANS
scheduled for hearings before the
HOUSE COMMITTEE ON WAYS AND MEANS
as part of hearings on
MISCELLANEOUS TAX REFORMS

ON BEHALF OF THE NATIONAL RETAIL FEDERATION
by
DELMER R. THREADGILL, VICE PRESIDENT AND DIRECTOR OF TAX
J.C. PENNEY COMPANY, INC.

I am Delmer R. Threadgill, Vice President and Director of Tax for J.C. Penney Company, Inc., and Chairman of the Taxation Committee of the National Retail Federation. The National Retail Federation (NRF) is the world's largest retail trade association with membership that includes the leading department, specialty, discount, mass merchandise and independent stores, as well as 32 national and 50 state associations. NRF members represent an industry that encompasses over 1.4 million U.S. retail establishments, employs nearly 20 million people, or 1 in 5 American workers, and registered 1994 sales of more than $2.2 trillion. NRF's international members operate stores in more than 50 nations.

I am honored to be here today to testify on behalf of the NRF in support of three of the proposals that are the subject of this week's hearings -- a proposal to provide a methodology that taxpayers may use in estimating inventory shrinkage; a proposal to establish a 10-year recovery period for commercial improvements; and a proposal to modify sanctions for failure to meet the requirements of "qualified plans."

INVENTORY SHRINKAGE

The NRF urges the Committee to act on legislation that would permit taxpayers to estimate their "shrinkage" deduction for inventory accounting. "Shrinkage" is the reduction in a retailer's inventory that results from theft, breakage and bookkeeping errors.

Under current law, retailers may take a deduction for the "shrinkage" in their inventory. However, many retailers have been mired in disputes with the IRS over the appropriate methodology for calculating the amount of a taxpayer's inventory shrinkage. Since 1988 the NRF has worked towards developing a methodology for estimating inventory shrinkage that would be acceptable to the IRS, in order to eliminate these protracted controversies. To date, the IRS has chosen to litigate this issue on a case-by-case basis to determine if the methodology utilized by each taxpayer clearly reflects income, rather than setting forth rules that establish acceptable methodologies that may be relied upon by both taxpayers and the IRS. To avoid the continued waste of taxpayer and government resources on these controversies, the NRF respectfully requests that Congress enact legislation that would prescribe methodologies taxpayers may utilize in calculating shrinkage without IRS challenge.

By way of background, the IRS Retail Industry Specialization Program (ISP) published a position paper that would deny taxpayers a deduction for inventory shrinkage that is based on a calculation other than a year-end physical count of the inventory. Based on this position, many taxpayers have received proposed audit adjustments that deny a current deduction for the estimated shrinkage that occurred after the most recent physical inventory count and before the taxpayer's year-end. Several cases are at various stages in the litigation process. In the only decision on this issue thus far, the Tax Court has concluded that an estimate of inventory shrinkage may be used in computing year-end inventory so long as it clearly reflects income. *Dayton Hudson Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 101 T.C. 462 (1993). Subsequent to this decision, the IRS continues to litigate this issue to determine if each taxpayer's methodology clearly reflects income.

Many retailers (and many manufacturers as well) keep a perpetual inventory system that reflects purchases, sales, returns, and shrinkage (reductions due to theft, breakage and

bookkeeping errors). The starting point in any perpetual inventory is the actual inventory amount determined by a physical count of the inventory. The perpetual inventory is verified, or "trued-up," by a subsequent physical count of the inventory. Typically, this physical count occurs at lease once each year in order to keep the perpetual inventory current. Due to significant business constraints that result from assembling the resources needed to physically count inventory in every location at the end of the fiscal year, the physical count by many retailers does not always occur on the last day of the taxable year at all (and perhaps not at any) locations where inventory is maintained.

For financial statement purposes, taxpayers that do not physically count all their inventory on the last day of the fiscal year generally compute the amount of inventory shrinkage that has occurred since the most recent physical inventory count by reference to historical shrinkage patterns as a percentage of sales. This treatment is intended to most accurately reflect the true value of the taxpayer's inventory at year-end in situations where an actual year-end physical count is not practicable. These taxpayers generally use the identical treatment for purposes of computing taxable income.

The overwhelming reason why a taxpayer would not physically count inventory at the end of the fiscal or tax year is because management has determined that it is uneconomical to count all or any locations as of the end of that date due to the number of employees and amount of equipment that would be required. In addition, the availability of shrinkage data prior to the end of the fiscal year allows management to react to problems on a more timely basis.

The accrual method of accounting, which is used in determining inventories, requires that liabilities be taken into account when economic performance and all events that fix the liability have occurred. However, a taxpayer need not be aware of the liability in order to deduct it in the year in which it is accrued, but rather the fact of the liability must be knowable. Similarly, the regulations do not require that the exact amount of the liability can be determined, but rather that the taxpayer is able to compute the liability with reasonable accuracy. Treas. Reg. 1.461-1(a)(2)(ii). Again, to determine this amount with reasonable accuracy, the accrual method of accounting does not require that the amount of liability is known at the end of the year, but that it is knowable. *See Continental Tie and Lumber Corp. v. U.S.*, 286 U.S. 290 (1932). Clearly, the fact and amount of a taxpayer's inventory shrinkage is knowable at the end of the year even, if a physical count has not verified it.

In order to clearly reflect income, taxpayers must be able to match income and expenses. Therefore, retailers must be able to match inventory shrinkage to their sales income for the year. Treasury regulation 1.471-2(d) permits taxpayers to utilize a perpetual method of inventory accounting and thereby approximate the value of inventory, which the regulations require be verified by physical inventories at reasonable intervals. The rationale behind permitting taxpayers to use a perpetual method of inventory accounting is that it is not feasible for taxpayers to count all inventory on the last day of the fiscal year. Because this method of accounting is based on a taxpayer's estimates of inventory, if a taxpayer cannot estimate the inventory shrinkage that occurs from the time of their last physical count until the end of the fiscal year, the perpetual method will not clearly reflect income.

In a November 1993 decision, the Tax Court in *Dayton Hudson* denied the IRS motion for summary judgment in holding that an estimate may be used to compute year-end inventory so. long as it clearly reflects income. The IRS has decided to litigate the factual issue as to whether the taxpayer's method for estimating shrinkage clearly reflects income. As stated previously, there are several other cases docketed in the Tax Court, and it is unclear at this time whether the IRS will litigate the factual issues in each case to determine whether the methodology adopted by each taxpayer clearly reflects income.

The NRF respectfully requests the Committee to include in 1995 tax legislation provisions that would provide taxpayers with methodologies that could be used in estimating inventory shrinkage and thereby eliminate the need for protracted controversies. In the aftermath of the *Dayton Hudson* decision, the industry was hopeful that the IRS would be willing to issue a set of straight-forward rules in this area that could be voluntarily applied by taxpayers on a consistent basis. Unfortunately, the IRS continues to pursue a litigation strategy that appears to prevent them from issuing administrative guidance at this time. As a result, taxpayers will have to continue to litigate this issue. This course of action will result in an extremely high level of controversies between taxpayers and the IRS, similar to the situation that arose in the

intangibles area. For this reason the retail industry believes that since the IRS is unwilling to issue administrative guidance in this area, a methodology for estimating inventory shrinkage should be included in tax simplification legislation. The NRF would appreciate the opportunity to work with the Committee to develop acceptable methodologies for making this calculation that may be relied on by taxpayers.

LEASEHOLD IMPROVEMENTS

The NRF urges the Committee to act on legislation to establish a new 10-year depreciable life for "qualified commercial improvement property" – such as improvements made by retail owners and lessors to improve their retail space. Currently, a building owner must depreciate the costs of improvements to its space over the 39-year life of the building. However, this treatment grossly overstates the actual economic life of retail improvements, thereby increasing the cost of capital and distorting business decisions. Providing a 10-year life for these improvements would better reflect economic reality and would remove the current-law distortion in business decisions.

Successful retailing periodically requires a fresh look; it does not allow the same improvements to be used for 39 years. Instead, retailers generally need to remodel their stores as often as every 5 to 7 years to reflect changes in customer taste and needs. Moreover, improvements simply do not last as long as 39 years and must be replaced far more frequently. Thus, adopting the proposed 10-year life for retail improvements would far better reflect economic reality.

In addition, it makes little sense to ascribe to improvements the same 39-year life that is ascribed to buildings. As indicated above, the economic lives of retail improvements are far shorter than the lives of the buildings in which they are contained. Moreover, providing the proposed 10-year life for these improvements would not represent a return to the complexity of the component system of depreciation. The proposal avoids the complexity of the component system by providing a single class life for all eligible items and by being inapplicable to new buildings and to structural components. Therefore, the current policy of providing one single, extremely long, life for both buildings and improvements should be changed; the depreciable life of improvements should be modified to reflect their far shorter economic life.

Some legislative proposals have attempted to address some of the problems associated with the current treatment of building improvements. However, while NRF appreciates these efforts and recognizes them as good first steps in addressing serious cost recovery issues, NRF believes that these proposals fall short of addressing the current problems – especially with respect to retailers who own, rather than lease, their retail space. For example, the recently-passed House version of the Contract With America included a provision that would address the current treatment of lessor-owned leasehold improvements that are removed at the termination of the lease; however, it would not address a situation in which a lessor disposes of leasehold improvements *during* the term of a lease or in which an *owner* of a building removes the same type of improvements to the interior space (for example, as part of renovation). As another example, Congressmen Shaw and Rangel (and other Members of Congress) have introduced legislation (H.R. 1171) that would create a new 10-year class life for certain "leasehold improvement property." While the NRF applauds this initiative, it is concerned that the proposed legislation (like the House version of the Contract) would not address the concerns of retailers that have chosen to own rather than to lease their retail space.

Proposals designed to address the problems arising out of the current treatment of improvements clearly should not be limited to leased property. The decision to lease or own is primarily a financing and business decision and has no effect whatsoever on the useful life of improvements within a retail space. It would be inappropriate to apply radically different depreciation systems depending upon which approach is chosen. Such treatment would create, in effect, a significant tax incentive for retailers to lease rather than to own their stores. The tax laws clearly should not interfere in this type of business decision. Thus, the NRF respectfully requests the Committee to include in 1995 tax legislation a provision that creates a new, economically appropriate, 10-year class life for all "qualified commercial improvement property" – whether leased or owned.

QUALIFIED PLAN COMPLIANCE

The NRF urges the Committee to act on legislation to modify the penalties associated with failure to comply with the qualification requirements for qualified employee pension and profit sharing plans. In recent IRS audits of large employer qualified plans, the IRS has imposed enormous penalties (in the millions of dollars) for technical violations of the qualified plan rules. The NRF believes that a penalty can be established that is more closely linked to the errors found in these plans so as not to unduly threaten the economic viability of the employer but yet still meet the policy goal of encouraging voluntary compliance.

The Internal Revenue Code ("IRC") provides for employer tax-deductible contributions to employee pension and profit sharing plans that meet certain specific IRC qualification requirements ("qualified" plans). The requirements include ensuring that there is broad based employee participation in the plan, that highly compensated employees don't receive a disproportionate amount of benefits, and that rights, benefits and features of the plans are available on a non-discriminatory basis. The tax favored status of these plans promotes (and is intended to promote) retirement savings by and on behalf of employees. The qualified plans of large employers often have billions of dollars in plan trusts, which are tax-exempt as long as the plan remains "qualified" by operating pursuant to the specific IRC requirements. Employees pay income tax on the benefits when distributed after retirement or other termination of employment.

Plan disqualification has disastrous results both for the employer and the employees covered by the plan. The employer retroactively loses the tax deductibility of its plan contributions and the plan benefits become immediately taxable to plan members. (The plan trust is also taxable on previously exempt income.)

The challenge for employers, some of which administer their respective plans for tens of thousands of employees, is to ensure they have met every letter of the law for the continued "qualification" of the tax exempt nature of their retirement plans. The Treasury regulations implementing the IRC qualification rules are complex, overwhelmingly detailed and highly technical, and in most cases, include no exceptions for de minimis errors in administration or a reasonableness standard of enforcement. Theoretically, a $10 understatement of a benefit, or omitting one employee out of 10,000 in determining plan eligibility, can "disqualify" the plan, creating a tax burden so large as to effectively necessitate plan termination.

The IRS recently has begun intensive auditing of large employer qualified plans. Technical violations inevitably are found, and, in lieu of "disqualifying" the retirement plan (which is recognized as placing an enormous burden on the employees who are to be benefited by the plans), the IRC "negotiates" a "relief" settlement with the employer. The starting point for the negotiation is an amount which is the total tax which would be due by the employer, the plan trust and the highly compensated employees if the plan were disqualified. Cases have been documented recently where the "relief" required the payment of penalties exceeding $10 million.

The penalties are paid to the IRS (rather than to the qualified plan involved in the audit) and are non-deductible. Therefore, the penalty program not only does not contribute to the retirement security of the covered employees, but arguably, in large penalty cases, it jeopardizes that security by undermining the financial strength of the plan's corporate sponsor. Presumably, in some cases, the threat of penalties would deter an employer from establishing or continuing to offer qualified plans as an employee benefit.

The IRS has initiated a program that permits an employer to voluntarily audit its plans and submit its findings to the IRS along with a proposal to correct operational errors (at the employer's expense), but no employer can be sure it has found each and every "disqualifying" error. The threat of arbitrary penalties continues. As suggested by the current Congressional trend of applying private sector laws to the public sector, this situation is analogous to mandating Congress to ensure the U.S. Government will not make a single error in Social Security administration and imposing a monetary penalty on Congress if errors are made.

The goal of encouraging plan sponsors' voluntary compliance can be met without imposing unduly burdensome penalties on employers. Specifically, legislation could be enacted to

provide a penalty, to be assessed in the form of an excise tax that may not be more than 100% of the amount involved in the correction of operational errors found upon plan audit.

CONCLUSION

The NRF respectfully requests that the Committee include in 1995 tax legislation provisions that would provide acceptable methodologies for estimating a retailer's inventory shrinkage; provide a 10-year recovery period for commercial improvement property; and modify sanctions for failure to comply with qualified plan requirements. We look forward to the opportunity to work with the Committee in developing these three legislative proposals.

Chairman ARCHER. Thank you, Mr. Threadgill.

The Chair recognizes a Member of the Committee, the gentleman from Georgia, Mr. Collins, to introduce the next witness.

Mr. COLLINS. Thank you, Mr. Chairman.

I am pleased to introduce to the Committee and welcome before the Committee Bob Dumbacher. Mr. Dumbacher is with Racetrac Petroleum. Racetrac has a number of facilities in and around the Atlanta area, not only in the Third District of Georgia, but also in Committee Member John Lewis' district.

Mr. Dumbacher is the chief financial officer for Racetrac. Racetrac has been in business in Georgia for some 60 years. They have been headquartered in Atlanta for some 20 years. Mr. Dumbacher wants to speak to us today in regard to depreciation and changes in depreciation schedules and allowances that the IRS is putting forth in rule changes.

We welcome you, Mr. Dumbacher, and Mr. Chairman, it is my honor to introduce Bob Dumbacher.

Chairman ARCHER. Mr. Dumbacher, we are pleased to have you with us, and you may proceed.

STATEMENT OF ROBERT J. DUMBACHER, CHIEF FINANCIAL OFFICER, RACETRAC PETROLEUM, INC., ATLANTA, GEORGIA, ON BEHALF OF NATIONAL ASSOCIATION OF CONVENIENCE STORES AND SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

Mr. DUMBACHER. Thank you, Mr. Chairman and Members of the Committee, and thank you, Mr. Collins, for that nice introduction.

We are a petroleum retailer, and we have outlets from Virginia to Florida to Texas, covering 13 States. We employ 2,300 people, and as was just mentioned, we have been in business for 60 years, serving the petroleum and motoring needs of American drivers.

We thank you for the opportunity to appear on behalf of Racetrac and the SIGMA, Society of Independent Gasoline Marketers of America, and the NACS, National Association for Convenience Stores, which are two national trade associations representing more than 2,000 petroleum marketers.

I do want to testify today on the depreciation of buildings located at the retail motor fuel outlets. This is an issue of great importance to petroleum marketers and of particular importance to Racetrac. The IRS is currently examining Racetrac, and the two issues that consume most of my time doing an examination are the depreciation periods for buildings and for canopies located at our retail motor fuel outlets.

For many years, the depreciation period for motor fuel outlet buildings was clear. It was 15 years. However, at the beginning of this year, the IRS issued a coordinated issue paper in which it takes the position that most retail motor fuel outlets where nonpetroleum products are sold must depreciate the buildings over 39 years because in their opinion the buildings are not primarily used in the marketing of petroleum products.

The IRS says that these buildings are like small grocery stores or typical convenience stores. At the heart of the IRS' new position is its contention that a retail motor fuel outlet does not meet its primary use requirement unless 50 percent or more of the gross

revenue at a retail motor fuel outlet is from petroleum marketing activities, and 50 percent or more of the floor space of the building at that outlet is devoted to marketing petroleum products.

The IRS' new position is wrong, both for technical and policy reasons. It reads into the rules a primary use requirement that does not exist and is contrary to economic reality. Even if there were a primary use requirement, the IRS' two-pronged mechanical test to determine primary use is overly restrictive and unreasonable.

Racetrac, like most petroleum markets, has been in the business of marketing petroleum products for many years. This is our primary business. A Racetrac outlet is obviously different than a small grocery store or typical convenience store. We have passed out some pictures that will illustrate this.

Our retail motor fuel outlets have up to 24 gasoline fueling positions, a larger canopy over the pumps, and large signs informing the driving public of the price of gasoline.

Racetrac's customer surveys overwhelmingly demonstrate that what causes a person to drive into one of our retail motor fuel outlets is the desire to purchase gasoline at the price stated on the sign.

The typical retail motor fuel outlet has evolved into a somewhat larger outlet with a greater variety of products as a result of customer demand. However, this customer demand for services and products does not change this establishment from a petroleum marketing outlet, nor does the customer lose his or her identity as a retail gasoline customer.

The retail motor fuel outlet's primary reason for having a building at the location is to sell gasoline and other petroleum-related products.

In addition to being technically incorrect, the IRS position ignores economic reality. I can personally attest to the fact that the owner of a retail motor fuel outlet spends a tremendous amount of time and tens of thousands of dollars worrying about and complying with the many rules and regulations that specifically affect petroleum marketers, not grocery stores or fast food establishments.

Moreover, selling real property that was once the site of a retail motor fuel outlet is far more difficult than selling real property that was the site of a small grocery store.

The economic and useful life of buildings located at retail motor fuel outlets has remained constant for more than 70 years. As early as 1925, the Board of Tax Appeals found a gasoline station to have a 12½-year useful life. Recent industry experience still shows that these buildings have an average economic useful life of 12 years whether or not food products are also marketed at the outlet.

An issue that clearly demonstrates the unreasonableness of the IRS in this area is the depreciation of canopies. The IRS insists on requiring canopies to be depreciated over 15 years even though the U.S. Tax Court has clearly held that canopies that are not inherently permanent structures are depreciable over 5 years. The IRS agents have stated to us that it is the IRS' national position that they are a 15-year property.

The petroleum marketing industry is not asking Congress for something new or different. We are simply asking that the IRS not change the longstanding and well-established depreciation period for retail fuel outlet buildings. The IRS agents we have dealt with have conceded that their position may be extreme. Racetrac agrees and asks Congress to help us with this problem.

Thank you, Mr. Chairman, and Members of the Committee for the opportunity to comment on these important issues.

[The prepared statement follows:]

STATEMENT OF ROBERT J. DUMBACHER
CHIEF FINANCIAL OFFICER, RACETRAC PETROLEUM, INC.
ON BEHALF OF NATIONAL ASSOCIATION OF CONVENIENCE STORES AND SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

Mr. Chairman and members of the Committee: I am Robert J. Dumbacher. I am the Chief Financial Officer of Racetrac Petroleum, Inc., a position I have held for the past twelve years. Racetrac is a petroleum marketer with outlets from Virginia to Florida to Texas, covering 13 states. We employing 2,300 people, and have recently celebrated our sixtieth year of serving the petroleum and motoring needs of American drivers. Thank you for this opportunity to appear on behalf of Racetrac and the Society of Independent Gasoline Marketers of America ("SIGMA") and the National Association of Convenience Stores ("NACS"), two national trade associations representing more than 2,000 petroleum marketers.

I am testifying today on the depreciation of buildings located at retail motor fuel outlets. This is an issue of great importance to petroleum marketers, and of particular importance to Racetrac. The Internal Revenue Service ("IRS") is currently examining Racetrac, and the two issues that have consumed most of my time during this examination are the depreciation periods for the buildings and canopies located at our retail motor fuel outlets. This is especially frustrating because there should be no question about the proper depreciation of these assets.

For many years, the depreciation period for retail motor fuel outlet buildings was clear - 15 years. This 15-year period is currently set forth in Asset Class 57.1 of Revenue Procedure 87-56, 1987-2 C.B. 674, issued by the IRS. About five years ago, however, IRS agents began challenging the 15-year depreciation period for buildings at retail motor fuel outlets where food and other non-petroleum goods were being sold, arguing that such buildings are non-residential real property depreciable over 31.5 years (now 39 years). The IRS refers to these buildings as gasoline convenience store buildings.

These challenges, which are contrary to Asset Class 57.1 and case law, were not the independent acts of IRS agents, but the result of a coordinated effort by the IRS National Office. With the release of a Coordinated Issue Paper earlier this year, the IRS made clear its position that gasoline convenience store buildings must be deprecated over 39 years unless certain limited requirements are met. To support its position, the IRS gives the following reasons:

(1) Typically, only about 10 to 20 percent of the gasoline convenience store building's floor space is devoted to the marketing of petroleum products;

(2) The building contains none of the features typically associated with traditional oil company service stations such as service bays, tire changing and repair facilities, and car lifts; and

(3) The building is a fully adaptable retail building that competes with other convenience stores and small grocery stores.

The Coordinated Issue Paper contains an exception that allows a gasoline station convenience store building to come within the meaning of Asset Class 57.1, thereby qualifying for the 15-year depreciation period, if it is *primarily* used in petroleum marketing. A two-prong test is used for determining whether a building is primarily used in petroleum marketing. Under this test, a building meets the primary-use requirement only if:

(1) 50 percent or more of the gross revenues "generated by the C-store" are derived from gasoline (and presumably diesel fuel) sales; and

(2) 50 percent or more of the floor space in the building (including rest rooms, counter, and other areas allocable to traditional service station "services") is devoted to the petroleum marketing activity.

In addition to the two-prong test, the Coordinated Issue Paper provides that the IRS will not challenge the 15-year depreciation period "[i]f an island marketer's building has 1,400 sq. ft. or less . . .."

Efforts by Racetrac, SIGMA, NACS, and other industry representatives to persuade the IRS from adopting its new position on the depreciation of gasoline convenience store buildings have been unsuccessful, notwithstanding the fact that the Technical and Miscellaneous Revenue Act of 1988 repealed the Treasury Department's authority to change any Asset Class Life.

The IRS' new position is wrong for technical and policy reasons. It reads into Asset Class 57.1 a primary-use requirement that does not exist, and it is contrary to economic reality.

Asset Class 57.1 provides, in relevant part, that it "[i]cludes section 1250 assets, including service station buildings and depreciable land improvements, whether section 1250 property or section 1245 property, used in the marketing of petroleum and petroleum products." The phrase " including service station buildings and depreciable land improvements, whether section 1250 property or 1245 property," is illustrative. It does not restrict the general rule that Asset Class 57.1 *includes section 1250 assets used in the marketing of petroleum and petroleum products*. This point was made clear in the recent United States Tax Court decision in *JFM, Inc. and Subsidiaries v. Commissioner*, T.C. Memo 1994-239, involving the appropriate depreciation period of gasoline pump canopies, in which the court said "[i]t is clear that classes 57.0 and 57.1 were intended to cover *all possible types of real and personal property used in the marketing of petroleum products* . . .." Emphasis supplied. There is nothing indicating that a primary-use requirement should be incorporated into Asset Class 57.1, and the IRS is technically wrong in its new application of Asset Class 57.1.

Even if Asset Class 57.1 incorporated a primary-use requirement, the IRS' adoption of the two-prong mechanical test to determine primary use is overly restrictive and unreasonable. Racetrac, like most petroleum marketers, has been in the business of marketing petroleum products for many years -- this is its primary business. No sane person would ever mistake a Racetrac outlet or other typical retail motor fuel outlet for a small grocery store or typical convenience store. These retail motor fuel outlets have a number of gasoline pumps, a large canopy over the gasoline pumps, and large signs informing the driving public of the price of gasoline - all clearly visible from a distance.

What causes a person to drive into a retail motor fuel outlet is the desire to purchase gasoline (or diesel fuel) at the price stated on the sign. While there the driver may clean the windshield, check the oil, water, and tires, purchase windshield wiper blades and washer fluid, oil, and antifreeze, if needed, and use the rest rooms - all services in the traditional service station sense. Even though he or she may purchase a soda, cigarettes, or some other item, his or her primary reason for driving into the retail motor fuel outlet is to buy gasoline and service, albeit self-service, his or her automobile.

The typical retail motor fuel outlet has evolved into a somewhat larger outlet with a greater variety of products as a result of customer demand, and any marketer who does not respond to customer wants will soon find itself uncompetitive and eventually out of business. Customer demand for additional services and products, however, does not change the establishment from a petroleum marketing facility nor does the customer lose his or her identity as a retail gasoline customer.

As with the retail gasoline customer, the retail motor fuel outlet's primary reason for having the building at the location is to sell gasoline and other petroleum related products. The availability of non-petroleum products is merely a convenience to the drivers. I recently confirmed this directly with our customers by conducting numerous surveys of our customers asking them what first attracted them to our outlets and what was the principal use of our outlets. The overwhelming response from our customers

was that they were attracted to us as a gasoline marketer and they were there to buy gasoline. As a gasoline customer, however, they were also, in many cases, wanting to get a drink or snack while refueling, rather than having to make a second stop. Determining primary use in these cases is not a function of a mechanical test, but simple common sense.

The IRS places importance on the fact that gasoline convenience store buildings do not have mechanics to service the automobiles. The reason many retail motor fuel outlets do not have mechanics is that automobiles need far less maintenance today than they did a decade ago. In fact, many automobile manufacturers now claim that they build cars that can be driven 100,000 miles before they need a tuneup, and tires with 60,000 mile warranties are common. The fact that automobiles need less servicing today does not alter the fact that a retail motor fuel outlet's primary reason for its existence and the use of its building is the marketing of petroleum products.

In addition to being technically incorrect, the IRS position ignores economic reality. The economic realities of the petroleum marketing industry are very different from the economic realities of the grocery store industry, and equating the economics associated with a building used in the petroleum marketing industry to the economics associated with a building used in the grocery store industry or fast food industry is misplaced. For more than twenty years, Federal, state, and local governments have adopted tighter and tighter controls on businesses that extract, produce, transport, store, and sell petroleum products. These controls have focused on both energy conservation and environmental concerns.

The typical owner of a small grocery store spends little time or money worrying about the Clean Air Act, the Clean Water Act, or the Resource Conservation and Recovery Act. On the other hand, I can attest to the fact that the owner of a retail motor fuel outlet spends a tremendous amount of time and tens of thousands of dollars worrying about and complying with the many rules and regulations that affect the zoning of a site for petroleum marketing, delivery of petroleum products, the storage tanks, the dispensing pumps, the recycling of used oil, the reporting of gasoline and diesel fuel spills, and many, many other issues. Moreover, selling real property that was once the site of a retail motor fuel outlet is far more difficult than selling real property that was the site of a small grocery store.

These factors directly affect the economic and useful life of buildings located at retail motor fuel outlets. A survey conducted by the national accounting firm of GrantThornton shows that retail motor fuel outlet buildings have an average economic useful life of 12 years, whether or not food products are marketed at the outlet. This relatively short economic useful life is a function of the need to constantly relocate, renovate, or rebuild to respond to commercial demands and regulatory requirements. This is not a recent phenomena. In fact, the economic life of retail motor fuel outlet buildings has remained constant for more than 70 years. As early as 1925, the Board of Tax Appeals found an oil service station to have a 12 1/2-year useful life. *Moberly Oil Co. v. Commissioner*, 3 B.T.A. 163 (1925). In 1944, the Tax Court found the physical useful life of a gasoline station to be 15 years, and its economic useful life to be only 10 years. *Austin v. Commissioner*, 3 TCM (CCH) 1106 (1944).

The new position of the IRS is wrong as a technical matter and it is wrong as a policy matter. Without assistance from Congress, petroleum marketers will be forced into time consuming and costly litigation with the IRS. An issue that clearly demonstrates the unreasonableness of the IRS in this area is the depreciation of canopies, which I mentioned earlier. Most canopies today are readily moveable, and therefore, qualify for 5-year depreciation under Asset Class 57.0. The IRS insists on requiring canopies to be depreciated over 15 years, even though the United States Tax Court clearly held in *JFM, Inc. and Subsidiaries, supra,* that canopies that are not inherently permanent are depreciable over 5 years. The IRS agents examining Racetrac refuse to follow the *JFM* case, even though Racetrac has clearly demonstrated that its

canopies are moveable (and, in fact, have been moved). The IRS agents have stated that it is the IRS National position that canopies are to be depreciated over 15 years.

The petroleum marketing industry is not asking Congress for something new or different. It is simply asking that the IRS not change the long-standing and well-established depreciation period for retail motor fuel outlet buildings. The IRS agents we have dealt with have conceded that their "position may be extreme." Racetrac agrees and asks Congress to help us with this problem.

The IRS does not have the authority to change Asset Class 57.1. Nor should it be allowed to change the application of Asset Class 57.1 by reading into it a primary-use requirement. If the IRS insists on maintaining its new position, legislation should be enacted to clarify the current state of the law. This could be done by amending section 168(e)(3)(E) of the Internal Revenue Code of 1986 to read as follows:

(E) 15-year property. The term "15-year property" includes--
(i) any municipal wastewater treatment plant,
(ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications, and
(iii) any building and depreciable land improvement, whether section 1245 or 1250 property, used in the marketing of petroleum products, such as a retail motor fuel outlet building where gasoline and food are sold, but not including any of these facilities related to petroleum and natural gas trunk pipelines.

To address concerns that this provision could be abused (*e.g.*, placing a gasoline pump in front of a supermarket), the legislative history could provide that this provision is not intended to cover any section 1250 asset used only to an insubstantial extent in the retail marketing of petroleum and petroleum products.

The IRS' new position on the depreciation of retail motor fuel outlet buildings will substantially increase the cost of capital for small businesses. It is contrary to a clear reading of Asset Classes 57.0 and 57.1, and totally ignores economic reality. Without the help of Congress, taxpayers will be forced into time consuming and expensive litigation with the IRS.

Thank you Mr. Chairman and the members of the Committee for the opportunity to comment on this important issue.

Chairman ARCHER. Thank you, Mr. Dumbacher.

Next, we will hear from George Enochs, president of Cutler/Williams, Inc., Dallas, Texas, on behalf of the National Association of Computer Consultant Businesses.

Welcome, sir.

STATEMENT OF GEORGE ENOCHS, PRESIDENT, CUTLER/WILLIAMS, INC., DALLAS, TEXAS; ON BEHALF OF THE NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

Mr. ENOCHS. Thank you, Mr. Chairman, and thank you for the courtesy the Committee has afforded me in adjusting to a difficult travel schedule. I appreciate the chance to visit with you now.

I am here on behalf of the 230-member firms of the National Association of Computer Consultant Businesses to share with you some information about how the leased employee laws are causing unnecessary layoffs of U.S. workers and can damage the productivity of Fortune 1000 customers we serve.

Our firms provide highly skilled technical professionals in the computer and engineering fields to these customers who need help for temporary technical project support.

The leased employee laws were intended by Congress to stop abuses by firms that fired their employees and simply leased them back through other companies to avoid pension coverage. But these laws have been extended far beyond their original intent in a way that has hurt the technology projects which are feeding the growth of U.S. companies.

In my oral statement, I want to focus on two basic points. First, the two new safe harbors proposed in the Joint Tax Committee report before you would do very little if anything to solve the problem in our high-tech industry. Instead, we will offer another safe harbor option.

Second, more fundamentally, unless we redefine who is a leased employee, enacting any new safe harbor is merely rearranging deck chairs on the Titanic.

As to the first issue of safe harbor, the Joint Tax Committee report describes one new safe harbor proposal that will be available only to qualified leasing organizations that meet extensive criteria and that register with the IRS. We strongly oppose this proposal. It would create a new, intrusive IRS bureaucracy with the mission of affecting marketplace competition by giving the Good Housekeeping seal of approval to selected organizations.

Nor can we support the second new safe harbor proposal in the Joint Tax Committee report, which would treat certain leasing organizations as the sole employer of their leased employees under certain defined conditions. This proposal is too narrow and contains many uncertainties.

In our industry, for example, service recipients have some role in controlling certain aspects of computer projects on which our employees work, and recipients may also help evaluate performance.

Instead of the above options, we urge that a simple 401(k) plan be considered as a new safe harbor. But even then, requiring employer contributions to such a plan is an unwise, one-size-fits-all approach that could seriously depress wages in industries like ours.

We pay premium wages to highly educated, highly skilled professionals. If Congress wants to require workers to contribute to their own plans, then please do so directly, as was done with Social Security. Do not make employees believe that employers can pay both premium wages and offer safe harbor plans to which employers make expensive pension contributions.

The more fundamental issue, however, that I mentioned above—that is, the definition of leased employee—is really the key to reform in this area. We would not need safe harbor plans if the definition of leased employee were appropriately modified for our industry. In this regard, not only current law, but also the proposed "control" definition creates major problems for our industry. As I mentioned, we provide professionals to supplement a customer's programming or engineering staff for special projects of limited duration that cannot easily be staffed with available in-house expertise. Over one-third of special computer projects take more than 1 year to complete. Many but not all of these are completed in 2 years.

Unfortunately, under current law and the proposed "control" test, the IRS might argue that our customers control professionals that we provide to them so that these workers would be leased employees after 1 year on a special project. We propose any of the following three redefinitions of leased employee that will not unreasonably interfere with bona fide arrangements in our industry that have nothing to do with firing and rehiring abuses.

First, exclude professionals sent by a temporary help service from the definition of leased employee. Texas, New York, Massachusetts, Minnesota, Florida, and many other States have an analogous exclusion for Workman's Comp. purposes, and it helps our industry greatly.

Second, increase the threshold to 2 years before a professional becomes a leased employee. Ironically, the Federal Government currently has a 2-year window for all of its temporary employees. Private industry should not be treated more harshly. This would also greatly help our industry.

Third, adopt a different version of the "control" test from the overly broad one that was in last year's H.R. 3419. We can work with you to refine this definition.

To conclude, please do not just rearrange the deck chairs on a sinking ship. Instead, marry a reasonable safe harbor with a fair definition of leased employee that will stop the layoffs in our industry and that will allow our Fortune 1,000 customers to complete their high-tech projects with greater productivity, which will enhance their ability to compete in the global economy.

Thank you, Mr. Chairman.

[The prepared statement follows:]

NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

WRITTEN TESTIMONY OF
NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES
GEORGE ENOCHS, CHAIR, GOVERNMENT AFFAIRS COMMITTEE
Before the
COMMITTEE ON WAYS AND MEANS
U.S HOUSE OF REPRESENTATIVES

July 12, 1995

Mr. Chairman, the National Association of Computer Consultant Businesses ("NACCB") opposes the proposal to create a new safe harbor under which leased employees can be excluded from the pension plans of service recipient organizations. We testified previously at September 16, 1991 and June 17, 1993 hearings on Pension Simplification on the broader issue of "leased employees", and we are pleased to give you our alternative proposal today.

I. Description of NACCB and Summary of Testimony

NACCB has 230 member firms, with over 500 offices nationwide and combined annual revenues exceeding $2 billion, which are mostly small and mid-sized businesses. We are the only national association that represents — exclusively — companies providing highly skilled technical professionals in the computer and engineering fields to service recipient customers who need help for temporary technical project support. Project can typically last from several months to two or three years, and sometimes consist of separate phases. The professionals who work on these projects are either employees of our member technical services firms or, in appropriate cases, subcontractors, and they often earn $50,000 per year or more.

Let me start by briefly summarizing our concerns about the two principal proposals before you today to create alternative safe harbors under the leased employee laws and our suggestions for more fundamental reforms. While we agree with the proponents of the safe harbor proposals that current law fails to provide any realistic relief, the two safe harbor proposals would provide little relief to an industry which Congress never intended to regulate under this law — namely, temporary help firms that provide customers with technical professionals. More importantly, they would only further complicate the administration of the "leased employee" rules.

The first proposal would create a new safe harbor plan for "qualified leasing organizations" that meet extensive criteria and "register" with the IRS. Overall, we believe that Congress should not create a new IRS bureaucracy with the mission of giving the "Good Housekeeping Seal of Approval" to selective organizations. We cannot support more rules and more intrusive government interference into the competitive marketplace. The second proposal would treat certain leasing organizations as the "sole employer" of their leased employees is too narrow and contains too many uncertainties. In our industry, for example, service recipients have some role in controlling certain aspects of the computer project on which our employees work, and the recipients may also evaluate performance. Likewise, it is unclear what is meant by the requirements for "universal fringe benefits" and billing to clients "on a total-fee basis rather than on a direct cost pass-through basis".

Instead of these two proposals, we urge that a simple 401(k) plan be considered as a new safe harbor. But even then, requiring employer contributions to such a plan is an unwise, "one-size-fits-all" approach that could seriously depress wages in industries like ours. We pay premium wages to highly-educated, highly-skilled professionals. If Congress wants to require workers to contribute to their own plans, then please do so directly — as was done with Social Security; don't make employees believe that employers can pay <u>both</u> premium wages <u>and</u> make expensive pension contributions.

Lastly, we believe that the focus on the safe harbor under the leased employee law is misplaced. Rather, Congress should refine the definition of leased employee. The "control test" for defining a leased employee, which Congress has favored in the past, provides no relief for our industry. Instead, NACCB supports any of the following options: (1) excluding "professionals" sent by a "temporary help service" from the definition of leased employee, (2) increasing the threshold to 2 years before a professional becomes a leased employee, or (3) adopting a version of the "control" different from the overly broad one that was in last year's H.R. 3419.

II. The Proposal for New Safe Harbor Will Only Further Complicate the Administration of the "Leased Employee" Rules

Now that we have given you an overview of our position, let's talk about the specifics of each proposal. Our comments on the proposals for a new safe harbor will focus on two key issues. First, we will address the narrow issue of the safe harbor itself, both as a conceptual matter and as it would be implemented. Second, we will discuss the more fundamental problem with the current "leased employee" law. We believe that these two issues are inextricably intertwined.

The first proposal provides that if a "leasing organization" meets a large number of detailed criteria for a safe harbor, then the IRS would "register" the "leasing organization". Assuming that this proposal is similar to a proposal advanced in 1991 and 1993, among the criteria to be met are those involving employer contributions which equal limitations under Section 415(b) or (c) of the Internal Revenue Code; satisfaction of vesting requirements under Section 416(b)(1)(B) of the Code; and accounting for certain services that are not required to be taken into account by Section 411(a)(4)(D) of the Code. In addition, the "leasing organization" would also be treated as the "sole employer" of a worker if it had the sole right to hire, terminate and transfer the worker; if it directed, controlled and evaluated the manner and means of the worker's performance; if it provided universal fringe benefits; and if it billed the service recipient on a total fee basis rather than on a pass-through basis; etc.

We object to the fact that the concept of "registration" places the government in the position of essentially giving a "Good Housekeeping Seal of Approval" to certain companies. Make no mistake: these companies will then have every incentive to take their IRS registration certificates directly to service recipient clients and, in a blatant manner to harm competitors, they may warn those clients to do business only with "registered" firms in order to avoid potential pension plan problems. Most directly harmed would be those "leasing organizations" which can qualify for registration, but which choose not to expend the time or money to go through the registration process. The "leased employee" laws will have grown from a well-meaning effort to protect workers into a whole new federal licensing scheme which -- as experience shows in other areas -- imposes unreasonable start-up barriers against new entrants and excessive costs upon smaller businesses.

Mr. Chairman, not only do we object to the concept of "registration" — however well-intentioned it might be — but we also see major problems with administering such a system. The requirements for registration will not be self-enforcing. The IRS would have to evaluate each and every "leasing organization" that filed for registration. Because of the potentially anti-competitive effects on firms that choose not to register, perhaps hundreds if not thousands of firms would decide to register — even if registration was not universal. We already know the problems faced by the IRS in applying the even simpler pension plan requirements to non-"leasing organizations", and we can only imagine the added difficulty of applying the new and complex testing criteria of the proposed safe harbor to "leasing organizations". Of course, IRS evaluations would have to be done on an ongoing basis since organization's pension plans and operating procedures that affect registration can change from year-to-year; there would then have to be procedures for "de-registering" organizations that no longer met the criteria. Assuming the complexity of these tasks could be overcome, where is the IRS going to get the personnel to perform these functions? Is Congress ready to fund such new positions?

The second proposal would treat certain leasing organizations as the "sole employer" of their leased employees is too narrow and contains too many uncertainties. This proposal has flaws and contains terms that requires further clarification. For example, our experience indicates that service recipients inevitably have some role in controlling certain aspects of the computer project on which our employees work. Oftentimes our employees work independently at the service recipient's work site without the supervision of a project manager from the service provider. As a result, the recipients may have some role in evaluating the performance of a service provider. We would need assurances that the independent manner in which our professionals perform services would not jeopardize their status under the proposed safe harbor. Likewise, it is unclear what is meant by the requirements for "universal fringe benefits" and billing to clients "on a total-fee basis rather than on a direct cost pass-through basis". Contracts for projects in our industry, because of the complexity of the work involved, are often based on an hourly rate for each professional, rather than on a total project cost basis. It is not clear that this practice would qualify our industry for the safe harbor.

For the above reasons, NACCB opposes the concept and implementation of a registration system for "leasing organizations" and the alternate safe harbor. Moreover, as we explain below, we believe that the concept of registration takes reform of the "leased employee" laws in the opposite direction from the type of simplification that is really required.

III. Appropriate Reform of The Leased Employee Laws Should Focus on the Re-Definition of "Leased Employee" Because the Existing Laws Lead to Unreasonable and Arbitrary Results

Mr. Chairman, NACCB believes that an effort to create a new safe harbor under the "leased employee" laws ignores the more fundamental problems with those laws. We all know the genesis of the "leased employee" laws: employers which fired their employees and then "leased" them back through another company in order to avoid providing those employees with certain benefits. NACCB believes that the employees in this type of situation are certainly "leased employees" and they should be treated like employees of the service recipient for purposes of testing the service recipient's plans.

On the other hand, the "leased employee" laws go far beyond the situation which first generated Section 414(n). Unfortunately, these laws appear to be a mechanism by which Congress is attempting - in an indirect manner — to impose pension plan obligations upon certain types of employers which are really not "leasing organizations", such as NACCB member firms. If Congress wants employers to provide pension plans, it should apply this requirement to all employers — and it should tackle that issue head-on and should not use an indirect approach. The present "leased employee" laws, as we explain below, lead to unreasonable and arbitrary results.

Have you heard of the term "out-sourcing", Mr. Chairman? Did you know that in "out-sourcing" situations large employers have fired entire departments of lower-level employees, have arranged to have these former employees hired by a new employer, and then have subcontracted with the new employer to have the very same work done? Because the "out-sourced" work is performed under the direction of the subcontractor and in an adjacent room or building rented by the subcontractor, the subcontractor is not a "leasing organization" and the workers are not leased employees" The very types of workers that are supposed to be protected by the "leased employee" laws escape protection in this situation.

Let's also look at the situation involving administrative workers like secretaries, receptionists, data entry workers, and other clerical workers. Do you realize that these workers are often sent to one service recipient client for up to a one year period and then are systematically transferred to another client? In such situations, the transfers are easily effectuated and within days the workers adjust to the new client. Yet these workers — the very types of workers supposed to be protected by the "leased employee" laws — escape protection because they have not performed services for one service recipient organization for more than one year.

But who is "caught up" in the "leased employee" laws, Mr Chairman? In too many cases, those firms entangled in these laws are technical services firms like NACCB members which are not — and have not historically been considered to be — in the "employee leasing" business. Technical services firms do not exist because their service recipient clients want to avoid including workers in benefit plans; technical services firms exist because the rapidly changing technology in the computer and engineering industries typically means that service recipient clients cannot possibly obtain from only their own in-house employees the degree of technical expertise and specialization required. In such instances the service recipient clients seek the services of technical services firms to locate and provide the services of these "outside" workers for such special project work. Much like a law firm might provide a team of legal specialists to help a client with a major antitrust law problem — even though the client already has an in-house general counsel — so too technical services firms like NACCB members provide technical specialists to their clients.

Unfortunately, however, the present "leased employee" definition in the Internal Revenue Code is so broad that computer and engineering professionals paid by technical services firms, but who perform on-site services for clients, are often alleged to be "leased employees". The adverse consequences of this conclusion are real and serious: at the end of one year of service, these professionals are removed from projects by service recipient clients who do not want to take the risk that their own benefit plans might be jeopardized by using such workers and who do not want to undertake the administrative and paperwork burdens to prove otherwise. The service recipient clients thereby often find that their own projects are delayed and over-budget because they must locate new "outside" workers to pick up where the removed "outside" workers have left off.

Although these results seem bizarre, Mr. Chairman, they regularly occur because of how the Internal Revenue Code defines "leased employees". Ironically, relatively highly-paid, professional workers - those least in need of federal protection — are the victims of the "leased employee" laws.

NACCB believes that the only way to tackle to "over-inclusiveness" and "under-inclusiveness" of the "leased employee" laws is not through the creation of new safe harbor, but through the redefinition of who is a "leased employee".

IV. The "Control" Definition of "Leased Employee" in 1992 Legislation Must Be Further Refined If the Goals of Section 414(n) Are To Be Met in a Reasonable Manner

Mr. Chairman, last year the House considered a new definition of "leased employee" that would replace the currently over-broad test in Section 414(n) — which inquires whether work has been "historically performed" by employees — with a test of whether the services performed are "under the control" or "under any significant direction or control" of the service recipient client;

NACCB appreciates the effort made by the Congress to move away from the clearly unacceptable "historically performed" test. However, <u>we believe that using terminology of the "control" test will be virtually as broad and troublesome as the existing test</u>

A. General Problems With a "Control" Test

By way of background, under present law the IRS inquires whether the leased employees are performing services that have been "historically performed by employees". To determine if services have been "historically performed by employees", the IRS has asked whether "it was not unusual for services of [the] type [at issue] to be performed by employees ...." Of course, to determine whether "it was not unusual for "employees" to perform such services, it is necessary to determine who is an "employee" — and that requires application of the IRS 20-question common law employment test.

The common law employment test is, in reality, a form of "control" test. As the IRS Manual states, "Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to final results and as to the details of when, where and how the work is to be done.... The factors or elements that show control are described below in the following 20 items." IRM-Administration, Exhibit 5(10)00-4.

Unfortunately, it is precisely this same "control" test which has been long-criticized. The following words have been used by respected government officials and in comprehensive government studies to describe the "control" test: "complex", "open to broad and inconsistent interpretation", "extremely difficult to apply", "extremely subjective and often inconsistently applied by the IRS", "lack[ing] precision and predictability", "produc[ing] inappropriate results", and "not yield[ing] clear, consistent or satisfactory answers".

There are several reasons why the "control" test has been thus criticized, some of the major reasons being that:

* There are too many "control" factors to consider.

* Even on an individual basis, many of the factors are too imprecise, subjective and unpredictable.

* Attempts to balance several "control" factors to determine, on an overall basis, if there is "control" are too difficult because:

-- it is unclear how many factors must be present or absent to determine whether there is "control", and

-- it is unclear which factors must be present or absent to determine whether there is "control" since each factor may have a different degree of importance in any particular situation.

* In virtually every working relationship of any type, there is always some degree of "control" over a worker by a recipient of services. Hence, there is an inherent problem in drawing a line between how much "control" is too much "control".

* In view of the imprecise, subjective and inherently encompassing nature of the "control" test, the IRS has historically applied it in an overly broad manner which results in a conclusion of employment in the overwhelming number of situations. For example, according to the April 1991 issue of The Practical Accountant, in only 8% of the Private Letter Rulings issued by the IRS between January 1, 1987 and March 31, 1988, did the IRS conclude that a worker was not an employee; for the period July 1, 1989 through September 30, 1990, only 75 Private Letter Rulings were issued on the same issue, and in only one of these did the IRS conclude the worker was not an employee.

Governmental leaders have repeatedly made these same points in the well-recognized Report of the Comptroller General, GGD-77-88, entitled "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions", (November 1977); in Hearings on H.R. 3245 before Subcommittee on Select Revenue Measures of House Ways & Means Committee, 96th Cong., 1st Sess., at pp. 5, 9; in a November 1990 House Government Operations Committee Report; in a March 1991 study released by the Treasury Department, entitled "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986"; and in virtually unanimous testimony from over 20 witnesses in a hearing entitled "Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes", before the Subcommittee of Select Revenue Measures of the House Ways & Means Committee, July 23, 1992.

B. Problems with a "Control" Test for "Leased Employees"

Unfortunately, we do not see a great deal of difference between the "control" tests adopted in last year's 'leased employee' legislation and the 20-question common law employment test which has been so soundly criticized What difference may exist is simply a matter of degree, rather than of kind, and the degree is quite small, as we now explain. We have already identified the problems with the "control" test in the employment tax area. Addressing these problems one-by-one, it becomes clear that the "control" test for "leased employees" does little to solve them.

As to the number of factors that must be considered to determine if there is "control" by the service recipient, legislative history in past years has been used to narrow the particular factors that were relevant. However, despite such efforts, it could well be that there are 10 relevant factors, or 15, or even 20 or more — a possibility that confronts the taxpayer with too many factors to consider, which is a major problem with the employment tax "control" test. Our concern about the need to consider too many factors is not eliminated by past efforts to identify certain common law employment "control" factors that are not relevant to the "control" test under proposed amendments to the "leased employees" definition. In fact, the deletion of these factors — which would otherwise tend to show that the service recipient does not exercise "control" — only further confuses the issue of how to decide what other factors are relevant or irrelevant.

As to the fact that many of the "control" factors are too imprecise, subjective and unpredictable, again we see very little difference between the "control" test for leased employees" and the common law employment "control" test. For example, in IRS employment tax audits, major controversies have arisen over whether it constitutes "instructions about when, where and how to perform services" if a firm instructs a worker that he or she can begin a project by one date and must finish it by a second date. Taxpayers take the reasonable position that such instructions hardly amount to "control" over work hours, whereas the IRS often takes the opposite view. Likewise, taxpayers and the IRS typically disagree over what degree of involvement by a service recipient amounts to "supervision" over a worker. Disputes even arise over whether a service recipient is "controlling" the order or sequence in which a project must be completed where the services being performed are during only one stage of a multi-stage project — such as building construction — and it is obvious that certain stages must be completed before others can begin. Yet, even though substantial disputes exists over these factors — because they are too imprecise, subjective and unpredictable — these same factors have been identified as relevant to a determination of "control" under the "leased employee" test.

As to the issue of the difficulty in balancing several factors to determine, on an overall basis, if there is "control", again we see little difference between the tests under the "leased employee" legislation and the common law employment "control" test. It is seldom that all of the relevant factors which point towards "control" will be present. Major problems will exist regarding the weight to be given to each factor, as well as how to balance the existence of some relevant factors against the non-existence of other relevant factors. This has clearly been the experience in the common law employment "control" test, and there is no reason why it would be much different under either of these bills.

As to the concern that there is always inherently some "control" by a service recipient over a worker, this problem is not solved in the least by last year's "leased employee" legislation. By implicitly focusing on the existence of actual "control" and identifying certain relevant factors — such as "supervision" by the service recipient — these bills have failed to recognize a point made by one of America's great jurists, Judge Learned Hand, several decades ago. In discussing an IRS claim that a taxpayer's "control" over certain workers meant that the workers were the taxpayer's employees, Judge Hand stated:

> In the case at bar the plaintiff did intervene to some degree; but so does a general building contractor intervene in the work of his subcontractors. He decides how much the different parts of the work must be timed, and how they shall be fitted together; if he finds it desirable to cut out this or that from the specification, he does so. Some such supervision in inherent in any joint undertaking, and does not make the contributing contractors employees.

Radio City Music Hall Corp. v U.S., 135 F.2d 715, 718 (2d Cir. 1943) (emphasis added).

Precisely because of the above concerns, as is the case with the common law employment "control" test, the problem remains that the IRS can engage in an overly broad interpretation of the definitions in last year's legislation. Indeed, there is no sound basis for any confidence that the IRS will draw reasonably clear lines which would exclude from the new definition of "leased employees" more than a tiny fraction of workers who are likely to be designated as "leased employees" under the currently "historically performed by employees" test in Section 414(n). In short, if Congress truly believes that the present test is too broad and over-inclusive, so few workers will be affected by last year's "leased employee" definitions that legislation cannot be called "reform" legislation.

Finally, there is a new problem here which does not exist with the common law employment "control" test. As we will explain, rather than represent pension "simplification", we believe that it is likely that last year's legislation would only introduce "complication" to the "leased employee" issue. What we mean is that by virtue of its overbreadth, the "historically performed by employees" test in the current law is actually relatively simple to apply once it is understood that the IRS will almost always conclude that a worker is a "leased employee". In contrast, by introducing a new degree of "control" that is different from the existing degree of "control" which classifies a worker as a common law employee, the "leased employee" legislation from last year only further complicate matters. More specifically, if either of these bills is adopted, there will really be three degrees of "control" that are relevant to the analysis of every worker's status:

* If there is some "higher" degree of "control" by a service recipient, then a worker will be considered to be the common law employee of the service recipient.

* If there is some "mid-level" degree of "control" by a service recipient — but less than the degree of "control" which would classify the service recipient as a common law employer — then the worker will be considered to be the "leased employee" of the service recipient.

* If there is no "control" or only a "minimal" degree of "control" in the service recipient, then the worker is neither a "leased employee" nor a common law employee of the service recipient.

In addition, in all three situations there will still remain the separate question of whether or not there is enough "control" by the firm which provides the worker to the service recipient so that such firm is the common law employer of the worker. However, in answering this separate question of "control" in the employment tax context, taxpayers will have to consider some, but not all, of the very same factors that are relevant to the determination of "control" in the leased employee" context.

In conclusion, we believe that the "control" definition of "leased employee" in last year's definition will not solve — and may further exacerbate — the problems with the existing "historically performed by employees" language in Section 414(n). As with the common law employment tax "control" test, taxpayers will have too many relevant factors to consider; they will be uncertain about how to interpret several vague factors; they will not be clear about how to weigh each factor and how to balance the different factors together; they will have to consider factors which inherently include elements of "control" in most any situation; they will be left with a test which is likely to lead the IRS to engage in an overly broad interpretation of who is a "leased employee"; and they will be faced with the confusing task of distinguishing between two different concepts of "control" which have a substantial overlap of relevant factors. This is not simplification.

C. Possible Reforms of the "Control" Test

NACCB believes that if Congress wants to use some form of a "control" test, it would be most appropriate to use the "control" test in a bill from the 102nd Congress, H.R. 2641, which differs in a significant respect from the "control" tests that passed the House last year as part of H.R. 3419. Rather than focusing on the broad concept of "control" with its numerous component factors, the H.R. 2641 "control" test classifies a worker as a "leased employee" if "the [service] recipient exercises primary control over the manner in which such services are performed". H.R. 2641 was sponsored by Representatives Archer, Johnson, Matsui, and Chandler. We believe that this "manner of control" test — along with an exclusion for "professionals," as discussed below — is far more preferable to the much broader "control" tests in the other bills for a number of reasons.

First, the H.R. 2641 "Archer-Johnson-Matsui-Chandler" test focuses on only one aspect of "control", i.e., control over "the manner in which such services are performed." Although the "manner" of performing services might be described by a further reference to some other factors, it is clear that such other factors would be fewer in number and more narrow in scope than the factors that otherwise determine the existence of "control" as defined other legislation. For example, we do not believe that the "manner in which services are performed" would include consideration of directions as to the result that must be obtained by the performance of the services, or even of general instructions by the service recipient as to when and where the services should be performed; nor would a requirement that the services be performed by a particular worker amount to "control over the manner in which the services are performed". In contrast, where a service recipient provides detailed directions and instructions on the steps and methods to be used to achieve a stated result, this might constitute "control over the manner in which the services are performed."

Second, because fewer and more narrow factors would be considered in determining "control over the manner in which the services are performed", there would be less vagueness in this test. A line between the existence or non-existence of this type of "control" could be more easily drawn by taxpayers who would be better able to weigh the existence and non-existence of each individual relevant factor, and then arrive at an overall determination of whether such "control" exists.

Third, we believe that the H.R. 2641 "Archer-Johnson-Matsui-Chandler" test comes closest to covering the type of workers about whom Congress was most concerned when it initially adopted Section 414(n) typical support staff employees — like clerical workers, receptionists, and licensed practical nurses in doctors' offices — who perform routine support services in a "manner" that is directed and controlled by service recipients Other types of workers whose manner of performing services is not controlled by a service recipient — including high-level computer systems analysts and programmers who exercise a substantial amount of discretion and independent judgment in how to perform their services — were never intended to be covered by Section 414(n) and would not be covered under the test in H.R. 2641.

Although we believe that H.R. 2641 offers the most predictable and reasoned definition of "leased employee", we also believe that some further refinements should be made in the statutory language in this bill so that the potential problems associated with any form of "control" test can be minimized.

In particular, we urge that the phrase "the recipient exercises primary control over the manner in which such services are performed" should be changed to read "the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed." This change would accomplish two major benefits:

* It would remove the word "control" and instead focus on "directions and instructions" — and thus hopefully remove most of the critical "baggage" from the employment tax area that is associated with the word "control".

* It would focus only on "detailed" directions and instructions as to the manner in which the services are to be performed — and thus preempt any argument that "general" instructions and directions might suggest that the worker is a "leased employee". We appreciate that there may be some dispute over what is "general" versus "detailed", but at least the statutory language will serve to narrow the degree of the dispute.

We also urge that if H.R. 2641 is used, it should be amended to specifically exclude "professionals" from the definition of "leased employee". This exclusion would accomplish two major goals:

* It would establish for some types of work a "bright line" between covered and non-covered workers. In particular, it seems that the emphasis in last session's version of H.R. 2641 is to cover only those workers for whom the service recipient controls the "manner" in which the work is performed. This type of worker is on the opposite end of the spectrum from a worker who typically exercises significant discretion and independent judgment in performing his or her work. The latter type of worker is epitomized by the "professional". Rather than requiring a painstaking application of the "manner" test to every type of occupation, it is appropriate to create an explicit exclusion for "professional" workers.

* The inclusion of an exemption for "professionals", or a two-year threshold for such "professionals", would provide relief for individuals which Congress did not intend to include as "leased employees' Congress could specify which types of workers would be considered "professionals" for purposes of this law The IRS could be given authority to add other classes of "professionals". There is clear precedent for this type of exemption in other laws For example, the Fair Labor Standards Act includes a "professional" exemption from the overtime laws, and the Department of Labor has defined the term "professional. "[1]

With the above changes, a new H.R. 2641 would read as follows:

"(C) the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed, provided however that professional workers (as defined by the Secretary) shall not be included within this definition."

If Congress insists on retaining a "control test" as proposed by H.R. 3419, NACCB would support three options as an exclusion from the "control" test: (a) exclude "professionals" sent by a "temporary help service" from the definition of leased employee (this is based upon, and more narrow than, similar exclusions in many state statutes which regulate leasing organizations for workers' compensation purposes); or (b) increase the threshold to 2 years before a worker (or at least a "professional" from a "temporary help service") becomes a leased employee (because professionals may need to spend more time on complicated projects and are more difficult to replace in midstream).

D. Examples of the Presence and Absence of "Detailed Directions and Instructions As to Manner" in Which Services Are Performed

Even with a shorter, more predictable definition of "leased employee", Congress must provide clear illustrations of who is not a "leased employee" and who is. This will assist the IRS — and ultimately the courts — in assuring implementation of Congressional intent as to the breadth of any new definition.

We appreciate that last year's legislative history has done this in a limited respect. Certainly secretaries and similar support staff would be considered "leased employees" because, typically, service recipients which utilize temporary secretarial help often require a secretary to greet visitors in a certain manner, to take telephone messages in a certain way, to type documents in a certain format, and to file documents in a certain order. These are "detailed directions and instructions as to the manner in which the services are to be performed."

On the other hand, where a service recipient uses "outside" computer programmers, systems analysts, and other similarly skilled workers to provide their services on a particular computer project or to meet requirements that are not being met by a service recipient's own "in-house" employees, these "outside" professionals should generally not be considered "leased employees" regardless of whether they are employees of an "outside" technical services firm or are independent contractors who have contracted through an intermediary "broker". In these typical situations the service recipient would not primarily provide detailed directions and instructions as to the manner in which the services are to be performed. Rather, the manner in which the work is done is usually established by the worker using his or her own discretion and judgment — albeit under a timetable and in stages set by the service recipient according to well-accepted quality assurance procedures and techniques in the industry. Also the workers would be considered exempt "professionals".

IV. Conclusion

NACCB believes that a safe harbor of the type proposed for "leasing organizations" which "register" with the IRS is an inappropriate solution to the current problems with Section 414(n). Instead, Congress should re-define the term "leased employee" so that Section 414(n) applies only to the truly abusive situations which require governmental intervention.

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[1] Where the Department of Labor has interpreted that term too narrowly, Congress has intervened. See, e.g., P.L. 101-583, where Congress directed the Department to include computer systems analysts, computer programmers, software engineers and similarly skilled workers as "professionals . "

Chairman ARCHER. Thank you, sir.

Next, we will go to Bob Bannister, senior staff vice president, National Association of Home Builders.

Welcome, Mr. Bannister.

STATEMENT OF ROBERT BANNISTER, SENIOR STAFF VICE PRESIDENT, GOVERNMENT AFFAIRS DIVISION, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. BANNISTER. Thank you, Mr. Chairman.

I am Bob Bannister, for the NAHB, National Association of Home Builders. I appreciate the opportunity to appear before the Ways and Means Committee today on several issues that are important not only to the housing industry but housing consumers.

At the outset, Mr. Chairman, I want to thank the Members of this Committee who worked to make it possible to provide tax relief to the American people under H.R. 1215. I think it is particularly important at this time that we move forward on that tax relief, considering the precarious position of the economy.

As many are aware, housing is very significant to the economy; it has led us into and out of every recession since World War II. We are particularly concerned at this time because 4 out of the 5 past months, housing production and housing starts have dropped. The May figure for housing inventory is the highest in almost 5 years, at 347,000 units. We believe it is essential that Congress move forward with much needed tax relief.

Mr. Chairman, in my oral statement I want to highlight two issues; in the written statement, we have several other recommendations on matters before the Committee.

The first issue is the treatment of contribution in aid of construction. Prior to the 1986 Tax Reform Act, which repealed section 118(b) of the Internal Revenue Code, when an individual builder or developer contributed infrastructure to a utility, that was considered a contribution to capital. That was not taxed. After the 1986 act repealed section 118(b), it was considered income to the utility and therefore taxable.

Most public utilities cannot pass this increased tax on to their utility-based consumers; therefore, it is passed on to the builder or the developer. As a result, the builder or developer, for the privilege of donating the infrastructure to the utility, has to pay an additional fee, which is the tax that the utility bears. What makes matters worse is there is a gross up calculation increasing that to make the utility whole. Obviously, that is passed on to the housing consumer, and it is something that is of major concern. It varies in different areas of the country as to how much impact that is and to the given utilities, but it can range as high as $5,000 per home. If that fee is added to the other impact fees, it is easy to see the housing affordability problem that that type of fee can cause to the housing consumer.

I want to applaud the leadership and Members of this Committee who have worked on this issue—Nancy Johnson, who introduced legislation earlier this year, to correct this situation, and we support H.R. 957, which addresses this issue. However, we would request that the repeal apply not only to water companies, but also to all utilities as well.

The other issue that I want to refer to is the issue dealing with capital gains. We certainly applaud the efforts of the Committee and its actions earlier this year, but in addition we applaud a provision that is being considered at this hearing. That is, we want to voice our support for the proposal that would allow individual taxpayers who have held assets for 5 years to elect to pay either the present law tax, which we assume will be changed in the near future, hopefully, or a tax equal at 10 percent of the sales proceeds. We believe that more favorable capital gains treatment would not only encourage purchase of existing properties, but would also encourage investment in new construction, rehabilitation, and remodeling in the housing industry.

NAHB believes that taxation of assets at a lower rate than ordinary income certainly encourages investments and savings and is a job generator.

We believe a capital gains tax cut would benefit a wide range of taxpayers, and we note that one-half of the tax returns in 1991 claiming capital gains were for incomes of $60,000 or below, so it affects all income filers. And equally important, it is a job creator and helps economic activity.

In real estate, lower capital gains would increase investor and owner incentives to purchase rental housing property. In part, that would help to lower rents across the rental base. We think that this is particularly important when there is consideration being given to cutting certain HUD and housing programs, then this should be looked at very closely.

In concluding, I want to refer the Committee to the written statement and in particular ask that consideration be given to the low-income housing tax credit. There are some recommendations that we put forward in there, and as the proposals move forward in the appropriations process on cutting back on certain multifamily housing programs, it is important that this Committee realize that the low-income housing tax credit is one of the driving housing policies left in this country to provide low-income housing.

Thank you, Mr. Chairman.

[The prepared statement follows:]

**TESTIMONY OF THE
NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
July 12, 1995**

Mr. Chairman, members of the committee, my name is Robert Bannister, I am the Senior Staff Vice-President of the Government Affairs Division of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 186,000 members, I congratulate and thank you for holding this hearing. I am particularly appreciative of having the opportunity to appear here today as these hearings address a number of issues which are very important to our industry and which, without your insightful leadership Mr. Chairman, might not have seen the legislative light-of-day.

CONTRIBUTIONS IN AID OF CONSTRUCTION

As you are aware, the 1986 Tax Reform Act repealed Internal Revenue Code section 118(b) which allowed corporate regulated utilities to treat contributions in aid of construction as nontaxable contributions to capital. Congress believed, quite simply, that such contributions represented prepayments for services. As a result, CIAC is taxable to the utility company in the year of receipt. In order to make the utility whole, that is, in a position equal to its position prior to the tax law change, CIAC must be "grossed up" to compensate for taxes paid. The term "grossed up" is applied to the series of mathematical calculations required to determine the amount of money needed to offset the tax liability.

It is important to note that most public utility companies prohibit the inclusion of the cost of the added liability in the rate base. If this were allowed, the cost would be spread to all consumers. In reality, however, the utility companies simply consider their increased tax liability as an increase in the cost of adding new customers. As a result, most utilities charge the builder/developer a fee for transferring capital contributions in aid of construction that is equivalent to the tax. Builders often must pass these costs on to the buyer. Worse, the cost to the buyer is generally greater than the tax because the builder must borrow these funds during the development stages but does not recoup them until sale. Hence, home costs are increased by a multiple of the "gross up" to compensate for time and risk to the lender.

While the impact of CIAC varies across the country depending upon whether the particular area is served by a regulated public utility (tax paying) or a tax-exempt municipal or county utility, the costs can be as much as $5,000.00 per home depending on the area of the country affected.

The tax on CIAC fall more heavily on moderate income families. Most capital expansion for utility service is related to the number of units rather than the price of units. Hence a $2,000 extra cost of home in the affordable price range is a much higher percentage of cost than the same dollar increase to a luxury home.

CAPITAL GAINS

Prior to the Tax Reform Act of 1986, taxpayers who recognized gain from the sale of a capital asset-including depreciable real estate-received favorable tax treatment in the form of an exclusion from taxation on a portion of that gain. The theory was that this tax incentive generated investment. The Tax Reform Act of 1986 eliminated the tax preference for capital gains and treated all gains as ordinary income.

As a result of several modifications of the law since then, gains on the sale of capital assets held for more than a year are taxed at a maximum rate of 28%, and ordinary income may be taxed at higher rates, depending upon income. However, taxpayers with marginal tax rates of 28% or lower receive no tax differential for holding real estate, and taxpayers

with marginal tax rates over 28% receive only partial differential treatment.

NAHB supports the proposal to allow individual taxpayers who have held an asset for at least five years to elect pay to pay either present-law taxes on capital gains or, tax equal to 10 percent of the sales proceeds. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction.

NAHB believes that taxation of assets at a lower rate than ordinary income encourages investment and savings. However, taxation of realized gains on long-held assets at ordinary income rates (i.e. on sale or transfer) reduces the economic incentives to invest in the most efficient, highest return opportunities. Removal of the retardant effect of current law taxation would allow taxpayers to place their capital in the most promising sectors of the economy. More efficient capital flows would create jobs and stimulate the economy.

A capital gains tax cut would not benefit only higher income taxpayers. One-half of the 1991 tax returns claiming a capital gain or loss reported incomes below $60,000. Furthermore, encouraging investment through reduced taxes on the gains from that investment would create jobs and economic activity at all levels of income.

With respect to real estate, a capital gains preference would increase investors and owners incentives to purchase, rehabilitate and operate rental housing. Part of the total return to investors who own rental housing is property appreciation. The greater the owners after-tax income from the appreciation portion of their return, the less income required from rents to achieve the same earnings. Reducing capital gains tax rates will reduce residential rents. Since much of the appreciation in housing is due to price inflation, adjusting the gains for inflation will reduce rents even more.

We must insist however, that any capital gains incentive include real estate. Just as real estate served as the engine to lead the economic recovery, so it must be included in any capital gains reduction in order to maximize the dynamic economic impact of the proposal. Indeed, inclusion of real estate effectively rebuts any argument that a capital gains tax cut would favor only wealthy taxpayers. Mr. Chairman. I know this has been a long standing position of yours.
We also support the proposals to enhance the one time exclusion on the sale of a principal residence by an individual who has attained age 55.

LOW INCOME HOUSING

NAHB fully supports the proposals to change the Low Income Housing Tax Credit (LIHTC) State authority limitation stacking rule and to allow HOME funds to be used with the 91% credit. Currently, over 95 percent of the production of affordable rental housing for low- and moderate-income households involves the use of the low income housing tax credit program. The tax credit supplies a critical incentive for affordable rental apartments and supported the acquisition, rehabilitation, or construction of over 650,000 rental housing units between 1987 and 1993. In 1993 alone, the LIHTC was responsible for the construction of 67,279 new rental units and 38,729 rehabilitated units. The construction and rehabilitation of these units created nearly 90,000 jobs. The direct job impact generated $2.8 billion in wages and salaries. The wages and salaries, and company profits generated $1.4 billion in taxes to the federal, state and local governments.

This critical affordable housing program is in dire need of further improvement. Under current law, State tax credit agencies stack unused tax credit authority for the preceding year after the current year's per capita credit authority. In many states, this system operates to limit the period of usage of tax credit authority to one year. NAHB

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strongly urges that state credit authority limitation stacking rule be changed to stack credit authority carried forward from the previous year before the current year's per capita credit authority.

NAHB also supports the proposal to extend eligibility for the 91% and 39% credits, available in qualified census tracts and difficult development areas, to otherwise qualified buildings with HOME Funds. Effective large-scale national programs or techniques for debt financing for multi-family projects assisted by the tax credit do not exist. Few projects financed by tax-exempt bonds are viable at the lower credit percentage. Accordingly, we further urge that the proposal be modified to provide that projects financed with tax-exempt bonds or below market federal loans be made eligible for the 70 percent value credit.

Although we do not have policy with respect to H.R. 931, NAHB supports the concept of providing 15-year depreciation, exception to the passive loss rules and modification of the alternative minimum tax provisions to encourage the preservation of low-income housing.

SUBCHAPTER S REFORM

The S Corporation Reform Act (S. 758) would, in part, provide clear and objective rules with respect to preservation of S corporation status and simplification of requirements for qualifying for, and maintaining, subchapter S status. The bill would also raise the maximum number of eligible shareholders from 35 to 50, and preserve family businesses.

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. A builders' organizational structure tends to depend on the size of the business. Two out of three builder firms are organized as corporations. Twenty-five percent of small-volume builders (builders who build less than 25 homes per year) are sole proprietorships, whereas only 8 percent of the medium- (25-99 houses per year) and large- (over 100 houses per year) volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships. During the last ten years, more builders and remodelers have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

Under the present law, although the IRS may waive the effect of an inadvertent S corporation termination, it does not have the authority to waive the effect of an inadvertent invalid Subchapter S election. We support the S. 758 proposal to remove tax traps for the unwary, by allowing the IRS to also waive the effect of an inadvertent, invalid, or untimely S corporation election. We also agree with the suggestion that the proposal include a provision to change the S corporation definition of "passive income" to exclude income earned from the active conduct of a rental real estate trade or business. The current law definition precludes many rental real estate operating companies from electing S corporation status.

Finally, under present law, to qualify as an S corporation, the corporation may not have more than 35 shareholders. NAHB supports the proposal to expand the maximum number of shareholders to 50 and to allow all family members to be treated as one shareholder. This important change would do much towards making federal tax law more favorable to preserving family-owned businesses.

H.R. 1213, introduced by Representative Stark, would allow S corporations that subdivide unimproved land held for at least 5 years to enjoy capital gains treatment provided

the land had not previously been held as inventory property. Although NAHB has not adopted formal policy on this proposal, we believe it is an important component of S Corporation reform and therefore support H.R. 1213.

ESTABLISH A 10-YEAR RECOVERY PERIOD FOR CERTAIN LEASEHOLD IMPROVEMENTS

Under the present law, if a leasehold constitutes an addition or improvement to commercial property already placed in service, the improvement must be depreciated using the straight-line method over a 39-year recovery period. NAHB supports the proposal (H.R.1171) to provide a recovery period and class life of 10 years for certain real property leasehold improvements and suggests that the proposal be modified to include residential real estate and improvements benefitting common areas.

Environmental restrictions and technological advancements make certain elements of a building obsolete or otherwise unusable prior to the expiration of the applicable recovery period for residential or commercial real estate (such as Heating Ventilation and Air Conditioning systems. Replacement or remedy of said elements of a building often creates a phantom asset with a recovery period far in excess of its real useful life.

MODIFICATION OF RULES FOR REAL ESTATE INVESTMENT TRUSTS

Under current law, a 100 percent tax is imposed on the net income of a REIT from dealer property. The proposal would modify the safe harbor from the 100% tax to cover any number of sales per year, provided that the gross income from the sales does not exceed 10 percent of the adjusted basis (determined before any reduction for depreciation) of all the REIT's assets at the beginning of the REIT's taxable year. NAHB supports this proposal as a step in the right direction.

REITs represent an important vehicle for real estate investment by providing liquidity and opening up real estate investments to a broader range of investors. Accordingly, NAHB suggests that the 100% tax on income from dealer property as it applies to equity investments in housing production, and the limit on REIT income that may be derived from the sale of real property held for less than four years, be eliminated.

INSTALLMENT METHOD OF REPORTING OF INCOME FROM SALE OF SINGLE-FAMILY RESIDENTIAL LOTS

Under the tax law prior to 1986, a taxpayer who sold property on the installment basis was taxed as payments were received. Treating the income otherwise requires a tax on the entire gain in the year of sale when only a small portion of total sale proceeds may have been received in the year of sale.

The 1986 Tax Act prohibited the use of the installment method for dealer sales of developed lots. As a result, landowners are less likely to sell to builders on an installment basis or seek higher prices to compensate for the extra tax burden. Higher land costs and fewer willing land owner partners in new home building increases the cost of new homes and creates affordability problems for potential home buyers.

The instant proposal would allow real estate dealers to use the installment method of accounting treatment to recognize income from sales of newly constructed single-family homes if, inter alia: the sale price does not exceed 75 percent of the area median newly constructed home price, any second mortgage held by the builder does not exceed 20 percent of the purchase price, and the purchaser is financially qualified to finance 100 percent of the mortgages arising from the purchase.

It is difficult to determine the impact of this proposal. First, with respect to the downpayment provision, the majority of mortgage transactions are handled on the secondary market by FHA, Fannie Mae, Freddie Mac and private mortgage insurance companies. These organizations will not permit a seller to provide a second mortgage to finance a buyer's downpayment. We would suggest that the current restrictions be removed for such purchases.

We agree that some form of downpayment assistance is sorely needed. First time home buyers do not have sufficient cash for the down payment and closing costs nor do they have sufficient income to support the large mortgages necessary to purchase todays homes. Three in five potential first time home buyers do not have the income to support a representative home if the mortgage interest rate were 8 percent. About another 10 percent are disqualified if interest rates were 10 percent.

The Census Bureau report entitled *Who Can Afford to Buy a House?* supports these conclusions. According to that report, by including more mortgage qualification requirements (mortgage debt to income ratio and all debt to income ratio), about 90 percent of young renter families cannot afford to purchase even a modestly priced home. About seven out of every ten renter families who cannot afford to purchase have more than one affordability problem. The majority of renters who cannot afford to purchase have insufficient income to make the mortgage payment and insufficient cash, either to pay down other long term debt to within the mortgage underwriting guidelines for total debt burden or insufficient cash to make the down payment and closing costs.

The dual-edged problem many families face in trying to buy their first home is that the smaller the down payment, the larger the monthly payments. Hence, even if they are able to save enough for the minimum down payment, the mortgage necessary to finance the rest of the purchase requires monthly payments beyond their means. To worsen this situation, these young households are just starting job careers so that their current incomes are relatively low, especially compared to their potential over a lifetime. Further hindering their ability to borrow for a home, they have already incurred debt for their education, an automobile, furniture, etc. These responsibilities come at exactly the wrong time for a young household to incur additional debt and use their limited savings for a down payment.

NAHB supports the concept of this proposal and believes that it would provide and important step in alleviating the housing affordability problem.

PENSION SIMPLIFICATION

Under the H.R. 3419 proposal, nongovernmental tax-exempt organizations would be permitted to maintain qualified cash or deferred arrangements for their employees. NAHB fully supports the H.R. 3419 proposal. It would allow state and local home builder associations to establish 401(k) plans and would allow state home builder association employees to receive equal treatment under the federal tax laws.

CONCLUSION

For the reasons stated above, the National Association of Home Builders believes that the miscellaneous tax proposals would be of great benefit to the home construction and remodeling industry. As noted above, certain of these provisions (e.g. the CIAC proposal and the LIHTC stacking rule change) would provide urgently needed relief from certain unintended consequences of the Internal Revenue Code. Also, as we have stated, we suggest that certain proposals be modified to have a more meaningful and immediate impact.

Once again Mr. Chairman, NAHB thanks you for this opportunity to present our recommendations. We look forward to working more closely with you and your staff in the coming years.

Mr. COLLINS. Thank you, Mr. Bannister. All of your full statements will be entered into the record.

It is pleasing to hear—and of course, it usually comes from outside the beltway—but it is pleasing to hear that we have people out there who support the fact that we put forth a very good tax bill earlier in this Congress. We are going to push it all the way through before the end of this year. These proposals will stimulate the economy, will add to family budgets, will assist in the transfer and title of property and equipment, and will be very beneficial not only to the public but to the government.

I yield now to the Chairman of this Committee, Chairman Archer.

Chairman ARCHER. Gentlemen, thank you for your input.

I would like to ask Mr. Threadgill a question relative to his proposal on improvements that are done by an owner of a property rather than a lessor of the property.

In the Contract With America, we inserted a provision that if you were the lessor, any time that you removed a partition or some improvement to the property, you could write it off and not have to continue to depreciate it over the 39-year life of the property.

I am wondering whether that same sort of provision, if applied to owner's improvements, would not take care of your problem.

Mr. THREADGILL. Mr. Chairman, I think that IDEA would certainly go a long way in that regard, but I think part of the reason for the 10-year life is that when you are remodelling or refurbishing a store and doing a lot of different things, building a wall here, building a wall there, being able to identify how much cost goes into each of those particular assets that may later be ripped out or torn out is very hard to do. Basically, it goes in as one lump asset for that store for those improvements.

After a 5- to 7-year period, when you go in to renovate the space again, some of those assets may continue to remain in service, and others may be ripped out. Being able to identify which of those you can retire from your books and go ahead and write off versus those that are still being maintained and kept in service becomes almost impossible to do, certainly in a retail or in a department store setting. But it would certainly help.

Chairman ARCHER. OK. Thank you very much.

Mr. Collins.

Mr. COLLINS. Mr. Christensen, do you have any questions?

Mr. CHRISTENSEN. No questions.

Mr. COLLINS. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Bannister, I certainly support the proposal that you presented in your written statement about allowing taxpayers who hold an asset for at least 5 years to pay either the present law tax on capital gains or the tax equivalent of 10 percent, and also the one-time exclusion at age 55.

I want to go a step further and ask what would be your position or the position of Home Builders for a person who owns the household for 10 years, paying no capital gains tax. I represent a fairly senior citizen population in a very rural district, and a lot of people live in their homes a lot longer than 10 years, paying substantial taxes, inflation is added to the price, and then generally, when they

sell that property, it is what they live on for the remainder of their lives, and they generally sell to move closer to a child or other family members for assistance.

I just wonder if you have a position where, if the home is owned in excess of 10 years, there would be no capital gains.

Mr. BANNISTER. We certainly, Mr. Laughlin, would support what the Chairman has advocated for some time as no capital gains tax. In today's political climate, that is not a reality.

However, you touch on a very important point. That is, the average American has $66,000 in equity in his home, and to the extent that that is taxed at any point, it lessens his ability to have some of that for retirement. There is more equity in the Nation's homes today than in all types of pensions and savings. We think it is part of our program, if you will, in this country not only to provide shelter, but in a way to provide a comfortable retirement for an aging population. That is why we would certainly support anything that would encourage those in housing for a certain period of time to lessen their tax consequence when they leave that home for whatever reason.

Mr. LAUGHLIN. The Chairman and I have never discussed this issue, but I certainly think we should do all we can to encourage home ownership and then do the least amount of damage on taxing or penalizing the person when he finds it necessary to sell that home for whatever reason.

Mr. BANNISTER. I agree. Thank you.

Mr. LAUGHLIN. Thank you.

Chairman ARCHER. Thank you, Mr. Laughlin.

We thank each of you gentlemen for coming today and testifying before the Committee with your recommendations. We are pleased to have had such a good response in yesterday's hearing and in this one.

We stand adjourned.

[Whereupon, at 1:30 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

WRITTEN STATEMENT OF LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

I am pleased to submit this statement presenting the views of the Administration on miscellaneous revenue issues as described in the July 10, 1995, pamphlet prepared by the Joint Committee on Taxation[1] ("JCT Pamphlet").

The Committee has before it over 250 proposals representing substantive changes to a wide range of tax provisions. Many of these proposals deal with complex provisions of the law. In many cases, the proposals raise questions whether existing law should be thoroughly reviewed and subject to hearings, considering, among other things simplification and rationalization. For instance, Treasury is studying the treatment of financial instruments and entities engaged in financial services transactions and ways to modernize their regulatory and tax treatment. Some proposals that are the subject of these hearings might more appropriately be considered in the context of such a modernization effort.

In developing our positions on the proposals before the Committee, we have relied on a number of tax policy principles. One such principle is tax simplification. Given the widespread interest that has been expressed in simplifying the tax code, we believe that in evaluating these proposals, great weight should be given to the extent that they may either simplify or complicate the tax laws. Many taxpayers have complained that one of the greatest sources of complexity in the tax laws is frequent change in the law. We urge the Committee in considering these miscellaneous proposals to bear in mind the additional complexity that may result from large numbers of even meritorious changes in the tax laws.

The Administration strongly supports many of the simplification provisions contained in H.R. 3419, as it passed the House in the 103rd Congress and as proposed to be modified in the JCT Pamphlet. The Administration has recently announced additional tax simplification proposals.

For instance, last month the President announced a pension simplification package. A number of the miscellaneous tax proposals included in these hearings are the same as or similar to items in the Administration's pension simplification proposal. We believe that the complexity of the private pension system has raised the compliance and administrative costs of maintaining a plan to a level that discourages certain employers, particularly small employers, from providing any retirement plan for their employees. Accordingly, one of the principal elements of the Administration's proposed pension simplification package is a new, simple retirement plan for employers with 100 or fewer employees, known as the NEST (or National Employee Savings Trust). The NEST would combine the most attractive features of IRAs and 401(k) plans, and would not be subject to the top-heavy

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[1] Joint Committee on Taxation, <u>Description of Miscellaneous Tax Proposals</u> (JCS-19-95), July 10, 1995.

rules or to any other complex nondiscrimination rules. We look forward to working with Congress on a bipartisan basis to achieve this and other pension simplification this year.

In June, President Clinton also announced proposals, as part of the Administration's Reinvention of Government II (REGO II) initiative, to simplify the tax and wage reporting system, and to expand the Internal Revenue Service's partnership program with State tax authorities. We note that one of the simplification proposals in H.R. 3419 would permit IRS to enter into cooperative agreements with State tax authorities. The Administration supports this provision and is eager to work with the Committee to improve it.

In addition to tax simplification, the Administration has relied on several other tax principles in evaluating the miscellaneous proposals that are before the Committee. We oppose "rifleshot" measures that provide special tax relief to a targeted group of taxpayers. We generally oppose purely retroactive provisions that seek to supplant the judicial process. We favor equity among similarly situated taxpayers. We insist upon the administrability of each provision. Finally, to the extent that miscellaneous tax proposals represent tax expenditures, the relevant cost to taxpayers, and whether there are proposed revenue-raising offsets, are important factors to be considered.

The Administration's view with respect to many of the proposals under consideration today assumes that appropriate revenue measures will be proposed. Consequently, even for tax proposals that are meritorious, they must be offset by revenue-raising provisions that are compatible with the principles of deficit reduction. Moreover, even if appropriate revenue-raising offsets can be identified, the Administration will want to work with the Committee and the Congress as a whole to set priorities for the use of those revenues.

The remainder of this statement is a detailed discussion of the Administration's positions on the miscellaneous tax proposals that are the subject of the hearing. The discussion follows the order of the proposals described in the JCT pamphlet.

ADMINISTRATION POSITION ON MISCELLANEOUS TAX PROPOSALS

I. MISCELLANEOUS PROPOSALS

A. TAX ACCOUNTING PROVISIONS

1. Expensing of Certain Costs Associated with Natural Disasters

Administration Position. **Do not support.** The Administration is aware of concerns relating to lost or damaged crops. This proposal, however, goes well beyond allowing deductions to restore acreage to its pre-disaster condition by allowing deductions for capital investments.

2. Allow Installment Method of Reporting Income from Sale of Certain Residential Real Property

Administration Position. **Oppose.** Current law appropriately denies the installment method with respect to sales of real property by dealers. This provision would add significant complexity to the Internal Revenue Code and would be difficult for the Internal Revenue Service ("IRS") to monitor. Also, it is inconsistent with the narrow exceptions of current law, as it would not impose an interest charge on the deferred tax.

3. Eliminate "Look-Back Method" for Nonresidential Construction Contracts

Administration Position. **Oppose.** The look-back provisions serve to compensate either the government or the taxpayer for the under- or over-estimation that is inherent in the use of estimates. The narrow exceptions to the use of this method currently available serve to exclude those taxpayers for whom the calculations are overly burdensome.

4. Treatment of Contributions in Aid of Construction for Water Utilities

Administration Position. **Do not oppose.** Congress enacted the current statute in 1986 to prevent utilities from permanently excluding the income associated with these contributions. Congress believed that regulated utilities had the flexibility to recoup these expenditures (if they were incurred directly) through the ratemaking mechanism. It is not clear, however, that utilities have this flexibility. For example, many utilities are restricted to fixed-rate structures that do not permit them to earn a return on property of the type under consideration. Therefore, in these cases, there is no permanent exclusion of income as contemplated by Congress in the Tax Reform Act of 1986 ("1986 Act"). It is unclear, however, from a tax policy perspective why this proposal should be limited to water utilities.

5. Allow Trading Partnerships and Corporations to Use a Mark-to-Market Method of Accounting for Securities

Administration Position. **Do not support.** The Treasury is studying the treatment of financial instruments and entities engaged in financial services transactions and ways to modernize their regulatory and tax treatment. This proposal is more appropriately considered in the context of the larger issues. Furthermore, there are a number of technical issues that will have to be addressed with this type of treatment, such as the character of gain or loss on a mark of a capital asset generating ordinary income flows.

6. Allow Partnerships and S Corporations to Elect Taxable Years Other than Required Taxable Years by Paying Estimated Taxes on Behalf of Their Owners

Administration Position. **Oppose.** This provision is extremely complex and will impose greater administrative and compliance burdens on the IRS. Furthermore, there are a number of technical problems. For example, the entity makes payments at the corporate rate, unless owners have income from the entity above a certain amount, or, if the entity is a partnership, it has income above a certain amount without regard to the number of partners. This may result in significant deferral of estimated payments by the owners, depending upon their tax brackets. As another example, the owners may find it difficult to determine the actual amount of credit against their own tax liabilities that is flowing from the entity if ownership is changing throughout the year.

7. Allow Deduction for Intrastate Operating Rights of Motor Carriers

Administration Position. **Oppose.** Allowing a current deduction for the adjusted basis of operating authorities would contravene long-standing cost recovery principles and is even more generous than the Economic Recovery Tax Act of 1981 provision affecting interstate operating rights.

8. Allow Taxpayers to Estimate Shrinkage for Inventory Accounting

Administration Position. **Oppose.** The Administration believes that the use of estimates based on historical data in this context does not result in a clear reflection of income.

9. Provide Exclusion for Certain Amounts Received by a Utility with Respect to Nuclear Decommissioning Costs

Administration Position. **Do not support.** The effect of this proposal is to allow the utility to exclude from income customer contributions to future decommissioning costs without reducing the amount the utility is permitted to deduct for contributions to a nuclear decommissioning fund.

10. Repeal Treasury Ruling Requirement for Nuclear Decommissioning Costs

Administration Position. **Do not support.** Taxpayers are required to obtain a ruling establishing the schedule of contributions to a nuclear decommissioning fund in order to prevent excess accumulations in the fund and to assure that contributions are not deducted more rapidly than level funding.

We believe that centralized administration, through a ruling procedure, is the most efficient method of achieving these purposes. The Internal Revenue Service's experience with the ruling requirement is that the schedules submitted by taxpayers in their ruling requests frequently require adjustments in order to prevent excessive or accelerated deductions. We are concerned that, if the ruling requirement is eliminated and enforcement of limitations on contributions is left to the audit process, errors in the schedule of contributions are more likely to escape detection. We also believe the Internal Revenue Service should not be deprived of its discretionary authority to disqualify a nuclear decommissioning fund if the fund's assets are not used for decommissioning or there is self-dealing between the fund and the utility.

We recognize that, under current rules, it is possible that taxpayers may be required to request a new ruling to reflect

minor changes in the assumptions on which the taxpayer's original ruling was based. The Internal Revenue Service and Treasury are aware that in such cases, it is appropriate to streamline the procedures to ease administrative burdens on both taxpayers and the Internal Revenue Service.

11. Treatment of Certain Compensation Payable by Certain Personal Service Corporations Using an Accrual Method of Accounting

Administration Position. **Do not oppose, with possible modifications.** Provided the amount of compensation which may be deducted under this provision is limited in a manner similar to that proposed in H.R. 11 in the 102nd Congress, the mismatch that would result from this provision would not undermine the purposes of section 267.

12. Treatment of Livestock Sold on Account of Weather-Related Conditions

Administration Position. **Support.** This provision promotes the policy of allowing farmers to avoid unpredictable tax results due to events not within their control, and allows these taxpayers to associate expenses with income directly attributable to those expenses in the same manner as the natural business cycle.

13. Treatment of Certain Crop Insurance Proceeds and Disaster Assistance Payments

Administration Position. **Support.** This provision promotes the policy of allowing farmers to avoid unpredictable tax results due to events not within their control, and allows these taxpayers to associate expenses with income directly attributable to those expenses in the same manner as the natural business cycle.

14. Allow Certain Contractors to Use the Cash Method of Accounting

Administration Position. **Oppose.** The Administration does not believe that a statutory change is necessary.

B. ALTERNATIVE MINIMUM TAX

1. Allow Certain Investment Expenses to be Deducted for Alternative Minimum Tax Purposes

Administration Position. **Do not oppose, with modifications.** From a tax policy perspective, the AMT treatment of these expenses is inconsistent with one of the purposes of the AMT (to assure that economic income is subject to tax) and results in a mismeasurement of economic income. This relief should not be limited to individuals receiving distributive shares of section 212 expenses from partnerships. The economic distortion at issue applies no matter what form the taxpayer's investment takes.

2. Allow Energy Tax Credits Against Alternative Minimum Tax

Administration Position. **Oppose.** There is no reason that energy credits should be subject to substantially more favorable treatment than other tax credits, which generally are not allowed against the AMT. In addition, the purpose of the AMT, to assure that taxpayers with economic income are subject to tax, will be weakened if credits may be fully utilized against it.

C. BUSINESS EXPENSES

1. Any Period During Which a Federal Employee Is Certified By the Attorney General To Be Participating in a Federal Criminal Investigation Not Included in Computation of One-Year Limitation with Respect to Deductibility of Travel Expenses While Temporarily Away from Home

Administration Position. **Do not support.** It has not been established that the impact of the amendment of section 162(a) by the Energy Policy Act of 1992 upon federal investigators is unique or more burdensome than the impact upon State and local investigators or other governmental or business activities. Deduction of expenses for travel away from home may result in the deduction of personal expenses as business expenses. A universally applicable fixed time limit is appropriate and should minimize administrative disputes.

2. Deduction for Regularly Scheduled Air Transportation Limited to Normal Tourist Class Fare

Administration Position. **Oppose.** Imposing a new limitation on the deductibility of airline fares would create significant administrative burdens. In addition, it would be inappropriate to single out the airline industry in contrast to other forms of transportation by limiting deductions for airfare to a particular fare.

3. Increase Deductibility of Business Meal Expenses for Individuals Subject to Federal Hours of Service Limitations

Administration Position. **Oppose.** We are not persuaded that the circumstances of those individuals who would be affected by this proposal are sufficiently unique to warrant special treatment.

D. BUSINESS TAX CREDITS

1. Credit for the Rehabilitation of Certain Historic Homes

Administration Position. **Oppose.** The subsidy represented by the proposed credit is not warranted. Moreover, the transferability of the credit pursuant to rehabilitation mortgage credit certificates raises significant administrative concerns.

2. Increase Tax Credit and Modify Other Provisions with Respect to Electric Vehicles

Administration Position. **Do not support.** The current 10 percent credit (subject to a $4000 cap) for electric vehicles was enacted in 1992, effective for vehicles placed in service after June 30, 1993. We are concerned that certain of the proposed modifications would create greater disparity in the tax incentives for electric vehicles and the special expensing allowed for other clean-fuel vehicles.

3. Tax Credit and Tax-Exempt Financing for Environmental Remediation Expenses

Administration Position. **Do not support.** Although the Administration fully supports the goal of environmental cleanup, the proposal would be complex and difficult to administer. In addition, the proposal would have significant revenue cost, and would not be the most efficient means of providing subsidies to finance cleanup costs.

E. CAPITAL GAINS

1. Ten Percent Alternative Tax on Gains Held Five Years

Administration Position. **Oppose.** This type of proposal is inconsistent with the principles of an income tax since taxpayers with the same amount of capital gain would pay greatly different amounts of tax in many cases. The proposal would be very complex due to its potential interaction with other provisions such as loss carryovers, the 28 percent maximum tax on capital gains, limits on the deduction of investment interest expense, and the alternative minimum tax. In addition, this proposal would lose significant revenue.

2. One-Time Exclusion of Gain on the Sale of a Principal Residence by an Individual Who Has Attained Age 55

(a). Allow Multiple Exclusions Where Two Otherwise Eligible Taxpayers Marry

Administration Position. **Do not oppose.** There are a number of anomalies in existing law, particularly with respect to individuals who remarry. It is clear that improvements to the current rules can be made for otherwise eligible taxpayers who marry. We are happy to work with Congress to develop proposals to simplify current law.

(b). Allow Multiple Exclusions in Certain Cases

Administration Position. **Do not support.** This proposal has the potential to allow two exclusions within a marriage for a total of up to $250,000 in excluded gains. There are a number of anomalies in existing law, particularly with respect to individuals who remarry. We are happy to work with Congress to develop proposals to simplify current law, but we are concerned about the possibility in this proposal of allowing two exclusions within a marriage.

(c). Allow Multiple Exclusions in the Case of Certain Unemployed Persons

Administration Position. **Oppose.** This proposal raises significant administrative concerns.

(d). Treat Certain Disabled Persons as Satisfying the Age 55 Requirement

Administration Position. **Do not support.** It is unclear that this is an appropriate, targeted way to assist the disabled. In addition, we have concerns about the definitions used in the proposal.

3. Revise Targeted Capital Gains Exclusion for Small Business

Administration Position. **Do not support.** Section 1202 as currently drafted provides an appropriate incentive for investment in small business corporations. The Administration, however, recognizes the potential problems that can be created by the current provisions regarding shareholder redemptions and the amount of working capital that is treated as used in the active conduct of a trade or business. We would be happy to work with Congress to devise appropriate corrections to address these specific problems.

4. Exempt Tax-Exempt Bonds from Treatment as Market Discount Bonds

Administration Position. **Oppose.** Market discount on a tax-exempt bond is attributable to the time value of money and is appropriately treated as discount.

F. CHARITABLE DEDUCTION

1. Deduction for Commemorative Coins Purchased from U.S. Mint

Administration Position. **Oppose.** This proposal runs contrary to the fundamental tax policy principle which holds that a taxpayer makes a charitable contribution only to the extent the taxpayer's payment exceeds the value of anything provided in return. The U.S. mint sells commemorative coins for a set price per coin. A taxpayer who pays the set price for a commemorative coin has gotten back something of equivalent value, and therefore has not made any charitable contribution that would merit a deduction.

2. Charitable Deduction for Non-Itemizers

Administration Position. **Oppose.** A charitable contribution factor is already built into the standard deduction. Therefore, allowing taxpayers who do not itemize to claim a deduction for charitable contributions would effectively provide many taxpayers with a double deduction, and would pose significant budgetary and administrative problems.

3. Remove Charitable Deductions from Overall Limitation on Itemized Deductions

Administration Position. **Oppose.** There is no tax policy reason for distinguishing the charitable contribution deduction from any other itemized deduction that is subject to the reduction imposed by section 68.

4. Repeal Charitable Substantiation Rule for Contributions of $250 or More

Administration Position. **Oppose.** The substantiation requirement of section 170(f)(8) is intended to stop known abuse of the charitable contribution deduction by taxpayers seeking to deduct payments to charity that are actually payments for goods or services rather than contributions. Requiring written substantiation provides the IRS with an effective mechanism for verifying that a taxpayer's payment genuinely represents a charitable contribution.

5. Allocation of Basis to Sale Portion of Bargain Sales of Real Estate Interests to Charities or Governments

Administration Position. **Oppose.** By allowing a taxpayer to offset the gain from a bargain sale of real property to charity with the full basis in the property, this proposal removes an important check on the taxpayer's interest in inflating the value of the charitable contribution. It also increases the preference for using appreciated real property rather than cash to make charitable contributions. Furthermore, by preventing the IRS from considering negotiations and the actual sales prices when determining the fair market value of a restriction on use of real property that has been sold to a charity, the proposal creates an unwarranted exception to the general principles of fair market value. Arm's-length bargaining and sales prices are essential elements in any principled analysis of fair market value. Prohibiting their consideration would encourage taxpayers to claim unjustifiably that they have made bargain sales.

6. Enhanced Deduction for Corporate Contributions of Scientific Equipment for Design Research

Administration Position. **Oppose.** The special rule for contributions of scientific property for research was enacted in response to studies that showed that universities were unable to meet the rising costs of scientific equipment in such equipment-intensive research areas as physics, chemistry, and electrical

engineering. This rationale does not apply to contributions of equipment for use in design research. Moreover, there is no evidence that the costs of the equipment used in design research are rising. In fact, the cost of computer equipment, one of the principal tools of design research, is generally falling.

G. CHILD CARE CREDIT

1. Extend Dependent Care Credit and Dependent Assistance Programs to Certain Overnight Camp Expenses

Administration Position. **Oppose.** Taxpayers may claim this credit for certain child-care costs incurred in order to enable the taxpayer to work, but generally may not deduct expenses which are predominately for the entertainment or education of their child. In addition, this provision appears to limit the amount of allowable expenses on a weekly basis, adding significant complexity to the calculation of the credit and exclusion amounts.

H. COMPLIANCE

1. Allow Offset of State Tax Liability with Overpayments of Federal Tax Law (H.R. 757)

Administration Position. **Do not oppose.** The Administration supports the goals of H.R. 757, but believes modifications are necessary to ensure that the IRS can continue to administer its refund offset program in an efficient manner. We would be pleased to work with the Committee in crafting the needed modifications.

2. Repeal of Information Reporting on Real Estate Transactions

Administration Position. **Oppose.** This information reporting requirement is important in enabling the IRS to monitor compliance. The Congressional concern underlying the enactment of this provision in 1986 remains valid.

3. Extend IRS Offset Authority for Undercover Operations

Administration Position. **Support.** When it was available, offset authority was used by the IRS to conduct effective undercover investigations of crimes such as money laundering and motor fuel excise tax fraud. The offset authority also was used to conduct undercover investigations that led to the indictment of major drug traffickers and organized crime figures, and the seizure of millions of dollars in illicitly derived assets. The authority should be extended.

I. CORPORATE

1. Certain Distributions by Alaska Native Corporations and Treatment of Certain Settlement Trusts

Administration Position. **Do not support.** Any changes to the taxation of Alaska Native Corporations ("ANCs") should be structured to minimize administrative burdens on the IRS. The proposal would increase the situations in which the determination of basis in shares of ANC stock becomes relevant, and thus would increase administrative complexity.

2. Lengthen Corporate Capital Loss Carryover From 5 to 15 Years

Administration Position. This proposal would permit capital losses to be carried forward 15 years instead of five. The current five-year carry-forward may be unduly short. We are

concerned, however, about revenue effects and whether the proposed modification is appropriate for existing losses. We believe this proposal should be considered in light of the treatment of carryovers generally.

3. Repeal Rule that Accumulated Earnings Tax Applies Without Regard to the Number of Shareholders

Administration Position. **Do not support.** Changes to the accumulated earnings tax rules must be carefully considered, particularly with respect to their coordination with other anti-avoidance provisions in the Code, including the personal holding company and foreign personal holding company rules. Although changes in these rules may be justified, they should await a thorough review of these anti-avoidance provisions.

4. Modify Rules for Interest on Large Corporate Underpayments

Administration Position. **Do not support.** This proposal is inconsistent with the original design and intent of the 1990 legislation that imposes the higher rate of interest on large corporate underpayments.

J. DEPRECIATION AND AMORTIZATION

1. Normalization of Consolidated Tax Adjustments with Respect to Non-Regulated Subsidiary of a Regulated Public Utility

Administration Position. **Do not support.** The Administration is not convinced that regulatory commissions should be prohibited from allocating any of the consolidated tax benefits resulting from the accelerated use of losses incurred by unregulated affiliates to the customers of the utility against whose income the losses were applied. Moreover, if Congress wishes to restrict a regulatory commission's discretion, sanctions other than the loss of accelerated depreciation may be more appropriate.

2. Establish 15-Year Recovery Period for Small Retail Motor Fuel Outlet Stores

Administration Position. **Oppose.** The proposal is likely to lead to significant abuses and controversies.

3. Establish 3-Year Recovery Period for Semiconductor Manufacturing Equipment

Administration Position. **Do not support.** Changes in depreciable lives should be made only after detailed analysis of relevant economic and other evidence supporting a change.

4. Establish 3-Year Recovery Period for Property Subject to Certain Rental Purchase Agreements

Administration Position. **Oppose.** The Administration is unaware of any economic analysis that supports a shorter life for property subject to rent-to-own contracts.

5. Establish 10-Year Recovery Period for Commercial Improvement Property

Administration Position. **Oppose.** The Treasury is unaware of any economic analysis that supports this modification to the prohibition on component depreciation or the 10-year recovery period of this proposal.

6. Establish 10-Year Recovery Period for Certain Leasehold Improvements

Administration Position. **Oppose.** The Treasury is unaware of any economic analysis that supports this modification to the prohibition on component depreciation or the 10-year recovery period of this proposal.

7. Treatment of Intermodal Cargo Containers

Administration Position. **Oppose.** The investment tax credit and accelerated depreciation provisions were intended to stimulate investment in the United States. This proposal is inconsistent with that objective, and due to its retroactive nature, will not directly result in new investment. Moreover, the amendment of tax returns for many prior years presents significant administrative burdens for the IRS.

8. Exempt Acquisition of Software and Software Services Businesses from 15-Year Intangibles Amortization

Administration Position. **Do not support.** We are concerned that this proposal will lead to disputes over whether an acquisition qualifies for exemption from 15-year amortization and thus will undermine the goals of the 1993 intangibles legislation.

K. EITC

1. Advance Payment of the Earned Income Tax Credit through State Agencies

Administration Position. **Support, with modifications.** This proposal is very similar to a demonstration program proposed by the Administration in 1994 (section 741 of H.R. 4605, 103rd Congress). We would support this proposal if it were modified to conform to our proposal, primarily by addressing the critical issue of the States' responsibility for excessive payments and limiting the provision to a demonstration project involving a specified number of States for a limited duration with an agreement to share data for purposes of evaluating the program.

L. EDUCATION

1. Exclusion For Income Earned on State Prepaid Tuition Plans

Administration Position. **Support Administration's budget proposal.** The Administration strongly supports incentives for investing in and saving for education, but believes that the President's IRA and educational expense deduction proposals are a more flexible way to encourage savings and a more cost-effective means of helping middle- and lower-income individuals afford education. Moreover, the exemption under current law of interest on Series EE Savings Bonds used for education largely satisfies the needs addressed by this proposal for middle- and lower-income individuals saving for their children's education. In addition, we believe that the proposal has technical problems, and may have large revenue costs.

We understand, however, that the prepaid tuition plans currently in place in a number of States are appealing to individuals trying to save for their children's education. We also understand that uncertainty about the tax treatment of the plans under current law may discourage some from using the plans to save for college. We would be happy to work with Congress to create a less expensive, more targeted approach to dealing with this problem.

2. Adopt Education Savings Accounts

Administration Position. **Support Administration's budget proposal.** The Administration supports efforts to encourage savings and to promote investment in higher education. We believe, however, that our proposals to allow deductions for educational expenses and to expand IRAs is a preferable approach. The Administration's proposals are targeted on middle-income families and thus are a more cost-effective way to increase the savings rate in this country. Since there is no income limitation under this proposal, it may provide a tax windfall for higher-income individuals without increasing their overall rate of savings. The Administration's proposals are targeted to provide incentives for lower- and middle-income people who need help saving and paying for college. Finally, we prefer the Administration's IRA proposal because it is a more flexible approach to enhancing the savings rate.

3. Expand Section 108(f) To Provide That Cancellation of Private College Student Loans Is Not Taxable Income

Administration Position. **Do not oppose.** If Congress decides that the exclusion of cancellation of indebtedness income under section 108(f) should be extended to student loans from educational institutions under a program of an institution designed to encourage its students to serve in occupations or geographic areas with unmet needs, we would not oppose such a change on a revenue-neutral basis in the context of otherwise acceptable legislation. However, the Administration remains strongly committed to its prior proposal to clarify that debt forgiveness on Federal direct student loans with income-contingent repayment is excluded from income. The Administration sees its proposal as a priority.

M. EMPLOYMENT TAXES

1. Employment Tax Status of Certain Fishermen

Administration Position. **Do not oppose.** The proposal would take the traditional operation of fishing fleets into account in determining the employment tax status of crew members while ensuring that income paid to crew members is reported. We note that a determination of crew size based on the preceding calendar year (rather than the preceding four quarters) would simplify compliance and administration burdens related to the provision.

2. FICA Exemption for Certain Seasonal Children Camp Employees

Administration Position. **Oppose.** The proposal would create disparities between full-time students employed by children's camps and other students or young adults employed in a trade or business.

3. Extend FICA Tip Credit

(a). Extend FICA Tip Credit to All Employees Who Receive Tips

Administration Position. **Oppose.** The FICA tip credit was intended to apply only to the employer FICA tax paid on tips received from customers in connection with the provision of food or beverages for consumption on the premises of a food or beverage establishment. The Administration does not believe it is appropriate to expand this special tax treatment to tips received by employees for other services.

(b). <u>Effective Date of FICA Tip Credit</u>

<u>Administration Position</u>. **Oppose.** We oppose the application of the FICA tip credit to taxes paid on tips that are not timely reported by employees. Under current law, employers are eligible for the credit only for taxes paid on tips that are timely reported to them by employees. The extension of the credit to taxes paid on unreported tips would provide a disincentive for employers to encourage employees to report tips.

We also oppose the retroactive application of the FICA tip credit to taxes paid after December 31, 1993 with respect to tips received for services performed before January 1, 1994. This proposal, in combination with the proposed extension of the credit to unreported tips, would provide a significant windfall to employers whose employees did not report all or a portion of their tips received before January 1, 1994 and to employers that did not pay FICA taxes on the tips that their employees did report before January 1, 1994. These employers would be eligible for a 100 percent credit, even for their delinquent FICA taxes. In contrast, employers that timely paid their FICA taxes on timely reported tips and employers that encouraged their employees to accurately report their tips would have only received a deduction for their share of FICA taxes attributable to pre-1994 tips. In addition, extending the availability of the credit in the manner proposed could result in an unanticipated drain on general revenues.

4. <u>Repeal Presumption That Bakery Distributors are Employees for Employment Tax Purposes</u>

<u>Administration Position</u>. **Do not support.** Bakery drivers have been treated as statutory employees for employment tax purposes since 1951. We do not believe that there is sufficient reason to change this longstanding provision and disrupt existing arrangements.

5. <u>FUTA Exemption for Certain Religious Schools</u>

<u>Administration Position</u>. **Do not support.** We do not believe that there is sufficient reason to reduce unemployment compensation coverage for this group of workers and their employers. In addition, an exception that is based on whether the employer has a "primary religious purpose" would increase administrative complexity in the statute.

6. <u>Application of Common Paymaster Rules to Certain Agency Accounts at State Universities</u>

<u>Administration Position</u>. **Do not support.** The current provision is a narrow exception that is specifically limited to faculty practice plans where at least 30 percent of the plan employees are also employed by a State university medical school. We understand that technical State law issues prevent certain medical schools from utilizing this provision, and we would not oppose a change more narrowly tailored to address that problem. However, we have concerns about the elements of this proposal that would expand the types of institutions qualifying for common paymaster treatment and that would eliminate the concurrent employment requirement.

7. <u>Repeal Section 1706 of 1986 Tax Reform Act</u>

<u>Administration Position</u>. Worker classification issues should not be addressed on a piecemeal basis. It would be preferable to develop a more comprehensive approach that appropriately deals with worker classification issues. We would be happy to work with Congress to develop such an approach.

N. EMPOWERMENT ZONES

1. Expand Number of Community Development Corporations (from 20 to 40) Eligible for Tax Credit and Increase Aggregate Amount of Contributions Eligible for Tax Credit

Administration Position. **Oppose.** The Administration believes that it is premature to modify these provisions until there is better evidence on how the 1993 provisions are working.

2. Tax Incentives for Economic Recovery in Designated Areas with Employment Loss in Financial and Real Estate Businesses

Administration Position. **Oppose.** This proposal, in contrast to the Empowerment Zone and Enterprise Community program authorized in 1993, is focused too narrowly on reductions in employment and includes a number of tax incentives that in and of themselves would be unlikely to improve economic conditions in distressed areas.

3. Allow 20-percent Tax Credit for Commercial Revitalization in Empowerment Zones and Other Specially Designated Areas

Administration Position. **Oppose.** This proposed credit is unlikely to be effective in overcoming the primary barriers to non-residential development in these distressed areas, is likely to adversely affect businesses already located in these areas, and would be extremely complex to administer.

O. ENERGY

1. Modifications to Tax Credit for Producing Fuels from Nonconventional Source

(a). Allow the Credit to Be Claimed Against the Alternative Minimum Tax

Administration Position. **Oppose.** There is no reason that energy credits should be subject to substantially more favorable treatment than other tax credits, which generally are not allowed against the alternative minimum tax ("AMT"). The purpose of the AMT, to assure that taxpayers with economic income are subject to tax, will be weakened if credits may be fully utilized against it.

(b). Unrelated Party Sale Requirement

Administration Position. **Oppose.** Under either proposal, a taxpayer would have the incentive to erect an electric plant, sell electricity produced from self-generated gas on the national grid, receive the credit, and buy back the electricity from the national grid rather than using its own self-generated electricity. Use of self-generated electricity is already a common practice for many industries without the credit; therefore, this proposal would expand use of the section 29 credit beyond what was originally intended. Moreover, absent an arm's-length transaction, the amount of section 29 gas "constructively" or "deemed" sold would not be verifiable. Finally, the number of potential taxpayers who could claim the section 29 credit under the proposal (and hence the amount of the associated revenue loss) is far greater than originally estimated by Treasury in 1993, when the proposal was previously considered.

(c). Underground Coal Gasification

Administration Position. **Oppose.** The proposal would allow certain modules newly drilled within a coal production area to

qualify for the section 29 credit if there is an existing above-ground gas transportation system to bring the gas generated from in-situ processing to an existing above-ground facility for further processing. This could expand the use of the credit virtually indefinitely for a given coal seam and would, therefore, disadvantage other facilities that would have to comply with the placed-in-service expiration date.

(d). Definition of Tar Sands

Administration Position. **Oppose.** The placed-in-service date for wells from tar sands to qualify for the section 29 credit expired at the end of 1992. The source of the definition of tar sand presently in use by the IRS is a ruling by the Federal Energy Administration. The Tax Court has determined that this definition is the proper definition for purposes of section 29 the Code. In addition, there is no tax policy justification for creating a windfall by recharacterizing a significant number of deposits as eligible for the credit, when the oil or gas has already been economically produced. Moreover, the Administration would anticipate substantial difficulty implementing any standard that requires measurement of a gas-free viscosity at original reservoir temperature.

2. Determination of Independent Oil and Gas Producer Status

(a). Increase Permitted Retail Sales

Administration Position. **Oppose.** Producers that are sufficiently integrated to sell at retail are most likely large companies of the type intended to be excluded from percentage depletion. Regulated public utilities, which tend to be relatively large companies, should not be given a favorable rule for purposes of determining whether they qualify as independent producers.

(b). Increase Permitted Refining Activity

Administration Position. **Oppose.** The current 50,000 barrels of production threshold was carefully considered. There is no tax policy reason for adjusting the threshold.

3. Tax Credit for Lubricating Oil Produced from Re-refined Oil

Administration Position. **Oppose.** Motor oil, like other materials, is recycled when dictated by environmental regulations or when economically profitable. Today, lubricating oil is being recycled without the credit. Moreover, this credit would be difficult to administer. Because used oil is frequently blended with other hydrocarbons as part of the re-refining process, determination of the amount of lubricating oil that is actually derived from used oil would be complex. Implementation would also require a precise definition of "lubricating oil."

4. Allow Geological and Geophysical Costs Incurred in Connection with Oil and Gas Development to be Expensed in the Year Incurred

Administration Position. The Administration believes that the objectives of any proposal to change the tax treatment of geological and geophysical (G&G) expenditures should be simplification and neutrality. This proposal, however, does not achieve these goals. Instead, under this proposal, G&G costs would be treated more favorably than intangible drilling costs. The proposal would not reduce complexity. The Administration would welcome the opportunity to work with Congress on a proposal for G&G that would reduce compliance burdens for the industry and provide more equal treatment for both types of expenditures.

5. Extend the Renewable Electricity Production Credit to Electricity from Certain Fuel-Cell Power Plants

Administration Position. **Oppose.** There is no tax policy justification to single out fuel-cell power plants for a tax credit, since fuel-cell power plants have been competing in the international marketplace for several years.

F. ESTATE AND GIFT TAX PROVISIONS

1. Exemption From Estate Tax For Qualified Historic Property Subject To Permanent Conservation Easement

Administration Position. **Oppose.** The Administration believes that the deduction allowed under current law for the grant of a charitable easement on historic properties is sufficient. The proposal would permit a complete exclusion for qualified historic property of unlimited value from the gross estate, rather than the value of the charitable easement alone. The proposal would be subject to abuse and would erode the tax base.

2. Exempt Certain Land Subject To Permanent Conservation Easement From Estate Tax

Administration Position. **Oppose.** The Administration believes that the deduction allowed under current law for the grant of a charitable easement is sufficient. The proposal would permit an exclusion for surrounding land of unlimited value from the gross estate, rather than the value of the charitable easement alone. The proposal would be subject to abuse and would erode the tax base.

3. Estate Tax Marital Credit For Certain Employees of International Organizations

Administration Position. **Support, with technical modifications.** The Administration believes that the proposal is consistent with the United States' special role as host to international organizations.

4. Relief From Retroactive Gift Tax Regulation On Disclaimers

Administration Position. **Oppose.** The proposal would open up the statute of limitations for certain disclaimers for a one-year period. The United States Supreme Court decided this issue in the cases of Jewett v. Commissioner and Irvine v. U.S. We believe that this issue was properly resolved by the courts.

5. Extend the "Predeceased Parent Exception" To Collateral Heirs and To Taxable Terminations and Distributions

Administration Position. **Do not oppose.** The policies that underlie the special rule for transfers to a grandchild whose parent is deceased (Code section 2612(c)(2)) generally would support the proposed expansion to cover collateral heirs and to apply the rule to taxable terminations and taxable distributions, as well as to direct skips. The bill (H.R. 1099), however, requires technical modifications.

6. Increase Special Use Valuation Limit to $1.5 Million

Administration Position. **Do not oppose.** If Congress decides that the maximum of $750,000 by which the value of real property may be reduced under section 2032A is not sufficient, we would not oppose an appropriate increase in the context of otherwise acceptable legislation.

7. Estate Tax Credit For Conservation Property Donated to Federal Government.

Administration Position. **Oppose.** The Administration believes that the deduction allowed under current law for transfers of interests in property to the Federal Government for conservation purposes is sufficient. To the extent that this proposal is designed to assist taxpayers with liquidity problems, that issue is more appropriately addressed through the section 6166 installment payment provisions.

8. Proposals To Simplify and Improve Estate and Gift Tax

This proposal includes 33 specific proposed changes to "simplify and improve" the estate and gift tax. The proposals are discussed individually below. In some instances, the proposals are not sufficiently well developed at this time to permit the Administration to take a position.

(a). Equal Treatment For Individuals Who Utilize Revocable Trusts

Administration Position

(i) **Support,** with respect to the sixty-five day rule in proposal (2); and the equal treatment of individuals and revocable trusts with regard to amortization of reforestation proposal (10) (provided that in the case of proposal (10) the revocable trust and the grantor together are entitled to amortize a total of up to $10,000 of reforestation expenses). Proposal (2) would be beneficial to estates, would eliminate a distinction between wills and revocable trusts and would have no tax cost. Proposal (10) furthers the policy of treating the assets of a grantor trust as if they were owned directly by the grantor during the grantor's lifetime.

(ii) **Do not oppose,** with respect to the passive loss rule of proposal (4); the treatment as qualified shareholder for Subchapter S purposes in proposal (6); and the gifts from revocable intervivos trusts in proposal (8). Proposals (4) and (6) would eliminate differences between wills and revocable trusts and therefore are consistent with the goal of simplification. Proposal (8) furthers the policy of treating the assets of a grantor trust as if they were owned directly by the grantor during the grantor's lifetime.

(iii) **Do not support,** with respect to the set-aside deduction of proposal (1); the sales to related persons in proposal (5); and the taxable year of proposal (7). These proposals either create potential for abuse or create new complications not outweighed by their improvements.

(iv) While we share the goals of the separate share rule of proposal (3) and the equal generation skipping tax treatment of estates and revocable trusts following death of settlor in proposal (9), we need to study them further in order to make certain that they do not create opportunities for abuse.

(b). Eligibility for Ordinary Loss Deduction On Loss On Small Business Stock

Administration Position. **Do not oppose,** provided that the revocable trust and the grantor together are entitled to only one ordinary loss deduction. This proposal furthers the policy of treating the assets of a grantor trust as if they were owned directly by the grantor during the grantor's lifetime.

(c). Repeal of Income-Shifting Provisions (i.e., Throwback Rules (Code Secs. 665-668), Capital Gains (Code Sec. 644)

Administration Position. **Support,** but only for domestic trusts that have never been foreign trusts and only for accumulations after 1986. Limiting the application of these provisions would greatly simplify the income taxation of trusts and eliminate a confusing and burdensome requirement for taxpayers.

(d). Restore Unified Credit In Case of Split Gifts

Administration Position. **Support.** This proposal corrects a problem that leads to double taxation of lifetime gifts by allowing restoration of the surviving spouse's unified credit where the property is subsequently included in the deceased spouse's estate.

(e). Provide For Portability of Unified Credit and GST Exemption

Administration Position. This proposal has merit and may simplify estate planning by individuals. Particularly, this proposal would decrease the use of certain trusts that are now employed solely for their tax benefits. The Administration is concerned, however, that the proposal has some potential for abuse and believes that a more specific proposal must be developed before a position can be taken.

(f). Making Use of Unified Credit Optional

Administration Position. **Do not support.** This proposal creates new complications not outweighed by its benefits.

(g). Modification of Rules Relating To Marital Deduction

Administration Position. **Do not support.** Any proposal to allow reformations of QTIP trusts must include, at a minimum, limitations in terms of time and scope. The proposal to allow a surviving spouse to hold a limited power of appointment over the assets of a QTIP trust is contrary to the limited purpose for which QTIP trusts were established. QTIP trusts should remain devoted to the benefit of the surviving spouse for such spouse's lifetime.

(h). Provide For Federal Disclaimer Rules

Administration Position. **Support.** These technical changes to section 2518(c)(3), as well as the clarification that disclaimers are effective for income tax purposes, clarify and simplify federal disclaimer law. These proposals would conform provisions on transfer-type disclaimers to those that govern all other disclaimers.

(i). Provide That Disclaimer of Interests in Qualified Plans Do Not Violate the Spendthrift Restriction Applicable To Such Plans

Administration Position. **Support.** This proposal serves to increase taxpayers' flexibility in post-mortem planning without undermining the policy of prohibiting the assignment or alienation of qualified plan assets.

(j). Modify Rules For Qualified Domestic Trusts (QDOTs)

(1) Modification of Rules Relating To Trustee of a QDOT

Administration Position. **Do not support.** This proposal would allow taxpayers to comply with the QDOT trustee provisions of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), the

Omnibus Budget Reconciliation Act of 1990 ("1990 Act"), or OBRA 93. We favor the proposal contained in H.R. 3419, 103rd Congress, which extends relief only to QDOTs executed before the 1990 Act that conform with the TAMRA requirements.

(2) Modify Non-Estate Tax Consequences of Transfers By Surviving Spouse to QDOT

Administration Position. **Oppose.** This proposal would make the decedent the transferor of a trust the terms of which are written by the surviving spouse after the decedent's death, with potential tax implications not envisioned by the decedent.

(3) Transfers In Civil Law Countries to QDOT

Administration Position. This proposal is not sufficiently developed for the Administration to take a position. The Government's interest in collecting estate tax on the surviving spouse's death must be adequately protected in any proposed alternative to a QDOT arrangement.

(4) Delete Requirement That U.S. Trustee Have Power To Approve Distributions From a QDOT

Administration Position. **Oppose.** The requirement that a QDOT have a U.S. trustee is critical to the Government's ability to collect the estate tax due on the death of the surviving spouse.

(5) Clarification of Who Is the Transferor For GST Purposes in Case of QDOT

Administration Position. **Support.** The Administration supports giving the surviving spouse the right to elect to be treated as the transferor of the QDOT for GST purposes. This would give an alien spouse an election equivalent to that available to estates and surviving spouses under section 2652(a)(3).

(k). Modification of Generation-Skipping Transfer Tax Rules

Administration Position. **Do not support.** Most of these proposed changes address issues arising from the proposed regulations. These regulations are on the Priorities Guidance List to be issued in final form this year. We believe that it is premature to address these issues legislatively when the regulations have not been finalized.

(l). Modification of Period of Limitations For Assessment and Collection Against Transferees

Administration Position. **Oppose.** The Administration believes that the additional one-year period for collection of tax from a transferee is necessary due to the transfer of the property.

(m). Extension of Tax-Free Transfers Between Former Spouses to All Types of Property and To Transfers At a Spouse's Death

Administration Position. **Oppose.** The Administration believes that this proposal is overly broad and would create opportunities for tax avoidance.

9. Required Notices To Charitable Beneficiaries of Charitable Remainder Trusts

Administration Position. **Do not support.** While in principle the Administration favors requiring notification to a charitable remainderman that a trust exists for its ultimate benefit, the

proposal is too complicated and burdensome. The Administration is willing to work with the Committee to develop a less complicated and burdensome proposal.

Q. EXCISE TAXES

1. Modifications to Diesel Fuel Excise Tax Provisions

(a). Retail Collection of Tax on Recreational Boat Fuel

Administration Position. **Oppose.** The tax on diesel fuel used in pleasure boats would be unenforceable if collected at the retail level. Allowing the use of dyed fuel in pleasure boats would eliminate the utility of visual inspections, depriving the Internal Revenue Service of its primary enforcement mechanism under current law.

It appears that while many marinas carry both dyed and clear fuel, some marinas are carrying only dyed fuel for their commercial customers due to limited tankage. As a result, there have been complaints that pleasure boats are unable to buy clear fuel at all marinas. Many marinas, however, have already incurred the expense of adding a separate tank for clear, taxed diesel fuel in order to comply with current law. We are monitoring marinas in various areas and have found that clear diesel fuel is readily available in areas where recreational boating is popular. Moreover, availability has improved significantly since the summer of 1994, even in areas such as the Gulf Coast of Louisiana, where commercial boating predominates and retailers are least likely to accommodate recreational users. We believe that the availability of clear diesel fuel should continue to improve as the market adjusts to the new rules.

We are cognizant of safety concerns and want to receive more information about any area where the tax may have caused safety problems. We are also concerned, however, that uncertainty over the permanence of the new rules is retarding the adjustment process and may have discouraged some marina operators from installing the facilities needed to serve their pleasure boat customers.

(b). Penalty-Free Dilution of Dye Concentrations in Certain Cases

Administration Position. **Oppose.** The IRS currently permits the blending of kerosene with dyed diesel fuel after the fuel is removed from the terminal so long as the resulting blend continues to satisfy the generally applicable dye color and concentration requirements. Notice 94-21, 94-1 C.B. 339. The dye concentration requirements were adopted after extensive consultations with refiners, pipeline and terminal operators, and diesel fuel distributors. The Treasury Department made every effort to accommodate their concerns and set the concentration requirement at the lowest level consistent with effective enforcement of the tax. Thus, we are concerned that this proposal would either impair enforcement of the tax or require an increase in generally applicable dye concentration requirements to offset post-terminal dilution.

The Committee should also note that the Administration supports proposal Q.2. below to treat kerosene as diesel fuel. If this proposal is adopted, untaxed kerosene will be dyed when it is removed from the terminal and there will be no need to blend clear kerosene with dyed diesel fuel.

(c). Refunds for Bad Debt and Casualty Losses

Administration Position. **Oppose.** Many products other than diesel fuel are subject to Federal excise taxes. In general,

these taxes are not refunded when a casualty loss or bad debt loss is experienced with respect to a tax-paid article. We are aware of no reason for treating a loss with respect to tax-paid diesel fuel any differently than, for example, the total loss of a tax-paid luxury automobile in a traffic accident.

Property owners generally can protect themselves against casualty losses through insurance that compensates for losses attributable to excise taxes embedded in the cost of the property in the same manner as it compensates for other components of the property's cost. Although bad debt losses typically are not covered by insurance, creditors generally compensate for these losses by including a risk premium in the interest rates or prices they charge.

(d). Interest-Bearing Refunds for Certain Diesel Fuel Users

Administration Position. **Oppose.** Congress decided in 1993 that taxing fuels at the terminal rack and dyeing nontaxable diesel fuel are the best methods for ensuring compliance and preventing fraud. Current law reflects this decision. All nontaxable and partially exempt users of diesel fuel may purchase dyed diesel fuel on which no tax was imposed. Refunds are permitted when clear fuel is used for a nontaxable or partially exempt purpose, but these refunds are generally subject to strict limitations.

The proposed changes, by making the refund procedure easier and more attractive than under current law, would reduce the incentive to use only dyed fuel for nontaxable and partially exempt uses, and increase the extent to which the taxability of diesel fuel is determined after the terminal rack. We are concerned that the proposed changes would result in an increased volume of refund claims, thereby adding substantial administrative burdens and increasing opportunities for refund fraud.

(e). Exempt Alaska from Diesel Dyeing Requirement

Administration Position. **Support.** Alaska is the only State that is currently exempt from the Clean Air Act's dyeing requirements. The Administration believes the Clean Air Act and Internal Revenue Code dyeing requirements should be as harmonious as feasible, respecting the differences between the two statutes. Accordingly, we support a corresponding exemption from the Code's diesel dyeing requirements for diesel fuel sold in Alaska, subject to procedures established by the Treasury Department.

2. Treat Kerosene as a Diesel Fuel for Excise Tax Purposes

Administration Position. **Support, with modifications.** The Administration believes that the continuation of the present nontaxable treatment of kerosene would perpetuate the problems that Congress sought to correct in the Omnibus Budget Reconciliation Act of 1993 (OBRA 93), and that a change is essential if the new diesel fuel tax system is to function as Congress intended. We also believe, however, after consulting with the Consumer Product Safety Commission, that it is imperative to consider the consumer safety issues of adding dye to kerosene used in space heaters. Therefore, we would like to work with Congress, mindful of the differing needs of the consumer and the distributor, to devise a limited ultimate vendor refund rule in this specific case. We urge the Congress to address this issue as soon as possible.

3. Modify Rail Diesel Motor Fuel Tax Rate

(a). Equalize Diesel Fuel Taxes

Administration Position. **Oppose.** In OBRA 93, Congress decided to raise revenue for general fund purposes, and thus reduce the deficit, by increasing taxes on fuel used for transportation purposes. We are satisfied that Congress carefully considered the rates of tax that should apply to fuel used in various transportation modes, and we do not believe Congress should reconsider its decision at this time. It would be appropriate, however, to re-examine this issue in 1999 when the tax rate on railroad diesel fuel is scheduled to drop to 4.3 cents per gallon.

(b). Exempt AMTRAK

Administration Position. **Oppose.** We believe that any additional subsidies to AMTRAK should be provided through the appropriations process, where they will be subject to regular review, rather than through the tax code.

4. Expand Off-Highway Business Use Exemption from Motor Fuels Excise Taxes

Administration Position. **Oppose.** Allowing a refund for fuel used by a truck's engine while operating, for example, a power take-off on dump trucks, is unenforceable and would lead to widespread tax evasion. The courts have recently upheld the regulatory interpretation of the statute governing this provision, and we continue to support the position taken in the regulations.

5. Modify Gasoline Tax Refund Procedure for Gasoline Sold to States and Local Governments

Administration Position. **Oppose.** The IRS generally processes gasoline tax refunds within 45 days. Paying these claims within 20 days would require special manual processing and substantially increase processing costs.

The IRS is committed to providing quality customer service, including prompt payment of valid refund claims, and is moving toward this goal through its modernization effort. Customer service goals must be balanced, however, against the need to ensure the integrity of the tax administration system and improve overall compliance. Thus, the IRS carefully scrutinizes questionable claims to prevent the payment of fraudulent refunds. We believe Congress should take no action that might discourage such careful scrutiny.

Although gasoline wholesale distributors no longer have the opportunity to credit gasoline tax refunds against their diesel fuel tax liability, they are still treated more favorably than other claimants. In most cases, a person entitled to a payment with respect to a nontaxable use of gasoline is required to claim an income tax credit unless the payment to which the person is entitled exceeds a specified amount. In contrast, a wholesale distributor can file a claim for refund as soon as the gasoline is sold to a State or local government at a tax-excluded price.

6. Adjust Certain Fuels Tax Rates for BTU Equivalency to Gasoline

(a). Exempt LNG From Some Motor Fuels Taxes; Adjust the LNG Rate on Other Taxes

Administration Position. **Oppose.** There is no justification for exempting liquified natural gas (LNG) from the Highway Trust Fund component of the special motor fuels excise tax. The Highway Trust Fund portion of the special motor fuels excise tax applies to liquid fuels, and LNG is a liquid fuel. Under the OBRA 93 provisions, Congress maintained imposition of the Highway Trust Fund portion of the tax and imposed the deficit reduction portion of the tax on LNG, and made compressed natural gas (CNG) subject only to the deficit reduction portion of the tax. We believe that this issue should not be reopened at this time. We also believe that this issue should be re-examined in 1999 when the Highway Trust Fund component of the tax expires.

(b). Reduce the Tax Rates on Certain Fuels Based on BTU Equivalence

Administration Position. **Do not support.** In 1993, Congress carefully considered and agreed to an allocation of the motor fuels taxes on a broad base of transportation fuels. We believe that piecemeal unravelling of the agreement would be a mistake, although we believe that this issue should re-examined when the Highway Trust Fund component of the tax expires in 1999.

(c). Adjust Tax Rate for Propane Based on BTU Equivalence

Administration Position. **Oppose.** There is no justification for adjusting only the propane tax rate to a rate based on propane's BTU equivalence to gasoline. If adjustments are to be made, they should be made to all fuels. We also believe that this issue should re-examined in 1999, when the Highway Trust Fund component of the tax expires.

7. Modifications to the Retail Truck Excise Tax

(a). Impose Tax on Manufacturer

Administration Position. **Do not oppose, if conforming changes included.** Imposing the heavy truck tax on sales by the manufacturer, rather than the first retail sale, is likely to improve the administration of the tax. Until its modification by the Surface Transportation Act of 1982, the heavy truck tax was imposed on manufacturer sales, with generally good results. At that time, although as many as 1500 small trailer manufacturers were required to file returns, approximately 10 to 15 major manufacturers accounted for most of the sales revenue subject to the tax. Under this system, the IRS was able to target its enforcement efforts efficiently and taxpayers were generally well aware of their obligations. The 1982 change resulted in thousands of additional, generally smaller and less well-informed taxpayers, and less-focused enforcement efforts by the IRS.

In 1982, Congress changed the heavy truck tax because it was concerned that a manufacturers tax was likely to create a financial hardship for retail dealers who carry inventories of tax-paid trucks for long periods before the trucks are sold at retail. This concern may be less significant now because interest rates are much lower than at that time. The Committee should also note that a manufacturers tax on heavy trucks is not entirely free of administrative difficulties. In particular, the tax on subsequent additions of parts and accessories would apply much more frequently than under current law, offsetting to some extent the advantages of shifting the tax to the manufacturer.

If the proposal is adopted, certain conforming changes will be necessary. Under current law, the amount of tax is based on the retail sales price. If the tax is imposed on the manufacturer, the amount of tax should be based on the manufacturer's selling price and the tax rate should be increased to the extent necessary to avoid a revenue loss.

(b). Certain Activities Not Treated as Remanufacture

Administration Position. The meaning of "manufacture" is generally the same for purposes of the heavy truck excise tax as for all other manufacturers and retailers excise taxes. See Treas. Reg. §48.0-2(a)(4). In addition, however, the Code specifically provides that certain activities are not treated as manufacture for purposes of the heavy truck tax. We are willing to work with this Committee to develop appropriate bright-line tests in addition to those currently provided.

8. Consolidate Collection of Aviation Gasoline Excise Tax

Administration Position. **Support.** We believe that consolidation of the collection of the aviation gasoline excise tax at the terminal removal level, with the full 19.4 cents-per-gallon tax collected at that point, would improve efficiency and enforcement of the tax.

9. Expand Aviation Excise Tax Exemptions for Air Ambulances

Administration Position. **Oppose.** Aviation excise taxes support the Airport and Airway Trust Fund, which in turn provides funding for the maintenance and improvement of airports and airways. All users of airports and aviation services supported by the Airport and Airway Trust Fund should pay their appropriate share of the Fund's expenditures.

10. Reduce Harbor Maintenance Excise Tax

Administration Position. **Oppose.** The Administration is concerned that the proposed annual reductions in the ad valorem excise tax on cargos and passengers entering and leaving U.S. ports, followed by a rule that would trigger increases or decreases in the tax depending on the balance in the Harbor Maintenance Trust Fund, would be disruptive. The Administration has proposed that certain expenditures of the National Oceanic and Atmospheric Administration (NOAA) that aid commercial navigation be funded out of the Trust Fund. The Congress may want to consider funding construction projects out of the Trust Fund rather than the General Fund.

11. Reduce Ethanol Fuel Tax Subsidy if Carbon Dioxide Produced as a Byproduct is Marketed by the Producer

Administration Position. **Do not support.** Adjusting excise tax rates on gasohol to reflect the circumstances under which the ethanol contained in the mixture was produced would impose substantial complexities and administrative costs. The excise tax on gasohol cannot, as a practical matter, be set at a rate that varies according to the quantity of carbon dioxide produced and marketed as a byproduct of ethanol production. The tax is paid downstream from the ethanol producer; therefore, the taxpayer will have no way of knowing how much carbon dioxide may have been produced as a byproduct of any particular batch of ethanol and whether the producer of that ethanol directly marketed the carbon dioxide.

12. Provide a Lower Rate of Tax on Certain Hard Ciders

Administration Position. **Oppose.** The excise taxes imposed on a particular alcoholic beverage should be revised only in the context of a general review of alcoholic beverage excise tax

rates. The Committee should also be aware that some hard cider producers may object to the proposed change because they will lose part of the benefit of the credit for small domestic wine producers. For producers that currently receive the full credit, the tax would increase from 17 cents per gallon to 22.6 cents per gallon.

13. Wine Spirits -- Permit the Use of Other Agricultural Products

Administration Position. **Do not oppose, with modifications.** Under the proposal, the definition of wine spirits would be expanded to include spirits derived from agricultural wine (i.e., wine made from agricultural products other than fruit). Thus, agricultural products that currently are wasted could be used to make wine spirits to fortify nonstandard wines such as wine coolers.

To preserve the integrity of natural wine, the proposal should be clarified to provide that wine spirits made from agricultural products may not be used to fortify natural wine. In addition, to avoid inconsistency with the National Performance Review, which recommended repeal of the wine and flavor credit, the proposal should also be modified to provide that alcohol derived from agricultural products does not qualify for the credit.

14. Phased Repeal and Modifications of the Luxury Excise Tax on Automobiles

(a). Phase Out or Phase Down of Tax

Administration Position. **Oppose.** This proposal will have significant revenue costs. Congress decided in the Omnibus Budget Reconciliation Act of 1990 that it was appropriate to impose a tax on luxury automobiles for deficit reduction purposes. This decision was reaffirmed in OBRA 93, which repealed the taxes on other luxury goods and made minor changes to the luxury tax on automobiles. We believe it would be a mistake to revisit this issue.

(b). Exemption for Electric Cars

Administration Position. **Oppose.** Although the Administration supports limited tax incentives to encourage the use of electric automobiles, this proposal would provide an unlimited exemption from the luxury tax, unrelated to the additional cost attributable to the use of an electric propulsion system. This unlimited exemption is broader than necessary to encourage the use of electric automobiles and is inconsistent with the decision to raise revenues for deficit reduction purposes by imposing a tax on luxury automobiles.

15. Modifications to the Excise Tax on Ozone-Depleting Chemicals

(a). Exemption for Imported Recycled Chemicals

Administration Position. **Support, with modifications.** The Environmental Protection Agency is concerned that the tax imposed on imported recycled Halons, a group of ozone-depleting chemicals that the Montreal Protocol phased out of production at the end of 1993, is impeding the free flow of foreign stocks of recyclable Halons to essential uses in the United States. This may have adverse environmental consequences because foreign owners who are deprived of a market for recycled Halons will be more likely to vent unwanted Halons into the atmosphere.

The exemption for imported recycled ozone-depleting chemicals should be limited so as not to disadvantage domestic producers that are required to pay tax on the chemicals. Thus, we do not support an exemption for imports of chemicals other than Halons

so long as domestic production of those chemicals is permitted under the Montreal Protocol.

(b). Exemption for Metered-Dose Inhalers

Administration Position. **Oppose.** The use of ozone-depleting chemicals in metered-dose inhalers already enjoys a substantial tax advantage over all other uses of ozone-depleting chemicals. The base tax amount applicable to all other ozone-depleting chemicals is $5.35 per pound in 1995 and increases by 45 cents per pound in each year after 1995. The tax on chemicals used in metered-dose inhalers is permanently frozen at $1.67 per pound.

16. Exemption from Gas Guzzler Excise Tax for Limousines

Administration Position. **Oppose.** The Omnibus Budget Reconciliation Act of 1990 modified the treatment of limousines, including stretch limousines, to encourage a reduction in domestic consumption of petroleum products. In view of continuing concerns regarding the effects of inefficient fuel use on the environment and energy security, we do not think it is appropriate to modify the treatment of limousines at this time.

17. Allow In-Bond Transfers of Bottled Distilled Spirits Among Commonly Owned Distilled Spirits Plants

Administration Position. **Oppose.** The proposed change would adversely affect enforcement of the distilled spirits tax. The principal effect of the change would be to move the point at which tax is imposed downstream from the facility where the distilled spirits are produced. Currently there are approximately 117 tax collection points, but that number is likely to increase substantially if the collection point is moved downstream. This would greatly increase the administrative burden required for effective enforcement of the tax. In addition, permitting tax-free removals of bottled spirits, which can be more easily diverted than bulk spirits during a transfer, would provide increased opportunities for tax evasion.

The proposed change would result in revenue losses over the budget period because, in addition to increasing the potential for tax avoidance, it permits distillers to defer payment of taxes beyond the time at which payment would be required under current law.

18. Drawback of Distilled Spirits Tax on Spirits Used in Nonbeverage Products

Administration Position. **Oppose.** The current system for collecting the tax is simple and effective. It allows drawback of the tax only after distilled spirits have been used in a nonbeverage use, encourages accurate records, and avoids the need for controls to assure that distilled spirits withdrawn for a nonbeverage use are not subsequently diverted. The proposed change would reduce or negate these benefits and increase the potential for abuse and nonpayment of the tax.

The proposed change would result in revenue losses over the budget period because, in addition to increasing the potential for tax avoidance, it permits nonbeverage users to obtain the benefit of the drawback before the time at which the drawback would be allowed under current law.

R. **Exempt Organizations**

1. Treatment of Certain Costs of Private Foundation in Removing Hazardous Substances.

Administration Position. **Oppose.** This proposal would present an opportunity for inurement or private benefit. Taxpayers owning property that requires environmental clean-up would donate the property to a private foundation. The proposal would allow the foundation to use money it receives in the form of deductible contributions to pay for clean-up costs that the donor would otherwise have been forced to incur. These payments would not serve charitable purposes, and, therefore, should not be treated as qualifying distributions.

2. Prevent Reclassification as UBTI of Certain Dues Paid to Agricultural or Horticultural Organizations.

Administration Position. **Do not support.** This proposal would allow dues paid to a special category of tax-exempt organizations to avoid taxation as unrelated trade or business income regardless of whether the dues payments were related to the organization's tax-exempt purpose. There is no clear tax policy basis for treating section 501(c)(5) agricultural and horticultural organizations more favorably than section 501(c)(5) labor organizations, let alone organizations exempt under other parts of section 501(c). Moreover, this proposal would allow agricultural and horticultural organizations to run businesses that compete directly with for-profit entities but do not pay income tax simply because they label the business's income as membership dues.

3. Private Foundations

(a). Modify Rules for Private Foundation Grants to Foreign Organizations

Administration Position. **Do not oppose.** This proposal would simplify international grant-making by U.S. private foundations to certain foreign charities. Requiring private foundations to accept expenditure responsibility for such grants would provide adequate safeguards to ensure that the grant is properly classified as a qualifying distribution.

(b). Extend Due Date for First-Quarter Estimated Tax by Private Foundations

Administration Position. **Support.** Changing this due date will reduce the number of filing deadlines a private foundation must remember. It will also improve the foundation's ability to calculate its estimated tax liability accurately so as to avoid additions to tax.

4. Common Investment Fund for Private Foundations

Administration Position. **Do not oppose.** Such a fund would enable small private foundations to expand their investment capabilities by banding together and accepting grants of seed money from large private foundations. Presumably, such a fund would eventually increase the amount of resources available to serve charitable purposes. Allowing such a fund to be a tax-exempt charitable organization would be consistent with the exemption that the Code already provides for similar college and university common funds (section 501(f)).

5. Exclusion from UBIT for Corporate Sponsorship Payments Received by Tax-Exempt Organizations in Connection with Public Events

Administration Position. **Oppose.** This proposal would give tax-exempt organizations a competitive advantage over taxable enterprises in offering advertising to businesses. It would also favor large organizations that obtain sponsors for a single sizeable event once a year over smaller organizations that solicit corporate sponsors for several small fundraisers each year.

6. Repeal 1986 Extension of UBIT to Games of Chance

Administration Position. **Oppose.** Tax-exempt organizations are not necessarily furthering charitable purposes by regularly carrying on gambling activities. Thus, there is no tax policy justification for exempting income from such activities from the unrelated business income tax, especially where the exemption is available only in States that had laws permitting nonprofits to conduct gambling as of October 5, 1983. The decision made by a number of States to subsidize nonprofit organizations by granting them exclusive rights to conduct gambling activities does not affect the determination as to the proper federal income tax treatment of the proceeds from those activities.

7. Clarify UBIT Treatment of Licensing of Olympic Trademarks

Administration Position. **Do not oppose, if revised.** There is a need for additional guidance on the scope of the UBIT exception for royalties. However, it should apply to royalties received not only by qualified amateur sports organizations, but by all tax-exempt organizations. The proposed definition of "royalty" would include payments for which the right to use a trademark or similar item was a substantial part -- but not all -- of the consideration. This expansion of the definition would allow royalties to include income earned from unrelated trade or business activities conducted in direct competition with for-profit entities. We favor a proposal clarifying that the provision of certain types of services closely related to the use of a trademark or similar item will not cause a payment to cease to be a royalty.

8. Exception to Debt-Financed Rules (Sec. 514(c)(9)) For Private Foundation Debt to Improve Real Property

Administration Position. **Oppose.** The section 514(c)(9) exception to the debt-financed income rules was reviewed in 1993. There is no tax policy justification for creating an additional narrowly tailored category of organizations eligible to benefit from this exception.

9. Permit Tax-Free Liquidation of Certain Closely Held Corporations Whose Stock Is Given to Charity and Exempt Certain Assets from Section 514(c)(2) Debt Financed Rules

Administration Position. **Oppose.** In the wake of the repeal of General Utilities, the Treasury Department is studying the issues raised by conversions from taxable to tax-exempt status in a broader context than that presented by this proposal. We believe that these issues should be addressed on a comprehensive basis and not in response to discrete types of transactions.

The other aspect of the proposal concerns the debt-financed income rules. There is no tax policy basis for exempting a charity from UBIT on its income from debt-financed assets under these circumstances. Allowing charities to assume mortgages on property they receive not only as a bequest but also as a lifetime gift presents a significant opportunity for private

benefit, since it may be a means of improving a donor's personal credit position.

10. Allow Conversion of Scholarship Funding Corporation to Taxable Corporation

Administration Position. **Do not support.** The proposal would enable taxable, for-profit corporations to obtain the benefit of tax-exempt financing. The benefit is equal to the built-in arbitrage of the difference between the tax-exempt interest rates on the debt issued by the qualified scholarship funding corporations and comparable taxable interest rates. For-profit entities should not be entitled to such benefit. The proposal also creates an unwarranted exception to the excess business holdings rule. The excess business holdings rule was specifically created to prevent private foundations from controlling for-profit entities because there is the possibility that disqualified persons will use the foundation to run the business for their personal benefit rather than as a means of support for charitable purposes.

11. Treatment of Certain Amounts Received by Telephone Cooperatives

Administration Position. **Do not support.** This provision is inconsistent with the general tax treatment of cooperatives. It allows an organization to be treated as a tax-exempt cooperative even though it does not derive substantially all of its revenues from its members.

12. Clarify That Parent Holding Companies for Hospitals May Qualify as Public Charities Rather than Private Foundations

Administration Position. **Support.** The Administration supported this change as part of its proposal for health care reform. As health-care provider systems become increasingly sophisticated, it is common for them to form a nonprofit parent organization that coordinates and oversees the activities of the system as a whole. For the same reasons that a supporting organization is treated as a public charity rather than a private foundation, a health system parent organization that meets the criteria for tax exemption under section 501(c)(3) also should be treated as a public charity. This proposed addition to section 509(a) will eliminate technical questions that currently arise because the supporting organizations described in section 509(a)(3) have traditionally been expected to be subsidiaries of public charities rather than parents.

13. Treatment of Rural Electric Cooperatives

Administration Position. **Oppose.** The proposal is inconsistent with the general tax treatment of cooperatives and raises administrative concerns. It allows an organization to be treated as a tax-exempt cooperative even though it does not derive substantially all of its revenues from its members.

14. Codify IRS Directive Governing Calculation of UBIT Liability from Charitable Gambling

Administration Position. **Oppose.** Tax-exempt organizations are not necessarily furthering exempt purposes by regularly carrying on gambling activities. Therefore, they should be subject to unrelated business income tax on the profits from such activities. This fundamental principle is not affected by the legal rationale that enables certain non-charitable tax-exempt organizations to take a deduction for the mandatory contribution of their gambling profits to charity. Nor is it affected by the decision of a number of States to subsidize nonprofit organizations by granting them exclusive rights to conduct gambling activities. Finally, appropriate policy on this legal

question should not be tied to an IRS enforcement directive designed to allow for efficient administration of an IRS audit program.

15. Extend Private Inurement Rule to Section 501(c)(4) Organizations

Administration Position. **Support.** Current restructuring in the health care market is providing greater opportunities for insiders of nonprofit health care organizations to divert the resources of these organizations to their personal benefit. Under current law, health care organizations that want to avoid the inurement prohibition that applies to organizations exempt from tax under section 501(c)(3) may seek tax exemption under section 501(c)(4). Extending the prohibition against inurement to section 501(c)(4) organizations would deter insiders from seeking to take advantage of the restructuring of nonprofit health care organizations for their personal gain.

16. Permit Certain Corporate Conversions to Tax-Exempt Title Holding Company Without Asset Appreciation Tax Where Corporation is Wholly Owned by Tax-Exempt Entity that Received Stock as a Gift or Bequest

Administration position. **Oppose.** In the wake of the repeal of General Utilities, the Treasury Department is studying the issues raised by conversions from taxable to tax-exempt status in a broader context than that presented by this particular proposal. We believe that these issues should be addressed on a comprehensive basis and not in response to discrete types of transactions as contemplated by this proposal.

S. FINANCIAL INSTITUTIONS

1. Delete OBRA 1993 Denial of Losses Reimbursed by FSLIC Assistance for Failed Thrifts

Administration Position. **Oppose.** There is no tax policy justification for repealing this provision, which the Treasury concluded in a 1991 study was a clarification of existing law. Repeal would likely result in additional IRS and taxpayer resources being devoted to resolution of the issue.

2. Treat Small Commercial Finance Companies as Small Banks for Bad Debt Reserve Deductions

Administration Position. **Oppose.** The reserve method of accounting may allow taxpayers to claim deductions before a loss is realized. Treasury is studying the various tax and regulatory treatments of financial intermediaries and financial products. Any disparities in treatment of financial intermediaries operating similar businesses are more appropriately considered in the context of these larger issues.

T. Foreign

1. Increase in Section 911 Exclusion from $70,000 to $100,000 With Indexing

Administration Position. **Oppose.** The current exemption of $70,000 provides substantial simplification in tax filing for workers earning modest salaries abroad. Increasing the exclusion from $70,000 to $100,000 would not be appropriate in the context of our efforts to reduce the budget deficit.

2. Repeal of Limitation on Foreign Sales Corporation Exemption for Military Property

Administration Position. **Do not support.** At present, exports of military property through a foreign sales corporation (FSC) are entitled to only 50 percent of the FSC benefits that are available for other exports. Military property is defined as an arm, ammunition, or instrument of war designated in the Munitions List, established pursuant to 22 U.S.C. 2778. If Congress finds that U.S. exports of military property, either generally or specific items of military property, are facing increased competition, then it may be appropriate to repeal or partially repeal this limitation.

3. Inclusion of Computer Software as Foreign Sales Corporation Export Property

Administration Position. **Do not oppose.** Under current law, films, tapes, and records licensed for reproduction abroad qualify as export property for purposes of the foreign sales corporation provisions. However, technological developments are making the distinction between films, records, tapes and computer software less clear. Therefore, we would not oppose an extension of foreign sales corporation benefits to computer software licensed for reproduction abroad.

4. Recharacterization of Overall Domestic Loss for Foreign Tax Credit Limitation Purposes

Administration Position. **Do not support.** Allowing taxpayers to recharacterize overall domestic losses is expensive and complex and is not theoretically justified. Taxpayers can choose to defer certain foreign earnings while realizing foreign losses. Therefore, it is appropriate to require taxpayers who offset U.S. source income with foreign losses to recapture those losses out of future foreign earnings. The current overall foreign loss rules are necessary to prevent abuses, and should not necessarily be mirrored for domestic losses.

5. Election to Use Earnings and Profits Basis for Allocation of Interest Expense for Foreign Tax Credit Limitation Purposes

Administration Position. **Do not support.** This provision is intended to eliminate the disparity in the interest allocation regulations between the basis of foreign assets, computed under special U.S. rules that apply to foreign assets, and the basis of U.S. assets, computed under general U.S. rules. In particular, the accelerated depreciation allowed for U.S. assets tends to diminish their basis for purposes of interest allocation, while foreign assets are generally depreciated using straight-line depreciation. Using E&P basis would synchronize the computation of basis for U.S. and foreign assets. There are two significant problems, however. First, accelerated depreciation already provides taxpayers with substantial tax benefits; allowing taxpayers to use straight-line depreciation for interest allocation may be seen as providing an unwarranted additional benefit. Second, the proposal introduces additional complexity into an already complex area, as taxpayers would have to compute an E&P basis for each asset, along with the tax basis.

6. Extension and Modification of Special Allocation of Research and Experimental Expenditures to U.S. Source Income for Foreign Tax Credit Limitation Purposes

Administration Position. **Support permanent extension at 50 percent.** This proposal is similar to section 864(f) of the Internal Revenue Code, which generally expired on December 31, 1994. It differs from current section 864(f) in that it would increase the 50 percent exclusive apportionment percentage of

section 864(f) to 64 percent. This proposal would also allow a taxpayer to elect not to utilize the place of performance rule under the sales method. As stated in the President's fiscal year 1996 budget, the Administration supports the permanent revenue-neutral extension of current section 864(f), which provides a 50 percent exclusive apportionment percentage. The Administration does not oppose the election to waive the place of performance rule under the sales method. However, the Administration does not support increasing the exclusive apportionment percentage to 64 percent.

7. Repeal Foreign Tax Credit Basket for "10/50" Noncontrolled Corporations

Administration Position. **Oppose.** The proposal offers taxpayers an inappropriate opportunity to average foreign tax rates on different types of income earned through different 10/50 companies and also effectively applies an election (on a company-by-company basis) to apply a "look-through" approach. The proposal opens even more opportunities for abuse than would pure look-through. Although the Administration opposes this proposal, it is generally sympathetic to the burdens presented by the 10/50 basket and therefore does not oppose the alternative 10/50 proposal at item T.14., below.

8. Extension of Period to Which Excess Foreign Tax Credit May Be Carried

Administration Position: **Do not support.** The reason the Code permits the carryover of foreign taxes is that foreign and domestic tax accounting rules may differ, resulting in income being taxed in the United States and a foreign country in different years. The current carryover periods generally are appropriate to account for these differences. Moreover, the availability of deferral effectively allows taxpayers to choose when to begin the carryover periods. Extension of the carryforward period to 15 years would permit inappropriate averaging of high- and low-taxed foreign source income, which the foreign tax credit rules generally seek to limit. It also would have significant revenue losses outside the revenue-estimating window.

9. Expansion of De Minimis Exception to Subpart F Income Treatment

Administration Position. **Do not support.** The proposal would raise the ceiling of the subpart F de minimis exception from 5 to 10 percent and eliminate the $1 million limit of current law. The Administration would be pleased to work with the Committee to consider alternative methods of revising the de minimis exception in order to simplify the operation of subpart F. However, we believe that any exception should contain a dollar limit, as well as a percentage limit, to avoid excessive deferral of U.S. tax on income not subject to substantial foreign taxation.

10. Treatment of Foreign Base Company Sales and Services Income of Controlled Foreign Corporations in the European Union

Administration Position. **Oppose.** Although the European Union is moving towards economic integration, the lack of direct tax harmonization creates inappropriate tax-planning opportunities. For example, the proposal would exempt income from taxation under subpart F even where it is subject to little or no foreign tax. Therefore, the European Union should not be treated as a single country for subpart F purposes at this point.

11. Exclusion of Foreign Base Company Shipping Income From Subpart F Income for Certain Controlled Foreign Corporations

Administration Position. **Oppose.** The proposal would reinstate prior law provisions granting deferral for certain shipping income. The Administration believes that the concerns regarding the absence of tax on such income, which motivated the Congress to curtail deferral in 1986, remain valid.

12. Limit Application of UNICAP Rules to Foreign Persons

Administration Position. **Do not oppose.** As we understand the proposal, it would exempt foreign persons from the uniform capitalization requirements of current law, except with respect to their U.S. effectively connected income and their subpart F income. Although this proposal would yield results that are somewhat less accurate from a theoretical perspective, we believe that it could achieve significant simplification for affected taxpayers.

13. Reporting of Foreign Corporation Earnings and Profits on a U.S. GAAP Basis

Administration Position. **Do not support.** Generally accepted accounting principles ("GAAP") are determined by the Financial Accounting Standards Board. In the interest of protecting shareholders and other stakeholders from aggressive accounting practices, GAAP earnings tend to accelerate losses and defer income. We believe, therefore, that it would be inappropriate to delegate the function of determining the amount of income to be picked up by controlled foreign corporations to an administrative body the interests of which may run counter to the tax system. However, we would be willing to work to with the Committee in an effort to identify limited opportunities where GAAP could be used to achieve simplification without adverse revenue consequences.

14. Permit Shareholder of a "10/50" Corporation to Elect to Treat It as a CFC for Foreign Tax Credit and Subpart F Purposes

Administration Position: **Do not oppose.** This proposal is a reasonable way to simplify the 10/50 basket rules. The proposal's coupling of foreign tax credit and subpart F consequences is consistent with Congressional intent as evidenced by the legislative history of the 10/50 rule (enacted in 1986). That legislative history indicates a Congressional belief that a multiple separate-basket approach for 10/50 corporation dividends was appropriate, because 10/50 corporations, unlike CFCs, could not be considered part of the same economic unit as the U.S. shareholder. It would be consistent with this legislative history, however, to permit single-economic-unit (i.e., CFC) treatment for foreign tax credit purposes, if the taxpayers are required to apply CFC treatment for subpart F purposes as well.

The bill's consistency rule may preclude certain taxpayers from making the CFC election if they cannot obtain sufficient data from one or two 10/50 companies to apply the look-through or subpart F rules (e.g., due to substantial majority foreign ownership). The consistency rule properly prevents taxpayers from electing CFC treatment only with respect to 10/50 corporations that have, for example, no subpart F income. Treasury would be pleased to work with the Committee to consider other alternative reforms of the 10/50 basket rules if it appears that a consistency rule would limit too severely the utility of a CFC election.

15. Increase in Reporting Threshold for Stock Ownership of a Foreign Corporation

Administration Position. **Do not oppose.** Although the basic corporate information collected under section 6046 is valuable, the Administration believes that raising the reporting threshold to 10 percent would not significantly jeopardize that interest and would ease the filing burden of U.S. shareholders holding minority interests.

16. Modification of Excess Passive Assets Provision for Corporations with Active Financing Income

Administration Position. **Oppose.** The Administration believes that this proposal creates significant administrative difficulties because it differentiates between "active" financing income and "passive" income outside the context of regulated entities that qualify for the existing banking, insurance and securities exemptions. We believe that this line is very difficult to draw. Moreover, this form of relief is inappropriate because it treats corporations differently depending on the manner in which they finance their businesses, not on the basis of how active those businesses are.

17. Exception from Foreign Personal Holding Company Income and Foreign Base Company Services Income for Active Financing Income

Administration Position. **Oppose.** The proposal would reinstate, with modifications, pre-1987 law provisions granting deferral for certain income derived in the active conduct of a banking, financing, or similar business or from certain investments made by insurance companies. The Administration believes that the concerns regarding the mobility of this income, which motivated the Congress to eliminate or curtail deferral for such income in 1986, remain valid.

18. Repeal of Excess Passive Assets Provision and Modification of Passive Foreign Investment Company Provisions

Administration Position. **Oppose.** The proposal would eliminate the excess passive assets provision and modifications to the passive foreign investment company assets test that were enacted in 1993 to prevent controlled foreign corporations from deferring tax indefinitely, as they were able to do before 1993 by managing their passive income and assets so as to avoid the passive foreign investment company thresholds. The third alternative proposal regarding passive foreign investment companies would make it even easier for a corporation to avoid treatment as a passive foreign investment company. In addition, the proposal to exempt controlled foreign corporations from the passive foreign investment company rules would allow less than 10-percent shareholders to achieve unlimited deferral of taxation on passive income. The Administration believes that the concerns regarding the ability of investors in foreign corporations to achieve unlimited deferral through the accumulation of passive assets abroad, which led to the passage of the passive foreign investment company rules in 1986 and the excess passive assets provision in 1993, remain valid.

19. Exemption of United States Shareholders of Controlled Foreign Corporations from Passive Foreign Investment Company Provisions

Administration Position. **Do not oppose.** The Administration believes that it may be possible to exempt the 10-percent United States shareholders of controlled foreign corporations from the passive foreign investment company provisions of the Code. We believe that this proposal could simplify the anti-deferral

provisions of current law without significant detriment to the policy concerns underlying those provisions, because the provisions added to subpart F in 1993 now inhibit the accumulation by controlled foreign corporations of excessive passive assets abroad, as the asset test does in the case of passive foreign investment companies.

20. Valuation of Assets of a Controlled Foreign Corporation under the Passive Foreign Investment Company and Excess Passive Assets Provisions

Administration Position. **Oppose.** We understand that the proposal is intended to benefit certain service companies that have substantial amounts of self-generated intangibles. Because it applies only to the extremely small number of controlled foreign corporations whose stock is publicly traded, it would not, however, benefit the vast majority of foreign service corporations. In addition, the proposal raises substantial problems, as well as associated administrative burdens, in determining valuations on an on-going basis.

21. Exempt Certain Income Derived by Insurance Brokers or Agents from PFIC Rules

Administration Position. **Oppose.** It is unclear that the situation of insurance brokers and agents is more similar to that of banks, insurance companies, and securities dealers, to whom the Congress has granted limited exceptions from the passive foreign investment company rules, than to that of service companies, to whom the Congress has not granted any exception. Moreover, the Administration believes that the proposed exemption is broader than necessary to achieve the stated purpose of treating insurance brokers and agents in a manner comparable to banks, insurance companies, and securities dealers. As drafted in H.R. 4626 (103rd Congress), the proposal would treat insurance brokers and agents more favorably.

22. Prizes and Awards Received from a Foreign Payor by a Nonresident Alien Relating to Competitions Held in the United States and Not Treated as Foreign Source Income

Administration Position. The staff of the Ways & Means Committee has advised Treasury that the explanation of this provision in the JCT pamphlet is incorrect. Treasury understands that this provision relates to compensation received by nonresident aliens in connection with Olympic competitions held in the United States. Treasury is concerned about creating a tax exemption for commercial activities related to the Olympics. However, Treasury is prepared to work with the Committee to ensure that the tax laws do not create an impediment to holding the Olympics in the United States.

23. Exempt Service Income of a Nonresident Alien Earned on International Ships or Aircraft from U.S. Tax

Administration Position. **Do not support.** Income earned within the United States should be subject to U.S. tax. Treasury would be willing to work with the Committee in order to evaluate whether the method of withholding tax applicable to international crew members is appropriate to the circumstances of international shipping.

The proposal also would exclude certain days spent within U.S. territory for purposes of determining residency under the substantial presence test of section 7701; this proposal is not acceptable as described. Treasury would be willing to work with the Committee in order to identify the proper residence status for tax purposes of alien individuals who do not enter the United States for purposes of immigration law.

24. Repeal Portfolio Interest Exemption

Administration Position. **Oppose.** Repealing the portfolio interest exemption would substantially increase the cost of government and corporate borrowing in international markets.

25. Exempt Certain Short-Term OID Obligations Held by a Non-Resident Alien from U.S. Estate Tax

Administration Position. **Support.** As we understand it, the proposal would extend the estate tax exemption for OID obligations held by nonresidents who are not U.S. citizens to include certain short-term OID obligations described in Code section 871(g)(1)(B)(i). This would conform the estate and income tax treatment of such obligations and remove a disincentive to purchase them.

26. Carryover of Excess Possession Tax Credit

Administration Position. **Do not support.** We do not support the proposal because the carryback of the excess possession credit would provide a windfall for taxpayers. The economic activity limitation is intended to increase possession employment and investment. A carryforward of excess possession credit might have that effect, but a carryback would not.

27. Pass-Through Treatment for Certain Dividends Paid by a Regulated Investment Company ("RIC") to Foreign Persons

Administration Position. **Do not oppose in part.** We do not oppose the provisions of the proposal that would treat RIC dividends as "interest-related dividends" to the extent attributable to interest income that would be exempt from U.S. tax if earned directly by a foreign person or as "short-term capital gain dividends" to the extent attributable to the excess of short-term capital gains over long-term capital losses. We also do not oppose the proposed treatment of RIC shares for estate tax purposes with respect to the estates of decedents dying after the date of enactment, except to the extent described below relating to "taxable interest dividends." We believe that these provisions will enhance the ability of U.S. mutual funds to attract foreign investors and eliminate needless complications now associated with the structuring of vehicles for foreign investment in U.S. securities.

However, we oppose the provision that would treat RIC dividends as "taxable interest dividends" to the extent attributable to interest income that would be taxable if earned directly by a foreign person. This provision would unilaterally extend to foreign investors in RICs the benefits of the reduced withholding rates for interest and estate tax treatment provided in our income and estate tax treaties, with no guarantee that comparable benefits will be provided for U.S. investors by our treaty partners.

28. Consolidate Income and Loss of Same Country Foreign Corporations That Elect To Be Taxed as Domestic Insurance Companies

Administration Position. **Oppose.** Current law provides specific "chain deficit" rules permitting U.S. shareholders of controlled foreign corporations in a chain to consolidate their income and loss from qualified activities, including insurance, in appropriate circumstances. Additional relief for certain insurance companies does not appear necessary or appropriate.

U. HOUSING COOPERATIVES

1. Tax Relief for Housing Coops on Interest on Reasonable Reserves and Income from Laundries and Parking; for Limited Equity Coops, Tax Relief for Commercial Rentals

Administration Position. **Do not support.** Although it may be appropriate to treat income from parking and laundry facilities (attributable to use by tenant-stockholders and their guests) as patronage-sourced, interest on reserves and rental income should not be treated as patronage-sourced.

2. Treatment of Coops Owning Only Land

Administration Position. **Do not oppose, if prospective.** The Administration is not aware of any reason why land cooperatives should not be entitled to the same treatment as housing cooperatives. However, the retroactive effective date (to December 31, 1987) is not appropriate.

V. INSURANCE

1. Treatment of Salvage and Subrogation of Property and Casualty Insurance Companies

Administration Position. **Do not oppose.** The Administration does not oppose a proposal that alters the statutory language contained in the 1990 Act to clarify Congressional intent.

2. Health Organizations Eligible for Benefits of Section 833

Administration Position. **Do not support.** Blue Cross/Blue Shield organizations receive special tax treatment that was granted in their transition to taxable status. These tax benefits include, among others, a special deduction, and the elimination of the 20 percent reduction in unearned premium reserves that applies generally to all property and casualty insurance companies. The scope of these special tax benefits should not be expanded on a retroactive basis.

3. Treatment of Certain Gains and Losses of Life Insurance Companies Under Section 818(b)

Administration Position. **Do not support.** Although life insurance companies do not get the benefit of section 1231 for depreciable property used in connection with a non-insurance business, this is one of the many features of the taxation of life insurance companies that do not conform to the taxation of non-insurance businesses. Any change in the taxation of life insurance companies should be considered in connection with the overall scheme of life insurance company taxation. In addition, the proposal would add complexity to the law by segregating the loss into capital and ordinary components on a percentage basis and allowing the ordinary portion to be deductible over five years.

4. Treatment of Certain Charitable Risk Pools

Administration Position. The laws of at least one State provide for the organization of charitable risk pools that provide insurance coverage to charitable organizations that are members of the pool. The courts have held that these charitable risk pools do not qualify for tax exemption under sections 501(c)(3) or 501(m).

The Administration would not oppose a provision under which a charitable risk pool could qualify as a section 501(c)(3)

organization, notwithstanding section 501(m), provided that the charitable risk pool receives a sufficient amount of contributions from non-members that it uses to subsidize the coverage provided to members. The Administration believes that, in the absence of such subsidized coverage, the operations of a charitable risk pool would be virtually identical to a mutual insurance company, and as such should be subject to tax in accordance with the policies underlying section 501(m).

5. <u>Deduction for Small Property and Casualty Insurance Companies</u>

<u>Administration Position</u>. **Oppose.** The proposal would provide an additional tax-induced distortion favoring the sale of insurance through small firms, lose significant revenues, and create substantial additional complexity in the Code. Under present law, property and casualty insurance companies with net written premiums (or, if greater, direct written premiums) that do not exceed $350,000 are exempt from federal income tax. In addition, a property and casualty insurance company may elect to be taxed solely on taxable investment income for any taxable year its net written premiums (or, if greater, direct written premiums) exceed $350,000 but do not exceed $1.2 million. A special deduction for small property and casualty insurance companies in addition to the tax benefits available to these insurers under existing law is not necessary.

6. <u>Treatment of Deposits Under Certain Perpetual Insurance Policies</u>

<u>Administration Position</u>. **Oppose.** Under a perpetual insurance contract, a policyholder deposits a one-time payment with the insurer in return for casualty insurance that is provided until the policy is canceled and the deposit is refunded to the policyholder. The policyholder generally may cancel the insurance at any time. The investment earnings on the deposit are retained by the insurer to fund insurance costs. If a purchase of a perpetual insurance contract is not treated as a below-market loan, the policyholder avoids tax on the interest earned on the deposit, allowing casualty insurance to be purchased with pre-tax dollars.

7. <u>Extend Section 130 Exclusion to Structured Settlements for Workmen's Compensation Payments</u>

<u>Administration Position</u>. **Do not oppose.** There appears to be no policy justification, apart from revenue considerations, for allowing less favorable tax treatment for work-related physical injury claims than other physical injury claims.

8. <u>Treatment of Certain Small Property Casualty Insurance Companies Under the Alternative Minimum Tax</u>

<u>Administration Position</u>. **Oppose.** Applying the small company election to be taxed solely on taxable investment income in calculating alternative minimum tax liability would subvert the goal of the alternative minimum tax to measure the economic income of companies and impose some tax on that income. In addition, piecemeal amendments to the alternative minimum tax is not desirable. Any revisions should be evaluated in the context of overall simplification of the alternative minimum tax.

9. <u>Tax Treatment of Consolidations of Life Insurance Departments of Mutual Savings Banks</u>

<u>Administration Position</u>. **Do not oppose.** The Administration does not oppose this proposal as long as it is limited to consolidation of life insurance departments of mutual savings banks under section 594 under requirement of State law, the provision applies only if policyholders have no rights to surplus

and no voting rights prior to the consolidation, and their approval was not required in order for the consolidation to occur.

10. Extend Section 832(e) to Financial Guarantee Insurance

Administration Position. This proposal does not raise a significant federal income tax issue, but instead relates primarily to regulatory matters. Because a company that claims a deduction under section 832(e) must purchase "tax and loss", noninterest-bearing federal government bonds equal to the amount of the tax savings attributable to the deduction, the amount that the company pays the government in a given year is the same regardless of whether it claims the deduction. The principal effect of the provision is to allow the company to report an asset for regulatory purposes as a result of the payment.

11. Increased Dollar Limits for Burial Insurance

Administration Position. **Do not oppose.** Apart from revenue considerations, it may be appropriate to increase the dollar limits applicable in the case of an insurance contract to cover payments of burial expenses or in connection with prearranged funeral expenses to reflect inflation.

12. Foreign Companies Carrying on Insurance Business

Administration Position. **Do not oppose, subject to provision of a prospective effective date.** Although we do not believe that the provisions of current law violate our treaty obligations, we believe the proposed amendments, effective prospectively, could improve the operation of the statute.

W. LOW-INCOME HOUSING

1. Provide 15-year Depreciation and Other Tax Incentives to Encourage the Preservation of Low-Income Housing

Administration Position. **Oppose.** Generous tax advantages, including substantial credits and relief from the passive loss rules, already exist for low-income housing. Shortening the depreciable life to 15 years, doubling the exception to the passive loss rules (from $25,000 to $50,000), and reducing the depreciable life for AMT purposes (from 40 years to 15 years) are not justified at this time.

2. Low-Income Housing Credit Provisions

(a). Allow HOME Funds To Be Used with 91% Credit

Administration Position. **Oppose.** Given the ceiling on tax credits, current law restrictions on combining federal subsidies are reasonable.

(b). Expand Community Service Area Costs Eligible for Credit

Administration Position. **Do not oppose, with modifications.** The low-income housing tax credit is a credit for housing and functionally related facilities. While there may be some justification for extending the credit to certain community service buildings, this proposal might allow financing of commercial-type facilities that allow as much as 49% of the use to be for persons other than residents. Any extension of the credit should provide a more targeted definition of community service buildings and use by residents.

(c). Change State Credit Authority Limitation Stacking Rule

Administration Position. **Do not support.** This change would effectively allow States to carry over unused authority for an unlimited period. Although this change should have little revenue impact, it could significantly reduce the flow of credits to the national pool. This could result in an inefficient use of the credit by benefiting States that could not use all of their credit authority at the expense of the States that did use all of their credit authority.

(d). Expand Credit to Lead Paint Removal

Administration Position. **Do not support.** The low-income housing tax credit is a credit for housing targeted to serve low income persons. It is an inappropriate vehicle to provide incentives for removal of lead paint in older buildings.

(e). Expand Credit to Certain Cooperative Housing

Administration Position. **Do not support.** The low-income housing tax credit was enacted to increase the stock of rental housing for low income families and individuals. Extending the credit to owner-occupied housing would dilute the goal of increasing rental property.

X. PARTNERSHIPS

1. Permanent Extension of Publicly Traded Partnership Grandfather Rule

Administration Position. **Oppose.** The effective date provisions of section 7704 provided existing partnerships with a generous 10-year period for preparing to comply with Section 7704. The debate regarding the effective date provisions of Section 7704 should not be reopened.

Y. PASSIVE LOSSES

1. Modify the Application of Passive Loss Rules to Timber Activities

Administration Position. **Do not support.** The current regulatory limitations on the facts-and-circumstances test for material participation are rules of administrative convenience designed to prevent disputes when there is little chance the taxpayer will prevail. Although the elimination of these limitations may increase the number of disputes between the Internal Revenue Service and taxpayers, taxpayers who are precluded from using the facts-and-circumstances test under current law (for example, because they do not participate in an activity for more than 100 hours) will still find it very difficult to establish, based on all the facts and circumstances, that their participation is regular, continuous, and substantial.

2. Modify the Application of Passive Loss Rules to Farming Activities

Administration Position. **Do not support.** The Administration position on this proposal is the same as its position on the similar proposal to modify the application of the passive loss rules to timber activities.

Z. PASS-THROUGH ENTITIES

1. Subchapter S Reform Proposals to Expand Availability of Subchapter S and Improve Its Operation

Administration Position. The Administration supports the goal of providing small business with needed S corporation reform and simplification. The Administration also supports many of the technical and administrative provisions of the proposals, such as increasing the number of shareholders from 35 to 50. We are concerned, however, that certain provisions of the proposals may unintentionally create undue complexity and provide increased opportunities for large taxable C corporations to escape corporate taxation by electing S corporation status. This seems to be an inappropriate consequence of proposals intended to benefit small businesses. We would be pleased to work with the Committee to produce a revenue-neutral reform package that is more precisely targeted to small business and does not introduce additional complexity into the Code.

There have been two recent developments that should strongly influence the shape of any S corporation reform. First, limited liability companies ("LLCs") have emerged as a tremendously popular alternative to S corporations. LLCs combine the flexibility of a partnership for tax purposes with the liability protection of an S corporation. LLCs, like S corporations and other forms of partnerships, are generally not subject to tax; the results of their operations flow through to the owners. Virtually all States have enacted some form of LLC legislation and, for most new enterprises seeking extended flow-through treatment, an LLC will likely become the preferred entity. Thus, as we consider S corporation reform, we should keep in mind that it can be expected generally to benefit only certain existing businesses.

Second, Treasury and the IRS have recently proposed a "check-the-box" system that would allow LLCs and other unincorporated entities to elect to be treated as partnerships for tax purposes simply by checking a box. This check-the-box system has been generally praised by taxpayers and tax practitioners. However, it would not apply to enterprises formed as corporations. We do not have the authority to extend the check-the-box system to non-publicly traded corporations -- large or small -- including S corporations.

In light of these developments, we believe that, as an alternative to some of the proposals, we should consider allowing, at least for a limited period of time, certain S corporations to convert to a partnership on a tax-free basis under prescribed circumstances. There are currently several practical limitations on an S corporation's ability to convert to a partnership. In particular, such a conversion generally results in a tax liability that may be too steep a price for many S corporations to pay, as well as various transaction costs (lawyer and accountant fees, State transfer taxes, etc.). If adopted, this proposal would eliminate or reduce the tax cost of the conversion and enable certain S corporations to elect the more flexible partnership treatment.

As part of this proposal, consideration should be given to whether it would be appropriate to grant Treasury authority to extend the check-the-box proposal to converting S corporations. If Congress were to do so, we would be authorized to issue regulations that would allow S corporations to continue their existing corporate status while converting to partnership treatment for federal tax purposes. As a result, S corporations that wanted to be treated as a partnership for federal tax purposes would simply file an election to be treated as a flow-

through partnership, rather than actually having to transfer assets to a new partnership entity. This proposal would enable S corporations to achieve partnership tax treatment without incurring the transaction costs involved in actually converting to a partnership (including an LLC).

Finally, the dual concerns of providing appropriate revenue offsets to this proposal and targeting it to small business suggest that we explore another possible S corporation reform. Specifically, we should consider whether it is advisable to conform the tax treatment of the conversion of large existing C corporations to S corporations with the treatment of their conversion to a partnership (including an LLC). This proposal (as applied to all converting C corporations, not just large C corporations) was suggested by the Joint Committee on Taxation in 1990 as part of an earlier simplification package. The Joint Committee recommended that "a shift from C corporation status to passthrough entity status where the passthrough entity is an S corporation [be] conformed to the present-law treatment where the passthrough entity is a partnership." See letter to Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, reprinted in Committee on Ways and Means, Written Proposals on Tax Simplification, WMCP 101-27, May 25, 1990, p.20. Currently, electing S status rather than converting to a partnership generally enables large C corporations -- corporations that would not meet anyone's definition of small business -- to escape most corporate taxes. In light of the recent developments discussed above, now may be an appropriate time to review the Joint Committee's proposal.

2. Subchapter S Corporations Eligible for Rules Applicable to Real Property Subdivided for Sale by Noncorporate Taxpayers

Administration Position. **Oppose.** The proposal would extend section 1237 treatment to S corporations and thereby equalize the treatment of S corporations and partnerships with regard to the sale of certain subdivided real property. The proposal, however, is to be effective for sales after January 1, 1992 and to sales before January 1, 1992 for purposes of characterizing post-1991 sales as falling under section 1237. While the Administration is generally sympathetic to equalizing the treatment of S corporations and partnerships, we oppose the proposal on the basis of this effective-date provision.

3. Treatment of Financial Asset Securitization Investment Trusts (FASITS)

Administration Position. **Do not oppose, with modifications.** The Administration did not support a similar proposal introduced in 1993. Since 1993, the proposal has been improved significantly. We still have concerns, however, about the complexity of the proposal and whether the safe harbor treatment of debt securities allows equity-like interests to be treated as debt. In addition, we have concerns about creating another special purpose tax entity rather than improving or expanding existing law. Finally, we are concerned about potential revenue losses outside the budget window. We believe that this proposal should be considered in the context of Treasury's study of the treatment of financial instruments and entities engaged in financial services transactions.

4. Treatment of Tax-Exempt Municipal Investment Conduits (TEMICS)

Administration Position. **Do not support.** We are not aware of the need for this proposal, which would introduce significant complexity into the tax law.

5. Modification of Rules For Real Estate Investment Trusts (REITS)

Administration Position. **Do not support.** The Administration is sympathetic to arguments that there are technical problems with the current REIT rules in the tax law. We are concerned, however, with the way this proposal addresses those problems. We look forward to working with the Committee to resolve these issues in an appropriate and revenue-neutral manner. We believe that the proposal should be considered in the context of Treasury's study of the treatment of financial instruments and entities engaged in financial services transactions.

6. Allow Bank Common Trust Funds To Be Transferred to More than One Mutual Fund without Taxing Trust Beneficiaries

Administration Position. **Do not oppose, with modifications.** This proposal would allow smaller banks that lack sufficient funds to create proprietary mutual funds to transfer their common trust funds to one or more larger mutual funds. We support this goal. We have, however, significant concerns about the complexity and effectiveness of the basis-pooling rules, and believe that this part of the proposal should be substantially revised.

AA. PEACE TAX FUND

1. Establish U.S. Peace Fund to Receive Conscientious Objectors' Income, Estate, or Gift Tax Payments To Be Used Only for WIC, Head Start, U.S. Institute of Peace, and Peace Corps

Administration Position. **Oppose.** The proposal would provide one category of individuals with more direct say over the way the government spends tax dollars, as opposed to the influence all taxpayers exert through the normal political processes and the ballot box. In this regard, it is similar to the provision in H.R. 1215 which we oppose regarding a Public Debt Reduction Trust Fund. The proposal also presents significant administrative problems.

BB. PENSIONS AND EMPLOYEE BENEFITS

A. PENSIONS

1. Nondiscrimination Rules

(a). Repeal Special Nondiscrimination Tests for Qualified Cash or Deferred Arrangements

Administration Position. **Oppose.** We oppose the repeal of the special nondiscrimination tests for qualified cash or deferred arrangements (known as the ADP test) and for employer matching contributions and employee after-tax contributions (known as the ACP test). These tests protect nonhighly compensated employees under a 401(k) or 401(m) arrangement by ensuring that they receive reasonable contributions (as a percentage of compensation) compared to highly compensated employees. However, the ADP and ACP tests, including the related correction procedures, can be complicated and costly to administer. The Administration's pension simplification package has proposed a simple "safe harbor" alternative that allows employers to avoid all ADP and ACP testing but that also protects nonhighly compensated employees. These design-based safe harbors -- which would apply both for 401(k) plans and for the Administration's proposed simple plan for small employers, the NEST (for National Employee Savings Trust) -- consist mainly of employer matching

and nonmatching contributions designed to increase the likelihood that nonhighly compensated employees will have meaningful contributions.

(b). Modify Definition of Highly Compensated Employee to Eliminate 1-Officer Rule

Administration Position. **Support.** H.R. 3419 defines a highly compensated employee (HCE) as any employee who is a more-than-5 percent owner of the employer or who earns more than $50,000 ($66,000 as adjusted in 1995 for cost of living). The proposal would eliminate the additional rule in H.R. 3419 that, if no employee is an HCE under this definition, then the highest-paid officer is treated as an HCE. In its pension simplification package, the Administration has proposed to define an HCE simply as any employee who is a more-than-5 percent owner or who earns more than $80,000 (effective for 1996 and indexed for future years), without a highest-paid officer rule. Consistent with our simplification proposal, we support the proposed deletion of the highest-paid officer rule. We also believe that raising the dollar threshold to $80,000, as under the Administration's proposal, would prevent many middle-income taxpayers from being classified as HCEs who are prohibited from receiving better benefits than others.

(c). Repeal Top-Heavy Rules

Administration Position. **Oppose.** The top-heavy rules provide rank-and-file employees with important protection not currently provided by any other Code provision. However, the top-heavy rules may require complex calculations that deter small employers from adopting qualified plans. To address this problem, as well as many other concerns unique to small business, the Administration has proposed a new, simple plan for small employers -- the NEST. The NEST would be exempt from the top-heavy requirements (and other nondiscrimination testing rules); instead, the structure of the NEST itself is designed to promote meaningful contributions for all eligible employees.

(d). Modify Leased Employee Rules

Administration Position. **Oppose.** The proposal does not simplify or clarify the leased employee rules; it adds new layers that increase complexity. The proposed five-year graded vesting schedule is likely to result in reduced benefits for rank-and-file employees who remain with leasing organizations for a relatively short time. The safe harbor alternative would permit service recipients and qualified leasing organizations to circumvent the existing safe harbor limit on the percentage of leased employees. In addition, the safe harbor would require a qualified leasing organization to register with the IRS. It is not clear what the IRS's responsibilities would be under this requirement. If, for example, registration required the IRS to evaluate each leasing organization that applied for registration and conduct a periodic review of the registrants, the provision could impose significant administrative burdens.

(e). Exempt State Judicial Plans From Nondiscrimination Requirements

Administration Position. **Do not support.** Tax-qualified plans of governmental employers generally are deemed to satisfy minimum participation, nondiscrimination and coverage requirements until plan years beginning on or after January 1, 1999. The delayed effective dates allow time for the development of appropriate nondiscrimination provisions for governmental plans. We do not believe that there is a sufficient tax policy justification for providing a total exemption from the nondiscrimination rules for any one class of employees.

(f). Repeal OBRA 1993 Provision Limiting Compensation Taken into Account to $150,000

Administration Position. **Oppose.** The OBRA 1993 reduction in the amount of compensation that may be taken into account under a qualified plan serves to reduce the extent to which employers can provide tax-qualified retirement benefits that favor the highly compensated employees. Reversal of that reduction would permit a larger share of the employer's tax-favored contributions to be allocated to employees who can better afford to save for their own retirement. In addition, the proposal would have significant revenue cost.

(g). Repeal for Pilots OBRA 1993 Provision Limiting Compensation Taken into Account to $150,000

Administration Position. **Oppose.** For the reasons noted above, we oppose the repeal of the OBRA 1993 reduction in the amount of compensation that may be taken into account under a qualified plan. Furthermore, we do not believe there is a legitimate tax policy reason to repeal the reduction (and thus have a different compensation definition) for one class of employees.

(h). Repeal Minimum Participation Rule

Administration Position. **Support, as applied to defined contribution plans.** As applied to defined benefit plans, the minimum participation rule prevents significant abuse. It prevents an employer from establishing individual defined benefit plans for highly compensated employees in order to provide those employees with more favorable benefits than those provided to lower paid employees under a separate plan. The rule also prevents an employer from favoring one small group of participants over another in other ways (for example, by covering them under two separate defined benefit plans and funding one plan better than the other). Accordingly, we oppose the repeal of the minimum participation rule for defined benefit plans. However, as applied to defined contribution plans, the minimum participation rule adds complexity for employers without delivering commensurate benefits to the system. Thus, consistent with the Administration's pension simplification proposal, we support the repeal of the minimum participation requirement for defined contribution plans.

2. Distribution Rules

(a). Repeal 15-percent Excise Tax on Excess Distributions

Administration Position. **Do not support.** Both the 15 percent excess distribution penalty and the section 415(e) combined plan limit (which applies to any employee who participates in a qualified defined benefit plan and a qualified defined contribution plan of the same employer) were designed to safeguard against an individual accruing excessive tax-favored retirement benefits under multiple plans. There is considerable duplication in the application of the two provisions. Because the 415(e) combined limit is the far more complicated provision -- and because it, unlike the 15 percent excise tax, applies only to the plans of a single employer -- we believe, consistent with the Administration's simplification proposal, that the cause of simplification would be best served by repealing the combined limit rather than by repealing the 15 percent penalty.

(b). Provide that Pension Distributions are Taxed as Capital Gains

Administration Position. **Oppose.** Under existing law, qualified plans receive very favorable tax treatment. Employees are not taxed on contributions to these plans; the trusts do not pay taxes on their earnings; and employees are eligible for special

tax treatment for certain types of distributions. We believe that the proposed additional tax incentive to provide compensation in the form of retirement benefits is not needed. In addition, the proposal would lose significant revenue.

(c). Reinstate Ten-Year Forward Averaging

Administration Position. **Oppose.** Reinstating ten-year averaging for lump sum distributions, which was generally repealed by the Tax Reform Act of 1986, would do nothing to simplify the taxation of lump sum distributions, and would lose substantial revenue. The application of ten-year averaging often involves difficult definitional determinations and complicated calculations.

(d). Permit Penalty-Free Withdrawals for Unemployed Individuals

Administration Position. **Support Administration's version of this legislation.** The Administration supports the objective of allowing unemployed individuals to make penalty-free withdrawals from IRAs, as included in the Middle Class Bill of Rights, H.R. 980. The Administration believes that this change should be part of a comprehensive expansion of IRAs for middle-income taxpayers, as provided in H.R. 980. In addition, this change should be limited to individuals facing long-term unemployment.

3. Limits on Contributions and Benefits

(a). Modification of Interest and Mortality Rate Provisions of the Retirement Protection Act

Administration Position. **Oppose.** The change in the interest rates and the specification of the mortality table that may be used for purposes of applying the section 415 limitations contained in the Uruguay Round legislation reestablished the principle that a plan may not provide a benefit in the form of a lump sum that is worth more than the equivalent of the maximum single life annuity that would be permitted at the same age under section 415. The effective date of the changes need not be deferred, because the Uruguay Round legislation also provided that a plan may protect the benefit accrued prior to the effective date of the new provision.

(b). Eliminate Combined Plan Limit for Participants in Both a Defined Contribution Plan and a Defined Benefit Plan

Administration Position. **Support.** The repeal of this limit has also been proposed by the Administration. The combined limit is cumbersome, requiring information concerning a plan participant's entire work history, and is commonly determined incorrectly. The goal of the combined limit -- to safeguard against an individual accruing excessive retirement benefits on a tax-favored basis -- is also addressed by the 15 percent excise tax on excess distributions, which the Administration's proposal would retain.

4. Employee Stock Ownership Plans

(a). Modify Rules Relating to Deferral of Gain on Certain Sales of Stock to an ESOP (section 1042 exchanges)

Administration Position. **Oppose.** We do not believe that there is sufficient tax policy justification for this expansion of section 1042.

(b). Permit ESOP to be Beneficiary of Charitable Remainder Trust

Administration Position. **Oppose.** We do not believe that the current charitable estate tax deduction for charitable remainder trusts should be expanded to cover ESOPs.

(c). Treatment of Certain Securities Transferred to an ESOP From Terminated Defined Benefit Pension Plan

Administration Position. **Oppose.** The Treasury historically has not favored this type of retroactive provision that provides tax benefits to a narrow class of taxpayers.

(d). Permit Payment of Estate Tax Liability by an ESOP

Administration Position. **Oppose.** We do not believe that there is sufficient tax policy justification for reinstating this benefit, which Congress repealed in 1989.

5. Permit Permanently Disabled Persons to Contribute to Section 401(k) Plans

Administration Position. **Do not oppose.** To encourage contributions for disabled workers, plans should be allowed to permit disabled former employees, highly compensated as well as nonhighly compensated, to make elective contributions to 401(k) plans. We would support legislation that achieves this goal if technical issues relating to the implementation of the proposal are appropriately resolved. We would be happy to work with the Committee to that end.

6. Modify Sanctions for Failure to Comply with Qualification Requirements

Administration Position. **Oppose.** By effectively eliminating sanctions in all but the most egregious cases, the proposal reduces employers' incentives to adopt systems and procedures that assure operational compliance with plan qualification rules. Unlike the current IRS administrative programs, the proposal is not targeted to providing incentives for voluntary compliance, such as implementation of plan procedures that minimize future errors. As a consequence, adoption of the proposal might well have an adverse effect on participants' benefits and rights and could significantly increase the need for IRS examination and enforcement efforts. As current administrative programs evolve, Treasury and the IRS will continue to work to structure systems that reduce plan burdens while encouraging voluntary compliance.

7. Allow Prenuptial Waiver of Spousal Annuity Benefits

Administration Position. **Oppose.** The proposal could undermine the important Federal retirement policy of protecting a spouse's rights, by permitting waivers to be made many years before retirement and long before meaningful information might be available concerning the value of benefits being waived.

8. Deny Federal Tax Information to States Imposing a Pension Source Tax

Administration Position. **Oppose.** The exchange of tax information between State and Federal tax authorities for tax administration is essential to the orderly collection of both State and Federal tax revenues. Prohibiting the exchange of tax information would interfere with the administration and enforcement of Federal tax laws. The access of States to Federal tax information should not be conditioned on compliance with requirements unrelated to the needs of Federal tax administration.

9. Unfunded Deferred Compensation Plans of Tax-Exempt and Governmental Organizations

(a). Exempt Deferred Compensation Plans for Volunteer Fire Fighters

Administration Position. **Oppose.** The proposal would effectively allow volunteer fire and rescue personnel to defer up to 100 percent of their compensation. Other employees of tax-exempt organizations or of State and local governments are generally limited to deferring one third of their compensation (or $7,500 if less). There is no tax policy reason to distinguish employees who perform these services from any other employees of tax-exempt or governmental employers.

(b). Increase Deferred Compensation Limit for Group Medical Practices

Administration Position. **Support a broader proposal that would apply to all tax-exempt organizations and State and local governments.** There is no tax policy reason to confer special benefits exclusively on such a narrow class of taxpayers. However, because excess benefit plans provide certain employees with benefits that are already provided to other employees under a qualified plan, we believe that excess benefit plans maintained by all tax-exempt organizations and State and local governments should be exempt -- without limit -- from the restrictions of section 457. The Administration's pension simplification proposal provides for this exemption.

(c). Require Individual Ownership of Plan Assets

Administration Position. **Oppose.** This proposal would, by its terms, require amounts deferred under a nonqualified deferred compensation plan of a tax-exempt organization or a State or local government to be funded for the exclusive benefit of plan participants. However, income tax on these amounts would be deferred as if they were not funded. This favorable tax treatment of participants would confer on a category of nonqualified deferred compensation plans significant benefits that are specifically reserved under the current statutory scheme for retirement plans that meet numerous nondiscrimination and other qualification requirements. Section 457 plans not only are allowed to discriminate in favor of highly compensated employees, but, in the case of tax-exempt organizations, they also are generally permitted to cover only a select group of management or highly compensated employees because of the interaction of the Code and ERISA requirements. We oppose extending significant benefits of qualified retirement plans to this very broad category of nonqualified deferred compensation plans.

10. Provisions Relating to Individual Retirement Arrangements ("IRAs")

(a). Permit Tax-Free Rollover of Certain Severance Payments

Administration Position. **Do not support.** We do not believe that it is generally appropriate to expand the individual retirement account rollover provisions to otherwise taxable severance payments that have not been dedicated to retirement savings under a tax-qualified plan.

(b). H.R. 682 (the "Savings and Investment Incentive Act of 1995")

Administration Position. **Support Administration's version of this proposal.** The Administration supports the expansion of IRAs, but believes the President's IRA proposal in H.R. 980 provides a more cost-effective way to increase net national

savings. The President's proposal expands savings incentives to individuals with more moderate incomes, who are now doing little saving. We also believe that penalty-free withdrawals should be made available to pay for long-term care expenses for an incapacitated parent, as proposed by the President.

11. Treatment of Indian Tribal Governments under Section 403(b)

Administration Position. **Do not support.** The Administration believes it would be more appropriate to address the retirement saving needs of tribal government employees through comprehensive pension simplification that would include consideration of all tax-exempt organizations. Accordingly, as part of its pension simplification proposal, the Administration has proposed allowing tax-exempt organizations and Indian tribal governments to sponsor section 401(k) plans in the future. Also, as a general matter of tax policy, the Administration does not favor this type of retroactive tax relief.

12. Special Rules for Church Pension Plans

Administration Position. **Oppose, except for certain technical changes.** As a general matter, the Administration opposes the proposal for the following reasons:

- We believe that the proposed exemption from the trust and nondiscrimination requirements for most qualified church retirement plans and section 403(b) annuities is not justified by differences in church organizational structures or polity, or other unique attributes of churches or church plans. Church employees are entitled to the same safeguards as employees of other organizations, regardless of their employer's internal administration. We have similar reservations about most of the other new special rules for church plans in the proposal. The proposed amnesty included in the proposal for all past violations of sections 401(a) and 403(b) and the retroactive effective dates of many of the proposals are contrary to our general policy against retroactive relief from prior compliance obligations.

- We believe that the current statutory approach of exempting church plans from certain provisions that are difficult to apply or inappropriate in the church plan context is the right approach because it applies, to the extent possible, the same retirement policy for all employers and employees.

- We oppose the extension of the special rules currently applicable only to qualified church-controlled organizations (QCCOs) to all church-controlled or affiliated organizations (other than certain hospitals and universities) because it is inappropriate to provide special treatment reserved generally for churches to organizations that function more as secular charities or commercial enterprises. We are, however, sensitive to problems that exist in applying the QCCO definition. We are also concerned about the problems that exist in applying the generally applicable employer aggregation rules to churches. We would be pleased to work with the Committee to develop simplified rules to address these issues.

We do not oppose certain technical changes included in the proposal. For example, the clarification of the ability of self-employed ministers to participate in a church plan may facilitate the application of certain provisions to church plans, and we would like to work with the Committee to develop this proposal more fully. In addition, we note that the proposal to modify the age 70 1/2 required beginning date for distributions is consistent with the Administration's proposal to generally eliminate the requirement that distributions from a qualified

plan must begin at age 70 1/2 even for an employee who continues to work for the employer maintaining the plan.

B. EMPLOYEE BENEFITS

1. Tax Treatment of Certain Disability Benefits for Police and Fire Fighters

Administration Position. **Do not support.** The Treasury Department generally has not favored this type of targeted retroactive tax relief.

2. Exclude from Income Retirement Benefits that an Employee Elects to Use to Purchase Employer-Provided Accident or Health Care

Administration Position. **Oppose.** Enactment of the proposed exclusion from income would create an entirely new mechanism for prefunding retiree accident and health benefits, and it is not clear whether any nondiscrimination or vesting rules would apply. The proposal may result in significant revenue loss.

3. Modify Restrictions on Golden Parachute Payments

Administration Position. **Do not support.** We do not support eliminating the 75 percent shareholder approval requirement in cases where one person owns more than 50 percent of the voting power of a corporation. The super-majority rule serves to promote serious shareholder consideration of compensation paid upon changes of control.

4. Employee Housing For Certain Medical Research Institutions

Administration Position. **Do not oppose.** The proposal would eliminate disparities in the tax treatment of employer-provided faculty housing for schools and institutions providing similar medical instruction for students.

CC. TAX-EXEMPT BONDS

1. Expansion of Arbitrage Rebate Exception for Certain Bonds

Administration Position. **Do not support.** It may be appropriate to review the arbitrage rebate exceptions as part of the Administration's effort to simplify the tax law. The arbitrage rebate rules were enacted to discourage unnecessary and early issuance of tax-exempt bonds by requiring that arbitrage profits be turned over to the federal government. However, this type of proposal should be considered in the context of a general review of these rules which would exempt more issues rather than more dollar volume from the rebate requirements while still preventing arbitrage abuse.

2. Bonds for Certain Output Facilities

Administration Position. **Do not oppose.** Although this change would have a revenue cost, it would simplify the tax laws. There does not appear to be any reason to treat municipal output facilities more harshly than other municipal facilities.

3. Bonds for Emergency Response Vehicles of Certain Volunteer Fire Departments

Administration Position. **Do not oppose.** Although this proposal will result in a slight revenue loss, it is a reasonable expansion of the limited authority to issue tax-exempt bonds under current law.

4. Spaceport Exempt-Facility Bonds

Administration Position. **Oppose.** This proposal would principally benefit a single municipality in Florida. Further, there could be a significant revenue loss because these bonds would not be subject to the volume cap.

5. Bonds for Solar Energy Facility

Administration Position. **Do not support.** Use of tax-exempt financing, particularly in combination with other federal subsidies exempt from the federal guarantee rule, would not be an efficient vehicle for encouraging solar energy facilities. Other federal tax incentives are available to support solar energy development.

6. Bonds for the Sale of the Alaska Power Administration Facility

Administration Position. **Oppose.** This proposal would principally benefit a single State in the purchase of a federal power facility which has already received other federal benefits.

7. Bonds for the United Nations

Administration Position. **Support.** The Administration believes that the proposal to use tax-exempt financing to provide office space for the United Nations is a matter of great importance and benefit to the United States. There would be an insignificant revenue impact because these bonds would be subject to the volume cap.

8. Bonds for Certain Pre-1990 Issues in the State of Connecticut

Administration Position. **Oppose.** This proposal would benefit a single State and have retroactive effect.

9. Bonds Related to the Transfer of Port Everglades, Florida

Administration Position. **Oppose.** This proposal would principally benefit a single municipality.

10. Qualified Mortgage Bonds - Home Improvement Loans

Administration Position. **Do not oppose.** It may be appropriate to review the dollar limitation on home improvement loans to persons meeting specified income limits. However, this type of change should be considered in the context of a general purpose of the mortgage revenue bond program, which is to provide housing to certain first-time homebuyers meeting income and purchase-price limits.

11. Qualified Veterans' Mortgage Bonds

Administration Position. **Do not support.** The qualified veterans' mortgage bond program continues to apply to only five States and to a limited class of veterans as a grandfather rule and it is not appropriate to further expand the program in this manner. Veterans' programs should apply uniformly across the nation. Veterans may be able to qualify for mortgages supported by tax-exempt mortgage revenue bonds or mortgage credit certificates.

12. Modification of Exception to Bank Interest Deduction Disallowance for Qualified 501(c)(3) Bonds

Administration Position. **Oppose.** This proposal would have significant revenue cost. This change effectively increases the $10 million small issuer limit by removing a significant category

of bonds from its coverage. In addition, by providing every 501(c)(3) organization with its own annual $5 million limit, the applicability and complexity of the small issuer rule would be increased substantially.

13. Qualified Small-Issue Bonds

Administration Position. **Do not support.** The small-issue bond provisions were extended permanently to provide a benefit targeted to small manufacturing businesses. This change is a significant increase in the ability of larger business to benefit from tax-exempt bonds.

14. Repeal Student Loan Marketing Association's Exception to the Rule Disallowing Interest Deductions on Debt Used to Acquire or Carry Investments in Tax-Exempt Bonds

Administration Position. **Support.** The Administration believes that it is appropriate to provide a transition rule for interest deductions during the period of time that the Student Loan Marketing Association moves toward either privatization or dissolution.

DD. TAX RETURN CHECKOFF

1. Permit Individual Tax Return Checkoff for U.S. Olympic Trust Fund

Administration Position. **Oppose.** Regardless of how meritorious the beneficiary of any voluntary checkoff on a tax return, such proposals add complexity to the return, result in confusion, and impose significant administrative burdens.

2. Permit Individual Tax Return Checkoff for Deficit Reduction

Administration Position. **Oppose.** This Administration has a strong commitment to deficit reduction. Nevertheless, this particular proposal would add complexity to the return, result in confusion, and impose significant administrative burdens.

EE. TRUSTS AND ESTATES

1. Income Tax Rates Applicable To Trusts and Estates

Administration Position. **Oppose.** These proposals reduce the income tax rates applicable to all (H.R. 329) or certain (H.R. 960) trusts. The tax rate brackets applicable to trusts were compressed in 1986. We believe that the present tax-rate schedule for trusts is appropriate, and we would consider a change to this schedule only in the context of a complete overhaul of the income taxation of trusts and estates.

FF. OTHER

1. Allow Nonprofit Educational Foundations to Sell U.S. Savings Bonds

Administration Position. **Oppose.** Although the Administration strongly supports efforts to make it easier for individuals to save and invest, the proposal to allow nonprofit educational foundations to be agents for the sale of U.S. savings bonds would increase risks and expenses to investors and to the Treasury, and likely would not result in additional investments in savings bonds. In addition, changing the prohibition against the use by private parties of the words "United States Savings Bonds" in advertising or solicitations would inhibit Treasury's efforts to stop deceptive advertising and solicitation practices. The

Treasury is developing guidelines for appropriate and acceptable uses of the words "United States Savings Bonds" by private parties.

II. POSSIBLE MODIFICATIONS TO SIMPLIFICATION PROVISIONS CONTAINED IN H.R. 3419 (103RD CONGRESS)

1. Provisions Relating to Individuals

(a). Permit Payment of Taxes by Credit Card

Administration Position. **Support.** Clarifying that the fees that may be imposed for using a credit card to pay federal taxes could not be borne by the federal government would improve this provision.

(b). Election by Parent to Claim Unearned Income of Certain Children on Parent's Return

Administration Position. **Do not oppose deletion.** Because this provision of H.R. 3419 was included in H.R. 1215, as passed by the House of Representatives, the Administration does not oppose deleting the provision from this tax simplification package.

(c). Expanded Access to Simplified Income Tax Returns

Administration Position. **Support deletion.** Section 116 of H.R. 3419 required the Commissioner to study ways to expand access to simplified individual income tax returns, including permitting itemizers to use Form 1040A and removing or raising the taxable income limitations on use of Form 1040A, and to submit a report discussing such actions. Since the Service is already working on such a study, this provision is unnecessary, and Treasury supports deleting this proposal from the simplification package.

2. Pension Simplification

(a). Tax-Exempt Organizations Eligible under Section 401(k)

Administration Position. **Oppose.** This proposal would impose a restriction on tax-exempt organizations that is not imposed on for-profit employers. For-profit employers are allowed to provide a nonqualified deferred compensation plan in addition to a broad-based section 401(k) plan. Restricting the ability of tax-exempt organizations to do the same would be contrary to the spirit of the basic provision (i.e., allowing tax-exempt organizations to maintain 401(k) plans), which is to put for-profits and tax-exempt organizations on an equal footing. In addition, the section 457 dollar limit (generally $7,500) for any individual is offset dollar for dollar by elective deferrals made by the individual to a 401(k) plan. Therefore, the benefits that are provided under a 457 plan to an employee who also participates in a 401(k) plan are already restricted.

(b). Nondiscrimination Rules for Qualified Cash or Deferred Arrangements and Matching Contributions

Administration Position. We support the Administration's proposal to provide a new simpler plan for small employers instead of modifying the SARSEP rules. We believe that one of the reasons SARSEPs have not been more widely used is that they do not allow employers to match employee deferrals. The extension of the 401(k) safe harbors to SARSEPs would presumably allow matching contributions to be used under a SARSEP as an incentive to induce employees to make elective contributions. We believe that nondiscrimination safe harbors (and the ability to have matching contributions) would be a significant improvement to SARSEPs. However, under the proposal, the matching contribution safe harbor would not appear to be a meaningful option for the many

SARSEPs that are top-heavy and therefore required to provide a 3 percent minimum nonelective employer contribution for all nonkey employees. At the same time, if no employer contribution is required for employees who do not elect to make salary reduction contributions, the matching contribution safe harbor currently proposed will not do enough to promote meaningful contributions for nonhighly compensated employees.

Instead of simply modifying the SARSEP provisions, the Administration has proposed a new, simple plan for small employers, known as the National Employee Savings Trust, or NEST. The NEST provides for design-based safe harbors that are almost identical to the safe harbors proposed in H.R. 3419, except that the NEST safe harbors exempt the employer from the top-heavy rules while also providing for a 1 percent nonelective employer contribution as part of the matching contribution safe harbor.

(c). Full-Funding Limitation of Multiemployer Plans

Administration Position. **Oppose deletion.** H.R. 3419 proposed to repeal the 150 percent limitation on deductible contributions for multiemployer plans and to allow triennial actuarial valuations (rather than annual valuations) for these plans. Consistent with the Administration's pension simplification proposal, we oppose the current proposal to delete these provisions from H.R. 3419. The 150 percent limit is intended to limit the extent to which an employer can deduct contributions to a defined benefit plan for liabilities that have not yet accrued. However, an employer has little, if any, incentive to make "excess" contributions to a multiemployer plan. The amount an employer contributes to a multiemployer plan is fixed by the collective bargaining agreement, and a particular employer's contributions are not set aside to pay benefits solely to the employees of that employer. Without the 150 percent limit, annual actuarial valuations are unnecessary and overly burdensome. Therefore, we believe that triennial valuations should be allowed for multiemployer plans if the 150 percent limit is repealed.

(d). Alternative Full-Funding Limitation

Administration Position. **Support deletion.** While we recognize that the OBRA 1987 full funding limitation has the effect of limiting pension plan funding for plans with liability that is heavily weighted towards younger employees, we believe that a narrow rule eliminating the effect of the OBRA 1987 change for a few employers is inappropriate. Furthermore, this proposal requires an offsetting adjustment to the 150 percent full funding limit to maintain revenue neutrality. This adjustment will be difficult to determine on an annual basis and will subject the employers affected by the adjustment to uncertainty.

(e). Special Rules for Plans Covering Pilots

Administration Position. **Support deletion.** We do not believe that an extension of the current exception for pilots to nonunionized pilots is warranted.

(f). Treatment of Employer Reversions Required by Contract to be Paid to the United States

Administration Position. **Oppose deletion.** The excise tax is intended to apply to reversions received by employers. Accordingly, it is inappropriate to impose the excise tax on the portion of a reversion that must be paid by a government contractor to the United States. The President's pension simplification proposal includes a provision excluding these reversions from excise tax.

(g). Continuation Health Coverage for Employees of Failed Financial Institutions

Administration Position. **Do not oppose deletion.** The primary motivation for including this provision in H.R. 3419 is now moot.

(h). Clarify Relationship Between Community Property Rights and Retirement Benefits

Administration Position. While the scope of the provision as described is unclear, the Administration generally supports clarification of the relationship between community property rights and retirement benefits. The Administration generally supports, with technical modifications, the proposal (described in the June 16, 1993 Joint Committee on Taxation Description of Miscellaneous Tax Proposals (JCS-8-93) at 71-72) to clarify the availability of the marital deduction where the non-participant spouse in a community property State predeceases the participant spouse.

3. Treatment of Large Partnerships

(a). Simplified Flow Through for Large Partnerships

Administration Position. **Oppose deletion.** The Administration opposes the suggestion of deleting the provisions that would modify the tax treatment of large partnerships and reduce the number of items that must be separately reported to the partners. The Administration would be happy to work with the Committee to devise any revisions that may be needed to provide more simplified flow through treatment for large partnerships.

(b). Simplified Audit Procedures for Large Partnerships

Administration Position. **Oppose deletion.** The Administration opposes the suggestion of deleting the provisions providing simplified audit procedure for large partnerships. The new audit system created by these provisions would improve the IRS's ability to audit large partnerships in a timely and efficient manner. The Administration would be happy to work with the Committee to devise any revisions that may be needed to provide more efficient audit procedures for large partnerships.

(c). Partnership Returns on Magnetic Media

Administration Position. **Support.** The Administration supports requiring magnetic media reporting for large partnerships and other partnerships with more than 250 partners. The Administration also supports the provision of H.R. 3419 that would provide the IRS with authority to require magnetic media reporting for large partnerships. Magnetic media reporting would assist the IRS in auditing large partnerships in a timely and efficient manner.

4. Foreign Provisions

(a). Deferral of Tax on Income Earned through Foreign Corporations and Exceptions to Deferral

Administration Position. **Support foreign simplification efforts.** The Administration supports meaningful simplification of the foreign provisions of the Code to the extent permitted by budgetary constraints. We would be pleased to work with the Committee to further develop simplification proposals.

5. Provisions Relating to Regulated Investment Companies

(a). Require Brokers and Mutual Funds to Report Basis to Customers

Administration Position. **Support deletion.** Because we understand that much of the industry is now voluntarily reporting basis to shareholders, we support deleting the mandatory reporting requirement in H.R. 3419.

6. Tax-Exempt Bond Provisions

(a). Clarification of Definition of "Investment-Type Property"

Administration Position. **Support deletion.** This issue was clarified in Treasury regulations.

7. Administrative Provisions

(a). Administrative Practice and Procedural Simplification

Administration Position. **Do not oppose deletion.** H.R. 3419 included nine provisions modifying administrative practice and procedure. Because these provisions are presently being considered separately in connection with the Taxpayer Bill of Rights proposals, Treasury does not oppose deleting these provisions from this simplification package.

8. Estate and Gift Tax Provisions

(a). Statute of Limitations Applicable To Valuation of Gifts

Administration Position. **Do not support.** The proposal as described appears too broad. It requires additional study to ascertain its administrative costs as well as its estimated revenue loss.

9. Other Provisions

(a). Treatment of Pre-Need Funeral Trusts

Administration position. **Oppose.** When trust income is distributed to the provider, it is taxable as a payment for services or merchandise, regardless of its original character to the trust. If the provider were treated as the owner of the trust, then trust income distributed as a payment for services or merchandise could escape tax, depending on the nature of the trust corpus. In addition, the proposed amendment would inappropriately allow purchasers and providers of a pre-need funeral to choose which party will bear the tax burden with respect to the income earned by the trust.

Statement of

AMERICAN VINTNERS ASSOCIATION

by Robert G. Kalik
President

Submitted for the

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

July 13, 1995

Introduction

Chairman Archer and Members of the Committee, my name is Robert G. Kalik, and I am President of the American Vintners Association ("AVA"), the national trade association of American wineries with a membership of over 450 wineries in 38 states.

I very much appreciate the opportunity to submit testimony concerning a proposal which would clarify the application of the uniform capitalization rules to certain agricultural crop losses.

The proposal to allow current deductibility of the costs incurred for replanting necessitated by casualty damage, including both weather and pest related damage, for any edible crop for human consumption, is necessitated by an overly restrictive IRS position disallowing full expensing of the costs of replanting. The IRS position appears to be at odds with both the plain language of section 263A(d)(2)(A) of the Internal Revenue Code ("Code") and an explanation of legislative intent behind the adoption of this language as expressed in a 9/29/92 colloquy on the floor of the United States Senate between Senator Robert Packwood and then Finance Committee Chairman Lloyd Bentsen. Senator Packwood's comments were particularly relevant because he was the Finance Committee Chairman in 1986, the year section 263A was enacted. The proposed legislation would assure that the IRS will administer section 263A(d)(2)(A) as originally intended by the Congress when it passed the Tax Reform Act of 1986.

The Current Conflict of Interpretation

The plain language of section 263A(d)(2) is seemingly beyond dispute. It states, in part: "this section shall not apply to **any** costs of the taxpayer of replanting plants bearing the same type of crop (emphasis supplied)."

Unfortunately, the Internal Revenue Service ("IRS") has chosen to give the provision a narrow interpretation. Under their interpretation, expenses required for replanting after natural disasters is limited to only preproductive period expenses. Such an interpretation thwarts the intent of Congress, as evidenced by the plain meaning of the provision, and impedes the efficient restoration of damaged farmlands, the central purpose of this provision.

Specifically, the IRS takes the position not all costs of replanting costs are exempt. Some costs should be capitalized rather than exempt from the provisions. Under IRS interpretation capitalized replanting costs include, for vineyards, (1) the engineering and design of the new vineyard (2) preparation of the land for replanting, (3) including fumigation, (4) purchase of vines, irrigation equipment and trellis system, (5) planting and installation costs, and (6) the grafting of scions onto appropriate rootstock.

We believe that this interpretation conflicts with congressional intent and the plain meaning of section 263A(d)(2)(A). First, the legislative history indicates that Congress intended section 263A to be the exclusive capitalization rule for farming businesses expenditures. Congress enacted section 263A as part of the Tax Reform Act of 1986 ("TRA") in response to its concern that different capitalization rules were being applied depending upon the nature and intended use of property. Section 263A provided a single, comprehensive set of capitalization rules. (See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 4, 1987), at 508-509.)

Congress also intentionally applied the new capitalization rules to farming businesses. The Senate's version of the 1986 TRA provision exempted farming businesses from the new capitalization rules, but the conference agreement followed the House provision which applied the new rules to farming businesses. (See H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., vol. II, at 113-114 (1986).)

The legislative history also indicates that Congress intended that the agricultural casualty loss exemption of section 263A apply broadly to the deductibility of all replanting costs, through section 263A(d)(2)(A). When section 263A was enacted in 1986, Congress repealed the former casualty loss provision contained in section 278©. Former section 278© had allowed a farming business to deduct replanting "amounts allowable as deductions (without regard to section 278)." However, reflecting a concern that section 278© was too narrowly drawn and restricted a farmer's ability to restore a vineyard to its original condition, Congress expanded the application of the loss provision when it enacted section 263A(d)(2)(A). Consistent with this belief that additional relief was needed, Congress modified the language of section 263A(d)(2) to exempt more broadly "*any costs*" associated with replanting under this code section. Moreover, the House report states that the loss exemption is for costs attributable to replanting, cultivation, maintenance, and development. This definition is much broader than merely costs incurred during the preproductive period (See H R. Conf. Rep. No. 99-841, at 113.)

The September 1992 colloquy on the floor of the United States Senate between Senator Robert Packwood and then-Finance Chairman Lloyd Bentsen also revealed the congressional intent with respect to section 263A. Senator Packwood's comments were particularly relevant because he was the Finance Committee Chairman in 1986, the year section 263A was enacted. In this colloquy, Senator Bentsen cited natural disasters like Hurricanes Andrew and Iniki, which destroyed crops in Florida and Hawaii, respectively, as well as the phylloxera infestation of Oregon, Washington, and California. The Senator also noted that the costs of replanting and the resulting lost production could cost $1 billion in Napa and Sonoma counties alone, and that such costs could force some wineries into bankruptcy.

Senator Bentsen asked Senator Packwood whether Congress intended section 263A(d)(2)'s exception to apply to "all costs otherwise subject to the capitalization requirements in section 263A or section 263 if section 263A did not apply?" Senator Packwood responded:

> Yes; it is. The exception to section 263A contained in paragraph (d)(2) of that section is intended to apply to all costs otherwise subject to 263A, or section 263 if section 263A does not apply, incurred as a result of freezing temperatures, disease, drought, pests, or casualty. The provision is intended to permit all replanting costs, not just preproductive costs associated with restoring orchards or groves to their original condition to be deductible.
>
> * * *
>
> [I]n the case of vineyards destroyed by phylloxera B, preproductive costs, costs such as replacement vines, replanting of rootstocks, the purchase of trellis and drain tile and irrigation equipment solely to replace equipment, the removal of which was necessitated by the infestation, and the costs of land preparation, would all be deductible under this exception.
>
> * * *
>
> Of course, since it was the intention of this exception to place a taxpayer in the same position as before the loss occurred, we would assume the IRS would not permit a taxpayer to upgrade the vineyard, grove or orchard . . . Similarly, we should also assume the IRS will prevent a double deduction from occurring under section 165(m).
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> 138 CONG. REC. S15593-15594 (daily ed. September 29, 1992) (statements of Sens. Packwood and Bentsen).

The Solution: Clarification through Amendment

Because the IRS is insisting on a narrow interpretation of the section's exemption, a legislative clarification has been proposed. The proposed amendment states that the exemption applies to all preproductive period costs and 80 percent of all other costs of a taxpayer incurred by replanting plants destroyed by freezing temperatures, disease, drought, pests, or casualty.

The 80 percent rule is proposed to equitably deal with the fact that under certain circumstances, replanting of a grove, orchard or vineyard may, benefit a business beyond what is necessary to restore the affected property to the condition it was in prior to the destruction. Nevertheless, the rule recognizes that a substantial portion of the replanting costs should be deductible in accord with the intent of Congress. The 80 percent rule would simplify administration of the tax law in this area. The amendment also retains full deductibility of preproductive expenses, which has never been contested by the IRS.

To avoid the double deduction to which Senator Packwood alluded in his colloquy, the proposed amendment would also redesignate subsection (m) of Section 165 as subsection (n) and insert new language which bars section 165 deductions where the costs of replanting are deducted under section 263A(d)(2)(A).

We believe that these proposed amendments would eliminate the confusion surrounding section 263A(d)(2), in a way which recognizes the original intent of Congress when the provision was enacted in 1986.

The Costs Inflicted by Phylloxera and Frostkill

Among other agricultural growers, vintners whose vineyards are infested with phylloxera or have suffered severe frost damage known as "frostkill" would be helped by this provision. Phylloxera is an aphid-like louse which cannot be combated by conventional pesticide methods; only the complete removal of the infested vineyards, including irrigation equipment, drain tiles, and trellis systems, followed by the fumigation and replanting of root stocks resistant to the pest, can remedy an infestation. Frostkill is a serious problem in the wine growing regions of New York, Pennsylvania, Ohio, Michigan, Missouri and Arkansas. Frostkill leads to seriously weakened vines that become extremely susceptible to disease and infestation. For example, as a result of recent severe weather in Missouri, Stone Hill Winery, the largest winery in the state, has been forced to remove an entire vineyard. There are numerous other examples of similar weather problems in other states. Whether the damage is caused by phylloxera, frostkill, or other grape related disease, the vines and roots cannot be removed without the elimination of related improvements, since the irrigation equipment, trellis systems, and drain tiles are completely intertwined with the vines.

By clarifying existing law, this amendment would greatly facilitate financing of replanting by grape growers in California, New York, Oregon, Missouri, Michigan, Ohio, Pennsylvania, Washington and other states who occasionally must shoulder huge and unexpected financial expenses because of plants lost by virtue of a natural disaster.

Mr. Chairman, on behalf of the American Vintners Association, and the entire wine industry, I thank you and the entire Committee for the opportunity to testify on the proposed amendment to clarify Internal Revenue Code section 263A(d)(2). I would be pleased to answer any questions you may have.

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
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July 14, 1995

The Honorable Bill Archer
Chairman
Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

The Associated General Contractors of America (AGC) is a national trade association of more than 33,000 firms, including 8,000 of America's leading general contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, waste treatment facilities, dams, water conservation projects, and defense facilities.

AGC applauds your efforts to address and, it is our hope, to correct numerous problems with the current tax system. For this reason, AGC welcomes the opportunity to provide this statement of support to the House Ways and Means Committee regarding the proposal to eliminate the lookback method of accounting for non-residential construction contractors.

The lookback method, which was added by the 1986 tax act, requires a construction contractor to file a completely new tax return for every contract that is subject to lookback in the year the contract is completed and to refile it in subsequent years if income or costs in the contract change. In the year a long-term construction contract is completed, the construction firm must go back and substitute for each year the contract was in progress the <u>actual</u> costs and revenues for the <u>estimated</u> costs and revenues used in the prior years tax computations. Then taxes for all prior years must be recalculated for both regular and alternative minimum tax purposes. Next, the difference between the taxes actually paid each year and the taxes that would have been paid must be calculated. Finally, daily compounded interest subject to rate change on quarterly basis must be completed on that difference. The construction contractor then either pays interest to or receives interest from the government.

AGC believes that repealing the lookback method of accounting for nonresidential construction contracts is an excellent way to simplify the tax code for several reasons.

- First, the complexity and lack of knowledge of the lookback method causes unneeded disputes.
- Second, the lookback rule costs far more for taxpayers to comply with than the revenue it produces for the federal government. It imposes a tremendous accounting burden on construction contractors, because of the thousand of calculations that are required.
- Third, it is AGC's experience that nine out of ten times the lookback method is either a revenue loser or revenue neutral for the federal government.

AGC is fully convinced that there is no purpose, fiscal or regulatory, that the lookback method of accounting serves in relation to nonresidential construction contractors. Now is the time to repeal this expensive and senseless tax burden. AGC looks forward to working with the Ways and Means Committee on this very important issue.

Sincerely,

Stephen E. Sandherr
Executive Director
Congressional Relations

TESTIMONY OF

THE CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

REGARDING CERTAIN MISCELLANEOUS TAX PROPOSALS

BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

JULY 11, 1995

[written testimony submitted for the record]

Mr. Chairman and members of the Committee:

The Construction Financial Management Association (CFMA) is pleased to comment on two of the accounting proposals among the numerous miscellaneous tax proposals currently before the Ways and Means Committee: (1) allowing certain contractors to use the cash method of accounting; and (2) elimination of the "look-back" method of accounting for nonresidential construction contracts.

CFMA represents more than 5,500 financial managers in the construction business. Our members are employed by over 2,500 construction companies across the U.S. More than one-third of them have gross annual revenue ranging from $25-99 million.

Federal tax policy plays an important role in the continued growth and profitability of the construction industry. If enacted, the proposals to eliminate the look-back method of accounting and to assure entitlement to the cash method of accounting for certain construction concerns would positively affect how we do business. We commend Chairman Archer and the Committee for its leadership in raising these issues, and we appreciate the opportunity to comment.

CASH METHOD OF ACCOUNTING

The cash receipts and disbursement method of accounting is specifically listed in section 446(c) as a permissible overall method of accounting. Congress has limited this general rule by enacting specific Internal Revenue Code provisions that preclude the use of the cash method by certain taxpayers. For example, section 448 prohibits the use of the cash method for large C corporations, large partnerships that have a C corporation as a partner, and tax shelters. A partnership or a C corporation is considered large if the three year average annual gross receipts of the company exceed $5,000,000.

In the legislative history to section 448, Congress specifically stated that it believed that small businesses should be allowed to continue to use the cash method.[1] In addition to Congress' explicit statements in the legislative history, the definition contained in code section 448 itself indicates that small businesses were to be exempted from the prohibition on the use of the cash method. A partnership or a C corporation that is not considered large because its three year average annual gross receipts do not exceed $5,000,000 is not subject to section 448, and thus is not prohibited from using the cash method by this section. It is logical to conclude that Congress intended that a partnership or C corporation that was not considered large was one type of small business that Congress referred to in the legislative history when Congress directed that small business should be allowed to continue to use the cash method.

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[1] House Ways and Means Committee Report to H.R. 3838, the *Tax Reform Act of 1985* (H.Rept. 99-426), pg. 605, December 7, 1985.

IRS Actions

Despite the clear directive in section 448's legislative history that small businesses were to be allowed to continue to use the cash method, the Internal Revenue Service has continually challenged the use of the cash method by small businesses. The Tax Court in a recent case held that the IRS abused its discretion when it attempted to deny the use of the cash method to a C corporation that was not considered large because its three year average annual gross receipts did not exceed $5,000,000. In the case, Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. No. 17 (1995), the company and the IRS agreed that the company was not subject to Section 448. However, the IRS believed that the company's use of the cash method of accounting did not clearly reflect income.

The IRS proposed to put the company on the method of accounting that the IRS believed would clearly reflect income: the percentage-of-completion method. The court disagreed with the IRS, and held that the company was entitled to use the cash method. The court noted that the following factors weighed heavily in its decision: (1) the company did not maintain an inventory; (2) the company consistently used the cash method since its incorporation; and (3) the company made no attempt to unreasonably prepay expenses or defer the recognition of income.

It appears that the IRS will continue its challenges to the use of the cash method by small contractors.

IRS Ruling

In the recently released Technical Advice Memorandum PLR 9524001 (June 1995), the IRS concluded that a contractor's materials are "inventory" for tax purposes, thus requiring the use of the accrual method. The IRS reached this conclusion based on the grounds that merchandise was an income producing factor requiring the use of inventories, and because the cash method did not clearly reflect income.

Although it is hoped that the Ansley decision would deter the IRS from challenging the use of the cash method based upon the "clear reflection of income" doctrine, PLR 9524001 indicates that the Service will continue its negative view of this method of accounting.

Proposal

The proposal currently before the Committee would clarify that a "qualified" contractor who meets a $5 million gross receipts test may use the cash method of accounting. A "qualified" contractor would be one who:

- performs services pursuant to a contract;
- does not take title or have other indicia of ownership with respect to the subject matter of the contract; and
- for whom the provision of services, rather than the sale of merchandise, is a material income-producing factor under the contract.

The proposal would be effective for taxable years beginning after December 31, 1985.[2]

Suggested Modification

It is respectfully suggested that the third element of this definition be clarified by adding language to the legislative history to indicate that for purposes of determining whether the provision of services is a material income-producing factor, "merchandise" does not include the sale of materials that result in the construction of improvements to real property. This clarification

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[2] *Description of Miscellaneous Tax Proposals* (JCS-19-95), Joint Committee on Taxation, pg. 17, July 10, 1995.

would be in accordance with case law that holds that real property is not subject to inventory accounting rules.[3]

Although some case law authority has held that construction industry activities are subject to the inventory accounting rules of section 471, this case law should be limited to its particular facts.[4]

Benefits of Proposed Changes

The cash method is beneficial to the construction industry since it is the most simple method, and imposes the least burden to meet Federal income tax filing requirements.

REPEAL OF THE LOOK-BACK METHOD

The Tax Reform Act of 1986 instituted the use of the "look-back" rule for long-term contracts using the percentage of completion method (PCM) of accounting. Under PCM accounting, contract costs and revenues are determined by estimated, rather than the actual figures. When the contract is completed, the look-back method is applied to substitute actual costs and revenues used in the prior years' PCM computations. Upon completion of these substitutions and computations, the taxpayer is either compensated for overestimating the taxes that were due or assessed taxes in cases where the taxpayer underestimated taxes due.

Problems Facing The Construction Industry

Under the present percentage of completion method, companies are required to make a good faith estimate of their total contract revenue and total contract costs. The look-back rule acts as a backstop to imprecise estimates, and requires that the taxpayers and the IRS to correct any imprecision in the estimates in the year the contract is actually completed. The application of the look-back rule may result in a company owing additional amounts to the IRS if it "underpaid" its taxes in the early part of a contract due to the imprecision of its estimates. Or, application of the rule may result in the IRS owing the company additional amounts if the company "overpaid" its taxes in the early part of the contract. The extreme complexity added by the look-back rule is not justified in light of the relatively insignificant "true up" that results from it.

The repeal of the look-back rule is appropriate since it imposes a heavy compliance burden on contractors in that it requires them to make complex calculations to recompute completely their Federal income tax liability to achieve the usually small "true up" of the cost of either "underpaying" or "overpaying" their taxes in the early part of a contract. It is respectfully suggested that the look back method is an example of unnecessary complexity in the Internal Revenue Code that is created by attempting to reach a technically "perfect" result. A much more beneficial policy is a simpler system that achieves "rough justice." A simpler tax code and "rough justice" will be achieved through repeal of the look-back method as provided in the proposed legislation.

Proposal

The proposal would eliminate the look-back method with respect to nonresidential construction contracts, and would be effective for contracts completed in taxable years ending after date of enactment.

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[3] W.C. and A.N. Miller Development Co. v. Commissioner, 81 T.C. 619 (1983).

[4] Thompson Electric, Inc. v. Commissioner, T.C. Memo. 1995-292 (electrical supplies); J.P. Sheahan Associates, Inc. v. Commissioner, T.C. Memo 1992-239 (roofing materials); Independent Contractors, Inc. v. United States, 73 A.F.T.R.2d Par. 94-677; 94-1 USTC Par. 50,135 (N.D. Ala. 1994) (Heating, ventilating, and air conditioning (HVAC) systems).

Reasons Why Repeal Of Look-Back Is Necessary

Significant Compliance Costs: The cost to contractors in time and money to compute required look-back calculations is significant. Thousands of look-back calculations are often necessary. The use of the PCM method is burdensome enough without the added effort expended on "look-back".

Companies in AMT Still Affected: An exception for small construction contracts from PCM does exist but its impact is minimal. To qualify, a contract must be completed within two years and be performed by a taxpayer with average annual gross receipts that do not exceed $10 million. However, if the contractor is subjected to the Alternative Minimum Tax (AMT), then the PCM computations are required.

Current Exceptions Are Insufficient: The current de minimis rule, which exempts from the look-back method contracts completed within two tax years where the contract price does not exceed the lesser of: $1 million, or one percent of average gross receipts for the three preceding taxable years, is too narrow to be effective. Most long-term contracts are generally larger than one percent of gross receipts.

For example, if a contractor had gross receipts of $8,000,000, only contracts under $80,000 that were completed in less than 2 years would not be subject to the look-back method. Thus, the de minimis exception to the look-back method exempts very few contracts.

Not Applicable to Construction Industry: When the look-back rule was instituted in 1986, Congress believed that the completed contract method of accounting for long-term contracts permitted unwarranted use of deferral of income from those contracts.[5]

Congress reasoned that requiring the taxpayer to estimate costs and revenues and then to "look-back" after the contract was complete to calculate the actual amounts would limit this abuse. In reality, what has resulted is a complex and burdensome reporting system requiring innumerable computations that construction contractors must comply with.

CONCLUSION

These two miscellaneous tax proposals would greatly relieve some of the tax compliance burdens on the construction industry. As the recent IRS private letter ruling indicates, the Service will continue to attempt to require construction contractors to use the accrual method of accounting. Clarifying Congress' original intent in determining situations when contractors can use the cash method of accounting would provide tremendous relief. In addition, repeal of the look-back rule would eliminate some of the numerous computations and time-consuming paperwork requirements that are currently demanded of contractors.

CFMA appreciates the opportunity to comment on these proposals and looks forward to working with the Committee to alleviate some of the debilitating burdens facing construction contractors.

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[5] *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), Joint Committee on Taxation. pg. 527, May 4, 1987.

Statement of the
National Association of Regulatory Utility Commissioners
for the
Committee on Ways and Means
on
Repeal of the Tax on Contributions in Aid of Construction
July 12, 1995

Dear Mr. Chairman and Members of the Committee:

The National Association of Regulatory Utility Commissioners (NARUC) appreciates the opportunity to comment on the miscellaneous tax reform measure being considered by this committee. The NARUC is a quasi-governmental non-profit organization of the governmental agencies engaged in the regulation of public utilities located in all fifty States, the District of Columbia, Puerto Rico and the Virgin Islands. The organization's primary objective is to serve the consumer by seeking ways to improve the quality and effectiveness of public regulation in America.

The NARUC urges the Committee to include in the legislation being considered a provision that would repeal the tax on Contributions in Aid of Construction (CIAC). Earlier this year, Representative Nancy Johnson introduced a bill (H.R. 957) to achieve this objective. The NARUC believes including this proposal in the tax measure will increase the accessibility of reliable drinking water to utility ratepayers; reduce the burden on small, troubled water systems; and increase service quality.

Since enactment of the Tax Reform Act of 1986, State regulators in general have permitted water companies to collect through rates from homebuilders, small local governments, and individuals the amount equal to the Federal tax liability associated with the tax on CIAC. Because upfront collection of the amounts equal to these taxes are also subject to income taxation, State regulators also permit water companies to collect amounts equal to these additional taxes.

What is a "Contribution in Aid of Construction"?

Water suppliers, like all utilities, are capital intensive businesses. Historically, they have received capital for the construction of a utility extension directly from the customer (typically a homebuilder, although public school systems, local governmental agencies or individual homeowners also contribute such capital). The customer contributes this capital (e.g., property or a cash equivalent) to the utility. This practice eliminates the need for utilities to spread additional borrowing costs in the form of rate increases to the existing customer base, who have already paid, and continue to pay, for the infrastructure they use. State regulators of these utilities work to avoid shouldering existing ratepayers with the burden associated with bringing new customers on-line. It is primarily for this reason that State commissions generally require private and investor-owned water and sewer utilities to collect upfront from the entity making the contribution any taxes or fees associated with the extension of the new service.

How Did This Tax Evolve?

Prior to enactment of the Tax Reform Act of 1986, CIAC was not considered as gross income of a private or investor-owned utility and, therefore, not subject to Federal income tax. Moreover, utilities were not permitted to profit from CIAC, nor could they benefit from tax depreciation or investment tax credits on CIAC.

The Tax Reform Act of 1986 repealed section 118(b) of the Internal Revenue Code, thereby subjecting CIAC to tax as gross income. This "reform" was included in the 1986 tax measure without the benefit of hearings and strictly as a means to raise revenue.

Negative Consequences Associated With the CIAC Tax

Several negative consequences have arisen as a result of this onerous tax, some of which reach all the way down to individual ratepayers. Estimates suggest that where utilities collect the CIAC tax upfront from the new customer contributing the capital or property, as much as $2,000 can be added to the cost of a new home In trying to avoid this tax, a new customer, in the case of a homebuilder, will often reduce or outright abandon a new housing project, having a depressing effect on the local economy. Another means of avoiding the tax is by connecting to a municipal utility. Because these utilities are not required to pay taxes at all, the net effect is a further erosion on the respective community's potential tax base and economic vitality. Last but not least, a new customer may opt to develop a new separate water system to avoid the CIAC tax. Therefore, the CIAC tax has the effect of preventing water system consolidations, which runs contrary to the Environmental Protection Agency's (EPA) stated goal of increasing small water system consolidations to improve water service reliability and quality while ensuring compliance with the Safe Drinking Water Act.

How H.R. 957 Resolves the Revenue Implications of a CIAC Tax Repeal

As stated earlier, H.R. 957 seeks to restore the pre-1986 tax treatment of CIAC to water and wastewater utilities. To offset the costs for restoring the pre-existing tax treatment, H.R. 957 would extend from 20 to 25 years the depreciable life of water utility property placed in service after the date of enactment of this measure, using straight-line depreciation methods rather than using the 150 percent declining balance method.

The congressional Joint Committee on Taxation has estimated repeal of the CIAC tax could reduce Federal revenues by $108 million over a period of five years. The extension of depreciation for CIAC property as proposed in H.R. 957 will, on the other hand, raise $140 million over the same period, resulting in a net gain of $32 million to the U.S. Treasury.

Conclusion

EPA estimates suggest that water utilities will need to spend nearly $50 billion from now until the year 2000 to comply with the Safe Drinking Water Act, as currently written. Ultimately, utility ratepayers and local governments will bear these additional costs. The NARUC is working with others to see that the Safe Drinking Water Act is amended in order to contain some of the Act's compliance costs while ensuring safe drinking water. Repealing the CIAC tax would be a good first step to relieve some of the burden facing private and investor-owned water utilities. By relieving water utilities from these costs in the shorter term, utility ratepayers would be benefitted in the longer term through increased utility restructuring and consolidation activities, which result in increased service efficiencies, reliability and quality.

In addition, the U.S. Treasury Department has stated that it is not opposed to repealing the CIAC tax. Furthermore, H.R. 957 as drafted would not deplete the U.S. Treasury of already scarce resources. Finally, a consortium of state regulators, water utilities, homebuilders, and realtors have supported such an approach.

To ensure that utility ratepayers enjoy reliable, high quality water service at affordable rates, the NARUC urges the Committee to enact legislation which includes provisions to repeal the tax on Contributions in Aid of Construction, and appreciates the opportunity to comment on the miscellaneous tax reform measure.

TESTIMONY OF THE NATIONAL ASSOCIATION OF WATER COMPANIES

The National Association of Water Companies (NAWC) would like to thank Chairman Archer for holding hearings on Miscellaneous Tax Reform provisions. As part of these reforms, we urge the committee on Ways and Means to act quickly on one such revenue neutral provision in particular, the repeal of the tax on Contributions in Aid of Construction as introduced in H.R. 957 by Representatives Johnson, Matsui, Jacobs, Kennelly, Herger, Neal, Thomas, Hancock, English, and Zimmer. Passage of this legislation will increase the public's access to safe reliable drinking water, decrease the number of small troubled water systems, and work to level the playing field between municipal and investor-owned water systems.

NAWC is the trade association representing the nation's investor-owned water utilities. Its more than 370 members in 41 states provide safe, reliable drinking water to more than 22 million Americans every day. Our members employ a combined work force in excess of 15,000 and have $9 billion invested in gross plant and equipment.

WHAT IS OUR CONCERN?

Since the enactment of the Tax Reform Act of 1986, most of our members have had to collect federal taxes from the builders of new homes, local governments, individuals and even the federal and state governments, for "Contributions in Aid of Construction" or CIAC. In addition, because the Internal Revenue Code treats collection of these up front taxes as taxable income to our members, our members often must also collect taxes on these taxes. This so-called "gross up" can result in the total taxes collected for Contributions in Aid of Construction equaling as much as 70 percent of the original contribution.

WHAT IS A "CONTRIBUTION IN AID OF CONSTRUCTION" OR CIAC?

Water suppliers, like all utilities, are capital intensive businesses. Historically, they have been advised by State Public Utility Commissions to obtain the capital for the construction of service extensions directly from the customer (typically a home builder, although it can be a public school, a government agency, or an individual homeowner). The customer contributes - or advances - this property, or a cash equivalent, to the utility.

It is important to keep in mind that privately owned water suppliers are regulated by State Public Utility Commissions. Almost all state commissions do not allow our members to earn a return for their stockholders from water and wastewater main extensions paid for by others. Also, with a few exceptions, state commissions require private and investor owned water and wastewater utilities to collect up-front from the entity paying the CIAC, any taxes or fees associated with the extension of new service.

WHY DO WE PAY TAXES ON CIAC?

Prior to enactment of the Tax Reform Act of 1986, the Internal Revenue Code exempted CIAC from the gross income of an investor-owned utility and CIAC therefore was not subject to federal income tax. In addition, utilities could not take tax depreciation or investment tax credits on CIAC.

The Tax Reform Act repealed section 118 (b) of the Internal Revenue Code and thus subjected CIAC to tax as gross income. This change was done at the time without the benefit of a hearing.

WHAT ARE THE NEGATIVE CONSEQUENCES OF TAXING CIAC?

The repercussions of this onerous tax are many and far reaching. For instance, it has been estimated that this tax can add as much as $2000 to the cost of a new home.

In order to circumvent this tax, new customers try to avoid doing business with an investor-owned water company. This, of course, creates a competitive disadvantage for investor-owned water systems and discourages privatization efforts.

Other negative aspects of this tax include:

A) Potential customers may either abandon or downsize new projects, with resultant depressing effects on the local economy.

B) Potential customers will seek connection to a municipal system - rather than an investor-owned system - which doesn't pay taxes at all, thereby reducing revenues to local, state and federal government entities.

C) New customers may build a new separate water system. This action is inconsistent with the Environmental Protection Agency's goal of discouraging the proliferation of small independent water systems, the very systems which are most often out of compliance with the Safe Drinking Water Act.

HOW DOES H.R. 957 SOLVE THIS PROBLEM AND HOW DOES IT OFFSET ANY LOST REVENUE TO THE FEDERAL GOVERNMENT?

H.R. 957 restores the pre-Tax Reform Act tax treatment of CIAC to water and waste-water utilities. H.R. 957 pays for restoration by extending the depreciable life of water utility property placed in service after enactment of the CIAC tax repeal from 20 years to 25 years using straight-line depreciation rather than the 150 percent declining balance method.

The Joint Committee on taxation has estimated repeal of the tax on CIAC will cost $108 million over five years. The extension of depreciation for water utility property is estimated to raise $140 million over five years, for a net gain to the Treasury of $32 million.

CONCLUSION

Tens of billions of dollars will be needed through the end of the century by America's water supply systems to comply with just the Safe Drinking Water Act. The growing cost pressure on localities dictates that increased privatization and access to private funds will be needed. The tax on Contributions in Aid of Construction unnecessarily discourages this much needed privatization, and ultimately only hurts the customers and taxpayers.

The Treasury Department has testified that it does not oppose this repeal. Further, the NAWC has worked closely with the staff of your committee to assure that every concern with the legislation has been addressed. The Senate has passed its version of this legislation twice in the past. Furthermore, the legislation would bring in $32 million over five years to the U.S. Treasury. The bill is supported by the National Association of Regulatory Utility Commissioners, the National Association of Home Builders, and the National Association of Realtors.

We urge the Committee on Ways and Means to adopt H.R. 957, legislation to repeal the tax on Contributions in Aid of Construction.

BRYN MAWR CAPITAL MANAGEMENT, INC.
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July 25, 1995

Mr. Phillip Mosely
Chief of Staff
House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on Proposed Mark-to-Market Regime for Investment Partnerships--for the Record of Miscellaneous Reform Hearings

Dear Mr. Mosely:

We understand that the Ways and Means Committee is considering proposed changes to the taxation of securities investment partnerships and their partners. In particular, we understand that the Committee may be considering an election to allow investment partnersips to mark their securities portfolio to market at year-end.

We are writing to express support for this proposal and to offer suggestions for coordination of the mark-to-market election with other rules in the Internal Revenue Code (the "Code"), in particular the wash sale rules of section 1091.[1] We believe that, without such coordination, the objectives intended by the Committee through the mark-to-market election would be undermined.

Investor and Tax Accounting Complexities

Bryn Mawr Capital, L.P., like most other funds of its type, essentially marks its portfolio to market each year when it reports its economic results to its investors. Unfortunately, because a mark-to-market election is not available for federal income tax accounting purposes, Bryn Mawr Capital, L.P. is effectively forced to keep two sets of books, one for investor reporting purposes and one for tax purposes. As one can imagine, the time and expense to comply with this dual reporting obligation is enormous.

The Wash Sale Rules

The wash sale rules present additional and unique complications. Section 1091 is designed to prevent investors from recognizing a loss with respect to a security if, within a period beginning 30 days before and ending 30 days after the disposition triggering the loss, the investor has acquired a substantially identical stock or security. The legislative intent behind the wash sale rule is discussed further below.

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[1] All section references are to the code unless otherwise indicated.

It is easy to imagine the complexity involved in tracking a substantial number of trades per year to determine compliance with the wash sale rule. In many cases Bryn Mawr Capital, L.P. must effectively shut down its trading in many securities for at least 31 days to avoid an enormous build-up in realized but unrecognizable losses because of the wash sale rule.

The Proposed Mark-to-Market Election

To eliminate some of the duplicate recordkeeping and reporting complexities discussed above for investment partnerships, we understand that the Committee is considering a mark-to-market election, enabling certain securities investment partnerships to effectively conform their investor reporting and tax reporting. While we have not seen any particular legislative proposals, we would imagine that the mark-to-market election would operate in a manner similar to the mark-to-market system applicable to regulated futures contracts under section 1256 and the mark-to-market regime applicable to dealers in securities under section 475.

We support this election as a means to simplify the complex accounting and tax reporting required for securities investment partnerships. Providing a mark-to-market election would be a logical extension of the mark-to-market rules.

While we have not undertaken to quantify the impact of the mark-to-market election, we believe that the election would be revenue neutral (or at least revenue "fair") because it would encourage investment partnerships to make the election for business reasons and thereby accelerate income into the mark-to-market year.

Guidance on taxpayer behavior with respect to a mark-to-market election can be seen in the other areas of the Code where a mark-to-market system has been suggested. For example, taxpayers have suggested a mark-to-market election to simplify reporting in the passive foreign investment company area. We believe that the number of recommendations for a mark-to-market system to simplify reporting and recordkeeping in a variety of areas in the Code is an indication that taxpayers would forego the tax benefits of deferral in order to realize the non-tax benefits of simpliying their books and records and reporting systems.

Impact of the Wash Sale Rules on a Mark-to-Market Election

We believe that if a mark-to-market system is proposed for certain securities investment partnerships, a "carve-out" or exemption from the wash sale rules would be necessary so that the benefits of the mark-to-market system are not unintentionally undermined. If the wash sale rule were to apply, tax and economic results could still differ significantly simply because the wash sale rule would trigger a deemed dispostion of the portfolio and require testing under the 61-day wash sale period.[2] This would be contrary to the objectives sought by the mark-to-market election in the first place. Accordingly, in order to achieve the goals desired by the mark-to-market election, we believe a carve-out would be necessary under which section 1091 would not apply to investment funds which have elected mark-to-market treatment.

Congress has provided a carve-out for section 1091 in other areas of the Code where a mark-to-market regime applies. For example, in 1993 when Congress enacted the mark-to-market requirement for securities dealers, it specifically precluded the operation of the wash sale rules.[3] Similarly, in making changes to the wash sale rules in the 1988 Act, Congress gave Treasury regulatory authority to

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[2] The section 1256 mark-to-market system treats the regulated futures contracts as having been sold for the purposes of Subtitle A of the Code.
[3] See section 475(d)(1).

provide exceptions to the wash sale rules for contracts subject to the section 1256 mark-to-market requirement.[4] Accordingly, we believe that a carve-out for the application of section 1091 when a mark-to-market system applies is appropriate and consistent with Congressional intent.

Moreover, the legislative intent behind section 1091 suggests that the rules were not intended to reach investment activity of the type engaged in here but instead were intended to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[5] This indicates that the wash sale rules were designed to prevent artifical crystallization of losses where a taxpayer did not effectively dispose of the underlying asset. When that intent is applied here, the need for and logic of the wash sale rule breaks down.

Conclusions

As discussed, we actively support the development of a mark-to-market election for securities investment partnerships. We believe this election would significantly simplify the reporting and recordkeeping requirements for these funds and eliminate many of the complex accounting procedures necessary to comply with the various :ode rules.

In connection with a mark-to-market election, we suggest that any such mark-to-market system include an exception to the application of the wash sale rules. Such a carve-out would enable the goals of the mark-to-market election to be achieved. Moreover, a carve-out for section 1091 would be consistent with legislative intent surrounding the wash sale rules.

Sincerely yours,

Kenneth B. Gray, Jr.
President
Bryn Mawr Capital Management, Inc.
(General Partner, Bryn Mawr Capital, L.P.)

[4] Conf. Comm. Rep., Statement of Managers, Pub. L. 100-647, Technical and Miscellaneous Revenue Act of 1938 (October 24, 1988).

[5] House Ways and Means Comm. Rep., Internal Revenue Bill of 1921, H.R. rep. No. 350, 67th Cong. 1st Sess. 10 (1921).

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July 26, 1995

House Committe on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Proposed Mark-to Market Method of Accounting for Securities

Dear Committee Member:

Included among the miscellaneous tax proposals scheduled for hearings before the Committee is one which would allow securities trading partnerships and corporations to elect the mark-to-market method of accounting for their actively traded property. We are writing to express our support for this proposal.

We are the general partner of a securities trading partnership. Like other funds of its type, we currently mark our portfolio to market for financial reporting purposes and for the determination of the economic value of our partners' capital accounts. However, except in the limited circumstances provided under the Internal Revenue Code (the "Code"), firms which are not dealers in securities are required to report income on the basis of historical cost in accordance with numerous complex and arcane rules. The result has been to create complex and duplicative recordkeeping which requires significant time and expense to maintain.

The election under this proposal automatically recognizes income on an economic basis in a simplified and more cost effective manner. This proposal, we believe, represents a logical extension of the mark-to-market rules which already exist under Code section 475. Integration of this elective treatment with the operative rules of Code section 475 and other related sections of the Code works toward the goals of tax simplification and uniformity.

The decision to make this election for eligible entities such as ours is a logical business one in that it reduces the burdensome and expensive recordkeeping requirements currently mandated by the Code. The tax impact to the treasury of this election is likely one of revenue neutrality. However, to the extent that it accelerates the recognition of unrealized capital gain income it would result in an increase in federal revenues.

We urge you to consider this proposal for inclusion in any pending tax legislation before the committee.

Feel free to contact me if I can be of assistance or provide further information regarding the importance of this issue.

Sincerely,

Eliot Goldberg

Eliot Goldberg
Vice President

GLENWOOD

Statement for the Record

House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Proposed Mark-to-Market Regime for Investment Partnerships

Dear Sir or Madam:

We understand that the Ways and Means Committee is considering proposed changes to the taxation of securities investment partnerships and their partners. In particular, we understand that the Committee may be considering an election to allow investment partnerships to mark their securities portfolio to market at year-end.

We are writing to express support for this proposal and to offer suggestions for coordination of the mark-to-market election with other rules in the Internal Revenue Code (the "Code"), in particular the wash sale rules of Section 1091.[1] We believe that, without such coordination, the objectives intended by the Committee through the mark-to-market election would be undermined.

Investor and Tax Accounting Complexities

Glenwood Partners L.P., like most other funds of its type, essentially marks its portfolio to market each year when it reports its economic results to its investors. Unfortunately, because a mark-to-market election is not available for federal income tax accounting purposes, Glenwood Partners L.P. is effectively forced to keep two sets of books, one for investor reporting purposes and one for tax purposes. As one can imagine, the time and expense to comply with this dual reporting obligation is enormous.

The Wash Sale Rules

The wash sale rules present additional and unique complications. Section 1091 is designed to prevent investors from recognizing a loss with respect to a security if, within a period beginning 30 days before and ending 30 days after the disposition triggering the loss, the investor has acquired a substantially identical stock or security. The legislative intent behind the wash sale rule is discussed further below.

It is easy to imagine the complexity involved in tracking a substantial number of trades per year to determine compliance with the wash sale rule. In many cases, partnerships in which we invest must effectively shut down their trading in many securities for at least 31 days to avoid an enormous build-up in realized but unrecognizable losses because of the wash sale rule.

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1 All section references are to the Code unless otherwise indicated.

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The Proposed Mark-to-Market Election

To eliminate some of the duplicate recordkeeping and reporting complexities discussed above for investment partnerships, we understand that the Committee is considering a mark-to-market election, enabling certain securities investment partnerships to effectively conform their investor reporting and tax reporting. While we have not seen any particular legislative proposals, we would imagine that the mark-to-market election would operate in a manner similar to the mark-to-market system applicable to regulated futures contracts under Section 1256 and the mark-to-market regime applicable to dealers in securities under Section 475.

We support this election as a means to simplify the complex accounting and tax reporting required for securities investment partnerships. Providing a mark-to-market election would be a logical extension of the mark-to-market rules.

While we have not undertaken to quantify the impact of the mark-to-market election, we believe that the election would be revenue neutral (or at least revenue "fair") because it would encourage investment partnerships to make the election for business reasons and thereby accelerate income into the mark-to-market year.

Guidance on taxpayer behavior with respect to a mark-to-market election can be seen in the other areas of the Code where a mark-to-market system has been suggested. For example, taxpayers have suggested a mark-to-market election to simplify reporting in the passive foreign investment company areas. We believe that the number of recommendations for a mark-to-market system to simplify reporting and recordkeeping in a variety of areas in the Code is an indication that taxpayers would forego the tax benefits of deferral in order to realize the non-tax benefits of simplifying their books and records and reporting systems.

Impact of the Wash Sale Rules on a Mark-to-Market Election

We believe that if a mark-to-market system is proposed for certain securities investment partnerships, a "carve-out" or exemption from the wash sale rules would be necessary so that the benefits of the mark-to-market system are not unintentionally undermined. If the wash sale rule were to apply, tax and economic results could still differ significantly simply because the wash sale rule would trigger a deemed disposition of the portfolio and require testing under the 61-day wash sale period.[2] This would be contrary to the objectives sought by the mark-to-market election in the first place. Accordingly, in order to achieve the goals desired by the mark-to-market election, we believe a carve-out would be necessary under which Section 1091 would not apply to investment funds which have elected mark-to-market treatment.

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2 The Section 1256 mark-to-market system treats the regulated futures contracts as having been sold for purposes or Subtitle A of the Code.

Congress has provided a carve-out for Section 1091 in other areas of the Code where a mark-to-market regime applies. For example, in 1993 when Congress enacted the mark-to-market requirement for securities dealers, it specifically precluded the operation of the wash sale rules.[3] Similarly, in making changes to the wash sale rules in the 1988 Act, Congress gave Treasury regulatory authority to provide exceptions to the wash sale rules for contracts subject to the Section 1256 mark-to-market requirement.[4] Accordingly, we believe that a carve-out for the application of Section 1091 when a mark-to-market system applies is appropriate and consistent with Congressional intent.

Moreover, the legislative intent behind Section 1091 suggests that the rules were not intended to reach investment activity of the type engaged in here but instead were intended to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[5] This indicates that the wash sale rules were designed to prevent artificial crystallization of losses where a taxpayer did not effectively dispose of the underlying asset. When that intent is applied here, the need for and logic of the wash sale rule breaks down.

Conclusions

As discussed, we actively support the development of a mark-to-market election for securities investment partnerships. We believe this election would significantly simplify the reporting and recordkeeping requirements for these funds and eliminate many of the complex accounting procedures necessary to comply with the various Code rules.

In connection with a mark-to-market election, we suggest that any such mark-to-market system include an exception to the application of the wash sale rules. Such a carve-out would enable the goals of the mark-to-market election to be achieved. Moreover, a carve-out for Section 1091 would be consistent with legislative intent surrounding the wash sale rules.

Sincerely,

Christopher P. Brown
Vice President, Glenwood Investment Corp.
General Partner of Glenwood Partners L.P.

3 See Section 475(d)(1).

4 Conf. Comm. Rep., Statement of Managers, Pub. L. 100-647, Technical and Miscellaneous Revenue Act of 1988 (October 24, 1988).

5 House Ways and Means Comm. Rep., Internal Revenue Bill of 1921, H.R. Rep. No. 350, 67th Cong. 1st Sess. 10 (1921).

STATEMENT OF
LEON M. METZGER
SENIOR VICE PRESIDENT AND CHIEF ECONOMIST
PALOMA PARTNERS MANAGEMENT COMPANY

CONCERNING MARK-TO-MARKET ACCOUNTING FOR SECURITIES TRADING PARTNERSHIPS

PRESENTED TO THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

For Hearings Scheduled to Begin on July 11, 1995

INTRODUCTION

Chairman Archer, Rep. Gibbons, Members of the Committee:

I am Leon Metzger, Senior Vice President and Chief Economist of Paloma Partners Management Company, which provides management services to multi-tiered securities trading partnerships and trading advisors. Our partnerships and clients, directly or indirectly, are significant participants in several securities markets. I am pleased to have this chance to submit this written statement to the Committee on Ways and Means on allowing trading partnerships to elect to use a mark-to-market method of accounting.

I applaud you, Mr. Chairman, for your leadership in holding these hearings to consider ways to simplify and improve the current tax laws while the Committee continues its longer-range project of fundamental reform of our nation's tax system. I particularly want to thank Rep. Nancy Johnson for bringing this proposal to the Committee's attention.

I submit my written statement to support the proposal to allow partnerships and corporations whose primary activity is buying and selling actively-traded personal property to use the mark-to-market method of accounting for tax purposes. Adopting this proposal will eliminate unnecessary costs imposed on businesses like ours, make markets more efficient, and improve market depth and liquidity.

This statement discusses the economic background behind my support for allowing trading partnerships to elect to use the mark-to-market accounting method to more clearly reflect the economic substance of a partnership's income and losses. Because using this method would be **elective**, non-dealers would not be forced to adopt the method.

The effect of adopting the proposal would be to avoid inequities that currently exist among partners of certain partnerships. Moreover, as I understand the federal-budget score-keeping rules, this proposal will raise revenues because it tends to accelerate the recognition of taxable income. However, I want to emphasize that our desire to accelerate taxes is not altruistic -- it is motivated by sound business reasons that I will describe in this statement.

PROBLEMS WITH CURRENT LAW

The current tax rules create a number of problems for trading partnerships like ours. The problems involve both the tax law requirements for recognizing current losses and investor concerns about inheriting someone else's tax liability. The discussion below sets out the current problems and why we think using a mark-to-market tax accounting method will provide a better solution.

Wash-Sale Losses

Market-neutral trading partnerships employ strategies like convertible and warrant hedging, mean-reversion, and option trading. In convertible hedging, one may buy a convertible debenture (a bond that the holder can convert into common stock) and simultaneously sell short an equal amount of market value of the underlying common stock when the market is not charging a sufficient "premium" for the right to convert the bond into stock. Assume that we place the trade on January 2 and (after the bond premium widens) we close out our positions on January 15. Let us also assume that during that two-week period the markets rose. Our profit on the convertible bond side, say 2%, should exceed the loss on the stock side, say 1%. Now assume that the premium narrows such that we repeat that trade on February 1, the pattern repeats itself, and we close out our positions on February 15. Now assume that this pattern is repeated every month for the balance of the year. We have earned an economic return of 12% (2% per month from the long side, less 1% per month from the short side); yet for tax purposes we must report 24% (the long-side profit only) because of the wash-sale-loss provision of § 1091 of the Internal Revenue Code ("Code").

§ 1256(d) Mixed Straddle Account ("MSA") Election

To the extent that our partnerships hedge their interest-rate or foreign-currency risk in the transaction with a regulated futures contract ("RFC"), they can eliminate this difference between economic and taxable income by making an MSA election. This election requires them, however, to mark their securities to market every day. While daily marking achieves the objective of making taxable and economic income the same, it creates logistic hurdles also.

For example, while our partnerships electronically receive independent price quotations as of month-end, less-actively-traded derivative securities, of which we trade many, do not receive daily coverage from the independent pricing services. To require our traders to place daily telephone calls to their trading counterparties to get more than one quotation for **each** less-actively traded security, perhaps 3,000 positions, reduces time to trade and, thus, has a negative impact on profitability and on market efficiency. Alternatively, to create an intra-month pricing algorithm brings many overhead costs with it.

Moreover, one cannot elect MSA treatment for some trading strategies. For example, one trading group buys long and simultaneously sells short baskets of securities. No RFC exists that would be economically appropriate to this strategy. Without the RFC, one cannot make an MSA election. Therefore, to eliminate the wash-sale losses, the trading group stops trading for 30 days, the market does not maintain its efficiency, and those who invested capital lose an opportunity to profit. Thus, by not allowing a trading partnership to mark to market for tax purposes, although it already does so for its financial statements, the Code creates economic inefficiencies.

UNDESIRABLE TAX DEFERRAL

While it is generally considered desirable by investors to defer taxable income, deferral can sometimes result in serious problems for investors in partnerships like ours. Because from time to time, new partners join or existing partners withdraw from these partnerships, because of partial withdrawals of capital and the contribution of additional funds, the relative interests of partners may change from year to year. Our

partnerships generally keep account of a partner's entitlement upon his or her withdrawal on the basis of economic income, which tends to exceed taxable income (because of unrealized gains). When that partner withdraws in full, a cash distribution that liquidates his or her interest in the partnership effectively results in that partner recognizing his or her share of unrealized partnership gains. Furthermore, because the partnership has not disposed of any appreciated securities to make the distribution to the withdrawing partner, under current tax law the remaining partners also will bear the tax burden of any gain subsequently realized by the partnership upon the actual disposition of those assets. This inequity is not corrected until the last partner leaves and the partnership liquidates.[1]

The following example shows how that problem arises when a partner contributes additional capital. Two investors, X and Y, form a partnership on January 1, 1994 and contribute $50 each. 1994's income, $100, all unrealized, is shared pro rata under the partnership agreement. On January 1, 1995, Y contributes an additional $100. 1995's unrealized appreciation, $300, plus 1994's unrealized appreciation which the partnership realizes in 1995, $100, are shared pro rata.

Note that a § 754 election to adjust the basis of partnership assets is not a practical solution to these problems. McKee, Nelson and Whitmire (Federal Taxation of Partnerships and Partners, page 24-33) write:

> If a transferee acquires an interest in a partnership that itself holds an interest in another partnership, the basis of the upper-tier partnership in its interest in the second-tier partnership is adjusted under § 743(b) if the first-tier partnership has a § 754 election in effect... The mechanical difficulties inherent in the application of § 743(b) to tiered partnerships are significant when there are inside-outside basis discrepancies in the lower-tier partnership.

On page 24-38, they continue:

> Another drawback of the [§ 754] election is the consequent increase in the records that must be maintained by the partnership. The extent of this clerical burden is a function of the number of assets held by the partnership and the frequency with which transfers of partnership interests and certain types of distributions occur. These problems may not be important in a closely held partnership, but they can be substantial, for example, in a large, publicly held limited partnership that owns many assets, particularly if the assets are depreciable.
>
> The decision whether to elect under § 754 is further complicated because the benefits of the election do not fall evenly on the partners in the case of § 743(b) adjustments arising from transfers of partnership interests, the immediate benefits of which are limited to transferee-partners. The continuing partners may well decide that the benefits of the election to their new partners are more than outweighed by the potential long-term detriments to themselves, in the form of record keeping headaches and possible future basis decreases as to their interests.

	X	Y	Total
January 1, 1994 capital contribution	50	50	100
Unrealized appreciation 1994	50	50	100
December 31, 1994 capital balances	100	100	200
January 1, 1995 capital contribution		100	100
January 1, 1995 capital balances	100	200	300
Unrealized appreciation 1995	100	200	300
December 31, 1995 capital balances	200	400	600
1994's unrealized appreciation realized in 1995	33	67	100

Because Y made a contribution at a time when the partnership held unrealized gain, Y pays taxes on some of X's economic income.

It is this inequity that our partnerships would like to eliminate. We would like to assure all investors that they will never pay taxes on other investors' capital gains. If we could use the mark-to-market accounting method for tax purposes, economic income and taxable income, in general, would coincide.

ECONOMIC BENEFITS OF ALLOWING THE MARK-TO-MARKET METHOD

When investors badly overprice a stock, liquidity dries up to the extent of the mispricing; without liquidity, a real market no longer exists; without a real market, owners cannot sell. If the security is overpriced, some, if not all, of the paper profits on the trade are fictitious, disappearing very quickly when one tries to sell the shares. The sell order causes the price decline until it reaches its correct value, a value at which buyers can be found.

When a market-neutral trader sees that investors have overpriced a security, that trader borrows the security from one of the owners who was unwilling to sell it, and sells it short while, at the same time, buying other securities to remain market-neutral. As a result, the trader prevents the extreme market inefficiencies that cause liquidity to shrivel. The trader is essential to the proper functioning of the market.

Nowadays, the capital base of most stock-exchange specialists is too small to allow them to trade a significant percentage of the total shares outstanding in the stocks for which they are responsible. As a result, each specialist regards highly the value of market-neutral traders who stand prepared to help the specialist by buying the specialist's stock on declines, and by selling the stock on rises. Without the market-neutral traders, the markets would be subject to much larger swings than they experience now. In fact, 1993 had the lowest volatility on record and 1992 had the second lowest, according to an early-1994 article in Barron's. I think that the 1987 market crash would likely have been less severe or might not have occurred at all had there been enough market-neutral traders in the market then.

Our partnerships perform a market-making function by profiting from mispricings. Just as current law allows dealers to mark their positions to market and declare their taxable

profits and losses that way, it makes perfect economic sense for our partnerships to mark their positions to market, a procedure that accurately states their true profits and losses, and one that will not distort their true taxable income.

Impediments to the functioning of our partnerships harm the best and proper functioning of the markets. In the end, such impediments do more harm than good. If current tax rules prevent our partnerships from marking to the market, they are an obstacle to the partnerships' performance of an important economic service.

Cash Method

Two reasons why current law treats individuals as cash-basis taxpayers are that they generally account for their income and expenses using the cash method, and that they do not necessarily have the cash to pay taxes on unrealized gains. For example, the average taxpayer who bought $10,000 of stock that doubled in price within one year, would probably have to liquidate his or her investment, in part, to generate cash to pay the taxes on his or her unrealized gain.

Being a provider of liquidity to the marketplace means that the partnerships have to be prepared themselves to be illiquid. Therefore, our partnership agreements provide for limited liquidity. Most investors pay for the taxable income generated by our partnerships with cash from sources other than the partnership. Furthermore, the partnerships mark to market for accounting purposes, as required by the American Institute of Certified Public Accountants' guide to audits of investment companies. Thus, the reasons for employing the cash method of accounting do not apply to our partnerships.

REVENUE IMPLICATIONS

I believe that if Congress adopts this proposal, there will be an acceleration of income recognition for tax purposes. This should result for two primary reasons. The first is that Congress will have eliminated barriers to using our trading strategies for thirty days, usually at year end. The second results from the very nature of our business. We are in the business of producing returns for our partners. We only earn money when our partners profit. If we become too concerned with maximizing tax differentials or with trying to reduce the tax liabilities of old and new partners, we are not maximizing the profits for either ourselves or our partners. If Congress adopts this proposal, we can concentrate all our energies on maximizing the economic profits of our investors. The nature of our business precludes us from any attempt to use the mark-to-market rules for a tax advantage. Any mark-to-market losses created for tax purposes would also be real losses to our investors. We could not stay in business if that were our goal.

PRECEDENTS FOR ALLOWING MARK-TO-MARKET TREATMENT

Precedents exist for allowing or even requiring taxpayers to mark to market. These precedents were driven, in part, by longstanding financial-accounting principles of using the mark-to-market method for financial instruments. They prove that such method is a proper one for companies that engage in passive-type income activities commonly considered as no more than investments.

§ 1256 Treatment

First, § 1256 of the Code requires taxpayers to report gain and loss from RFCs annually under a mark-to-market rule which corresponds to the daily cash settlement, mark-to-market system employed by commodity-futures exchanges in the United States for determining margin requirements.

The broker marks RFCs to the market daily. Simply put, to the extent that the account shows profit, the customer can use that daily profit as margin on additional RFCs or can receive it in cash. Similarly, to the extent that the account has a loss, the customer must add cash or securities to his or her account to the extent of the loss. Thus it makes economic sense to mark to market RFCs because even cash-basis taxpayers constructively receive income as it is accrued although the positions are not closed out.

MSA Election

Second, by providing for MSA elections (as discussed above), the Code permits taxpayers to mark to market trading strategies that include RFCs.

§ 475 Treatment

Last, § 475 of the Code requires securities dealers to mark to market non-inventory securities at the end of the tax year unless they identify those securities as held for investment or not held for sale. Were our trading groups to have even a single customer, they would fall under this section and thus be entitled to use the mark-to-market method for all of the securities we hold. The trading we do often mirrors the proprietary trading done for their own accounts by major international brokerages (which, unlike us, have customers). Those brokerages formerly employed many of our traders. Although the partnerships do not have the brokerages' major underwritings, large sales forces, or customer bases, the partnerships very much replicate what the brokerages do with their own capital, namely, invest in low-risk, market-neutral strategies. As a result, the Code permits international brokerage houses that compete with our partnerships to mark to market their proprietary trading securities for tax purposes, but it does not permit our partnerships to do the same.

The reason that our partnerships do not have customers is that the partnerships do not want to become dealers in securities and thus have significant overhead costs and risks. Furthermore, Connecticut, the state where they are domiciled, exempts non-resident partners from tax on their share of partnership income only if the partnership trades solely for its own account.

CONCLUSION

If Congress adopts this proposal, it would alleviate a significant problem for market-neutral trading partnerships like ours, but does not force any non-dealer to adopt the practice. Most important, from the government's point of view, it will raise revenue by causing the partners of the electing entities to pay taxes currently on appreciated securities, rather than at some distant date when the partnership sells those securities.

Although it may sound odd that the partnerships are advocating this position, we tell our investors that our concern is maximizing profits appropriate for the level of risk. Those investors who seek tax deferrals and other advantages are not the

ones we encourage to join our partnerships. We believe that the best investment is one that does not rely on artificial incentives.

Thank you for giving me this opportunity to testify.

REGAL ASSET MANAGEMENT
C O R P O R A T I O N

July 20, 1995

House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20525

Re: Proposed Mark-to-Market Regime for Investment Partnerships

Dear Sirs,

We understand that the Ways and Means Committee is considering proposed changes to the taxation of securities investment partnerships and their partners. In particular, we understand that the Committee may be considering an election to allow investment partnerships to mark their securities portfolio to market at year-end.

We are writing to express support for this proposal and to offer suggestions for coordination of the mark-to market election with other rules in the Internal Revenue Code (the "Code"), in particular the wash sale rules of section 1091. We believe that, without such coordination, the objectives intended by the Committee through the mark-to-market election would be undermined.

Investor and Tax Accounting Complexities

Regal Asset Management Corporation, like most other funds of its type, essentially marks its portfolio to market each month when it reports its economic results to its investors. Unfortunately, because a mark-to-market election is not available for federal income tax account purposes, Regal Asset Management Corporation is effectively forced to keep two sets of books, one for investor reporting purposes and one for tax purposes. As one can imagine, the time and expense to comply with this dual reporting obligation is enormous.

The Wash Sale Rules

The wash sale rules present additional and unique complications. Section 1091 is designed to prevent investors from recognizing a loss with respect to a security if, within a period beginning 30 days before and ending 30 days after the disposition triggering the loss, the investor has acquired a substantially identical stock or security. The legislative intent behind the wash sale rule is discussed on the following page.

Regal Asset Management Corporation, 8201 Preston Road, Suite 400, Dallas, TX 75225, 214-890-8800

It is easy to imagine the complexity involved in tracking a substantial number of trades per year to determine compliance with the wash sale rule (our firm does approximately 200,000 trades a year for all of our accounts). In many cases, Regal Asset Management Corporation must effectively shut down, or substantially curb its trading in many securities for at least 31 days to avoid an enormous build-up in realized but unrecognizable losses because of the wash sale rule.

The Proposed Mark-to-Market Election

To eliminate some of the duplicate recordkeeping and reporting complexities discussed above for investment partnerships, we understand that the Committee is considering a mark-to-market election, enabling certain securities investment partnerships to effectively conform their investor reporting and tax reporting. While we have not seen any particular legislative proposals, we would imagine that the mark-to-market election would operate in a manner similar to the mark-to-market system applicable to regulated futures contracts under section 1256 and the mark-to-market regime applicable to dealers in securities under section 475.

We support this election as a means to simplify the complex accounting and tax reporting required for securities investment partnerships. Providing a mark-to-market election would be a logical extension of the mark-to-market rules.

While we have not undertaken to quantify the impact of the mark-to-market election, we believe that the election would be revenue neutral (or at least revenue "fair") because it would encourage investment partnerships to make the election for business reasons and thereby accelerate income into the mark-to-market year.

Guidance on taxpayer behavior with respect to a mark-to-market election can be seen in the other areas of the Code where a mark-to-market system has been suggested. For example, taxpayers have suggested a mark-to-market election to simplify reporting in the passive foreign investment company area. We believe that the number of recommendations for a mark-to-market system to simplify reporting and recordkeeping in a variety of areas in the Code is an indication that taxpayers would forego the tax benefits of deferral in order to realize the non-tax benefits of simplifying their books and records and reporting systems.

Impact of the Wash Sale Rules on a Mark-to-Market Election

We believe that if a mark-to-market system is proposed for certain securities investment partnerships, a "carve-out" or exemption from the wash sale rules would be necessary so that the benefits of the mark-to-market system are not unintentionally undermined. If the wash sale rule were to apply, tax and economic results could still differ significantly simply because the wash sale rule would trigger a deemed disposition of the portfolio and require testing under the 61-day wash sale period. This would be contrary to the objectives sought by the mark-to-market election in the first place. Accordingly, in order to achieve the goals desired by the mark-to-market election, we believe a carve-out would be necessary under which section 1091 would not apply to investment funds which have elected mark-to-market treatment.

House Securities and Ways and Means

Congress has provided a crave-out for section 1091 in other areas of the Code where a mark-to-market regime applies. For example, in 1993 when congress enacted the mark-to-market requirement for securities dealers, it specifically precluded the operation of the wash sale rules. Similarly, in making changes to the wash sale rules in the 1988 Act, Congress gave Treasury regulatory authority to provide exceptions to the wash sale rules for contracts subject to the section 1256 mark-to-market requirement. Accordingly, we believe that a carve-out for the application of section 1091 when a mark-to-market system applies is appropriate and consistent with Congressional intent.

Moreover, the legislative intent behind section 1091 suggests that the rules were not intended to reach investment activity of the type engaged in here, but instead were intended to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges." This indicates that the wash sale rules were designed to prevent artificial crystallization of losses where a taxpayer did not effectively dispose of the underlying asset. When that intent is applied here, the need for and logic of the was sale rule breaks down.

Conclusions

As discussed, we actively support the development of a mark-to-market election for securities investment partnerships. We believe this election would significantly simplify the reporting and recordkeeping requirements for these funds and eliminate many of the complex accounting procedures necessary to comply with the various Code rules.

In connection with a mark-to-market election, we suggest that any such mark-to-market system include an exception to the application of the wash sale rules. Such a carve-out would enable the goals of the mark-to-market election to be achieved. Moreover, a carve-out for section 1091 would be consistent with legislative intent surrounding the wash sale rules.

I would be happy to discuss the foregoing issues in more detail if necessary. Please feel free to write me or call me for any additional recommendations.

Sincerely,

Jay W. Thompson
Chief Financial Officer

JWT/iam

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VIA FEDERAL EXPRESS

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Request for Written Testimony
Hearings on Miscellaneous Tax Proposals
Proposed Mark-to-Market Regime for Investment Partnerships (Accounting Item #5)

Dear Mr. Moseley:

On behalf of Ridgeline Partners, L.P., a professionally managed securities investment partnership ("Ridgeline"), we are responding to the Committee's June 30, 1995 request for written testimony regarding proposed legislation which would allow an election to allow investment partnerships to mark their securities portfolio to market at year-end.

On behalf of Ridgeline, we are writing to express support for this proposal and to offer suggestions for coordination of the mark-to-market election with other rules in the Internal Revenue Code (the "Code"), in particular the wash sale rules of section 1091.[1] We believe that, without such

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[1] All section references are to the Code unless otherwise indicated.

coordination, the objectives intended by the Committee through the mark-to-market rules would be undermined.

About Ridgeline and the Industry

Ridgeline is a California limited partnership which seeks gains through active trading in equity securities listed on the New York and American Stock Exchanges.[2] Ridgeline uses a proprietary investment model based on technical methods which produce a statistical forecast of future securities prices. These analytical techniques are used to predict movements in the prices of individual securities.

The investment model predicts changes in the prices of securities which predictions form the basis for trades made by Ridgeline throughout a particular trading day. During a typical trading year, Ridgeline enters into about 250,000 trading transactions and trades about 1 million shares per day. This is equal to roughly 0.4% of the total NYSE trading volume. Under the current version of the investment model, Ridgeline's investment portfolio turns over every 5-20 days. As can be seen, Ridgeline realizes primarily short-term capital gains from its investment activities, taxable as such.

Ridgeline is part of an estimated $100 billion industry loosely referred to as the "hedge fund" industry. In general, hedge funds actively invest in a broad spectrum of securities, often using proprietary models.

The hedge fund industry itself is but a small subset of the entire investment partnership industry which, in various forms, groups individual and institutional investment in the securities markets. Investors receive reports on at least on annual basis, which reports identify the change in net asset value of the securities in the partnership. Net asset value is the main criterion used by investors and potential investors to make decisions whether to buy interests in the partnership or redeem their investments therein. In short, investment decisions are generally based on net asset value which is derived through an analysis of the then existing market value of the securities portfolio.

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[2] Ridgeline is not a publicly traded partnership within the meaning of the Code or the various securities regulations. Investments in the fund are sold through confidential private placement memoranda.

Investor and Tax Accounting Complexities

Ridgeline, like most investment funds, marks its portfolio to market each year when it reports its economic results to its investors both at year-end and periodically throughout the year. Unfortunately, because a mark-to-market election is not available for federal income tax accounting purposes, Ridgeline is effectively forced to keep two sets of books, one for investor reporting purposes and one for tax purposes. As one can imagine, given the magnitude of the trades Ridgeline and the rest of the industry make each year, the time and expense to comply with this dual reporting obligation is enormous.

Moreover, the reports given to investors for tax purposes are not generally used by the investor to make investment or redemption decisions. Since this information is generally given between two and six months after the close of the previous year, the information on the partnership's Form K-1 is not particularly relevant to the investor's investment decisions. Accordingly, the second set of books and records maintained by the investment partnership for tax purposes is of little use to the partnership or the investor outside of the tax reporting area.

The Proposed Mark-to-Market Election

The Committee's June 30 Press Release indicates that the Committee is considering a mark-to-market election, enabling certain securities investment partnerships to effectively conform their investor reporting and tax reporting. On behalf of Ridgeline, we support this election as a means to simplify the complex accounting and tax reporting required for securities investment partnerships. Providing a mark-to-market election for Ridgeline's industry would be a logical extension of the mark-to-market rules and would enable investment decisions to be made in a manner consistent with tax reporting.

The Press Release indicates that proposals will not be considered which involve a significant revenue cost. While we have not undertaken to quantify the impact of the mark-to-market election, we believe that the election would be revenue neutral (and may ultimately raise revenue) because it would encourage investment partnerships to make the election for business reasons notwithstanding the effect that the election would accelerate income into the mark-to-market year.

In this regard, we believe that the number of investment partnerships that would make the election for non-tax reasons and thereby accelerate income into the mark-to-market year would more than offset any revenue loss that might arise when a mark-to-market election accelerates losses into the mark-to-market year. Indeed, we note that when section 475 was enacted requiring dealers to mark their securities inventory to market, it was expected that the provision would raise revenue.[3] This is an indication that a mark-to-market election here would also be revenue generating.

Guidance on taxpayer behavior with respect to a mark-to-market election can be seen in the other areas of the Code where a mark-to-market system has been suggested. For example, taxpayers have suggested a mark-to-market election to simplify reporting in the passive foreign investment company area.[4]

We believe that recommendations for a mark-to-market system to simplify reporting and recordkeeping in other areas of the Code is an indication that taxpayers would forego the tax benefits of deferral in order to realize the non-tax benefits of simplifying their books and records and reporting systems.

Issues Involved Under a Mark-to-Market Regime

Other than the brief language in the Joint Committee explanation accompanying the hearings, we have not seen any proposed legislative language. However, we would imagine that the mark-to-market election would operate in a manner similar to the mark-to-market system applicable to regulated futures contracts under section 1256 and the mark-to-market regime applicable to dealers in securities under section 475.[5] In this

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[3] The revenue estimates at the time section 475 was being considered by Congress indicated a revenue increase of about $3.8 billion over five-years. The revenue estimate included another minor technical change to the Code and the estimate was not broken down between the two items.

[4] See, e.g., Comments by the Investment Company Institute on the Treatment of Shareholders of Certain Passive Foreign Investment Companies, August 19, 1992, reprinted on LEXIS at 92 TNI 34-54; Comments by the New York State Bar Association on H.R. 13, May 3, 1993, reprinted on LEXIS at 93 TNI 84-15.

[5] In fact, one way of accomplishing the election would be to provide for the mark-to-market election in section 475 itself.

respect, a number of technical and mechanical issues arise that we would like to comment on.

(i) Qualifying Entities

The Joint Committee explanation indicates that the election will be available to partnerships and corporations which own "qualifying assets" having a value equal to 90% of total assets. The Joint Committee explanation indicates that qualifying assets will be defined as "actively traded" property as defined under the straddle rules of section 1092.[6] We agree that the straddle definition of actively traded property is appropriate in this case and that a 90% threshold is an appropriate threshold so as to target the election to those entities predominantly engaged in securities trading.

To the extent the definition of a "qualifying entity" is determined by reference to the "value" of the underlying assets, we would suggest the Committee consider the impact when the securities portfolio fluctuates in value relative to non-qualifying assets. We suggest that once an entity qualifies as a qualifying entity by meeting the 90% test, it remains a qualifying entity for future tax periods. Accordingly, we do not believe an entity should be precluded from remaining in the mark-to-market system if the value of its qualifying assets fall below 90% of total assets.

(ii) Annual or One-Time Election

We would expect that the Committee will consider whether the mark-to-market election would be an annual election or a one-time election as an accounting method which could then only be changed with Commissioner consent. We believe that the mark-to-market election can only be workable as a one-time election. However, we believe that there are certain partnership events which justify the ability to elect out of the regime. For example, if the partnership is deemed to dissolve under section 708 because of a substantial sale or exchange of interests in the partnership, we believe the "new" partnership should be able to make a new determination as to whether to make the election.

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[6] See Reg. Sec. 1.1092(d)-1(a).

(iii) Section 481 Relief

As noted, we believe that a mark-to-market election would at least be revenue neutral because the number of taxpayers that will elect mark-to-market for non-tax purposes (notwithstanding the acceleration of income) will offset the number of taxpayers electing mark-to-market to accelerate the recognition of losses. Moreover, we believe any anti-abuse rules developed by the Committee will curb potential abuse.

However, we believe that there should not be a significant disincentive for investment partnerships to make a mark-to-market election and suggest that the Committee consider allowing Section 481 relief for the election year, namely reporting of the accelerated income in the election year over a five year period. This would encourage partnerships to make the election and would also serve to mitigate the consequences that would arise if taxpayers could not make the election on an annual basis.[7]

(iv) Partnership Election

A mark-to-market election would benefit the investment partnership as a whole because it would enable the partnership to conform its overall financial recordkeeping with its tax books and records. Accordingly, we believe the mark-to-market election should be made at the partnership level rather than at the partner level. This would be similar to elections under section 754. Moreover, if the election were made at the partner level, the partnership would still be forced to keep two sets of books, one for partners which elect and one for partners which forego the election.

(v) Treatment of Mark-to-Market Income

Section 1256 contains special rules regarding the character of income recognized under the special mark-to-market regime applicable there. Under those rules, 40% is treated as short-term capital gain or loss and 60% is treated as long-term capital gain or loss. On the other hand, the section 475 mark-to-market rules do not alter the ordinary income treatment otherwise required for dealers.

Indeed, the availability of section 481 relief for dealers affected by section 475 reinforces our earlier point that a mark-to-market system raises revenue.

We believe that a mark-to-market election should not recharacterize gains and losses from capital to ordinary. We believe sections 475 and 1256 correctly deal only with the timing of income recognition and not the character of the underlying gain or loss.

It is possible that the Committee will wish to consider whether to apply some form of split between short and long term treatment for gains and losses recognized under a mark-to-market election. In fact, if the Committee did not consider such a rule, it is possible that a mark-to-market election would have the effect of treating all gains and losses as short-term since the property would be always be treated as held for one year or less under a mark-to-market system. As a result, if the legislation did not provide for a long-term component, investment partnerships which otherwise realize a significant amount of long-term gains would be unduly penalized in electing mark-to-market. Accordingly, we believe the legislation should, at a minimum, provide for a 60% long-term component consistent with the section 1256 rules. Moreover, we believe that there are justifications for a much greater long-term component.

The Wash Sale Rules

The wash sale rules present additional and unique complications for the securities investment partnership industry. Section 1091 is designed to prevent investors from recognizing a loss with respect to a security if, within a period beginning 30 days before and ending 30 days after the disposition triggering the loss, the investor has acquired a substantially identical stock or security. The legislative intent behind the wash sale rule is discussed further below.

It is easy to imagine the complexity involved in tracking 250,000 trades per year to determine compliance with the wash sale rule. To comply with section 1091, Ridgeline maintains a complex computer model and spends substantial time and expense each year making calculations to accurately report the impact of the wash sale rule to its investors. In many cases, Ridgeline must effectively shut down its trading in many securities for at least 31 days to avoid an enormous build-up in realized but unrecognizable losses because of the wash sale rule. Thus, Ridgeline forgoes substantial economic gains in the securities in which it is forced to restrain from trading.[8]

In fact, we believe the complexity in this area contributes in large part to a general lack of compliance in this area by some similarly situated investment funds. In this

Impact of the Wash Sale Rules on a Mark-to-Market Election

We believe that if a mark-to-market system is proposed for certain securities investment partnerships, an exemption from the wash sale rules would be necessary so that the benefits of the mark-to-market system are not unintentionally undermined. If the wash sale rule were to apply to funds like Ridgeline which make a mark-to-market election under the Committee's proposal, tax and economic results could still differ significantly simply because the wash sale rule would trigger a deemed disposition of the portfolio and require testing under the 61-day wash sale period.[9] This would be contrary to the objectives sought by the mark-to-market election in the first place. Accordingly, in order to achieve the goals desired by the mark-to-market election, we believe a carve-out would be necessary under which section 1091 would not apply to investment funds which have elected mark-to-market treatment.

Congress has provided a carve-out from section 1091 in other areas of the Code where a mark-to-market regime applies. For example, in 1993 when Congress enacted the mark-to-market requirement for securities dealers, it specifically precluded the operation of the wash sale rules.[10] Similarly, in making changes to the wash sale rules in the 1988 Act, Congress gave Treasury regulatory authority to provide exceptions to the wash sale rules for contracts subject to the section 1256 mark-to-market requirement.[11] Accordingly, we believe that a carve-out for the application of section 1091 when a mark-to-market system applies is appropriate and consistent with Congressional intent.

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regard, Ridgeline is at a competitive disadvantage simply because it is complying with the wash sale rules.

[9] The section 1256 mark-to-market system treats the regulated futures contracts as having been sold for purposes of Subtitle A of the Code.

[10] See section 475(d)(1).

[11] Conf. Comm. Rep., Statement of Managers, Pub. L. 100-647, Technical and Miscellaneous Revenue Act of 1988 (October 24, 1988). In this regard, given the potential delay in issuing regulations on this topic, we suggest that Congress specifically provide for the exemption from the wash sale rules rather than leave the exemption for Treasury to provide in regulations.

Moreover, the legislative intent behind section 1091 suggests that the rules were not intended to reach investment activity of the type engaged in by Ridgeline but instead were intended to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[12] This indicates that the wash sale rules were designed to prevent artificial crystallization of losses where a taxpayer did not effectively dispose of the underlying asset. When that intent is applied to an investment partnership such as Ridgeline, the need for and logic of the wash sale rule breaks down. Ridgeline is in the business of generating short-term gains and may buy and sell the same security several times during the year. Each trade is an economic decision based on the predicted movement in the security made by the model rather than an artificial transaction designed simply to recognize a loss.

Conclusions

As discussed, we actively support the development of a mark-to-market election for securities investment partnerships. We believe this election would significantly simplify the reporting and recordkeeping requirements for these funds and eliminate many of the complex accounting procedures necessary to comply with the various Code rules. We believe the election would at least be revenue neutral and would ultimately raise revenue if only because investment partnerships would have less overhead and would be able to pass more taxable income on to their investors.

In connection with a mark-to-market election, we suggest that any such mark-to-market system include an exception to the application of the wash sale rules. Such a carve-out would enable the goals of the mark-to-market election to be achieved. Moreover, a carve-out from section 1091 would be consistent with legislative intent surrounding the wash sale rules.

We would be happy to discuss our comments with you in person in greater detail and provide any further information you may desire. In the meantime, please feel free to call me at (213) 669-7295 if you have any questions.

Best regards.

Very truly yours,

Michael S. Lebovitz
for O'MELVENY & MYERS

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12 House Ways and Means Comm. Rep., Internal Revenue Bill of 1921, H.R. Rep. No. 350, 67th Cong. 1st Sess. 10 (1921).

MORRISON & FOERSTER

STATEMENT OF CONSOLIDATED FREIGHTWAYS, INC. AND AFFILIATED COMPANIES ON MISCELLANEOUS TAX PROPOSALS -- Accounting -- Allow Deduction for Intrastate Operating Rights of Motor Carriers*/

Consolidated Freightways, Inc. supports the simplification proposal to allow a motor carrier to deduct its adjusted basis in intrastate operating rights which it held on January 1, 1995. These intrastate operating rights were preempted on that date by section 601 of the Federal Aviation Administration Authorization Act of 1994 which rendered them valueless. Deduction of the basis will recognize the loss incurred by the carriers and provide a certain and uniform result which conforms with the correct accounting treatment required by financial accounting standards.

Consolidated Freightways, Inc. and its affiliated companies is one of the largest cargo transportation companies in the United States. Its motor carrier companies employ over 28,000 persons. Its affiliate, Emery Worldwide, is an integrated air freight carrier which employs 7,500 persons. Both the motor carrier companies and Emery operate throughout the United States and internationally.

1994 Preemption of State Operating Rights

Last year, Congress preempted and prohibited state economic regulation of motor carriers, effective January 1, 1995, in Section 601 of the Federal Aviation Administration Authorization Act of 1994. The Act preempted state regulation of routes, rates, prices, and services. States may continue to regulate safety, financial responsibility, insurance, vehicle size and weight, and other non-economic issues.

Prior to that federal preemption, approximately 41 states required motor carriers to obtain state operating rights (certificates of public convenience and necessity or permits) to operate intrastate trucking routes. Motor carriers incurred substantial expense to obtain these operating rights in regulatory proceedings or by acquisition of existing carriers or routes. At the time of preemption, these rights represented substantial and valuable assets.

Value of Consolidated Freightways' Intrastate Operating Rights

Consolidated Freightways has acquired substantially valuable state operating rights and authorities in 39 of the 41 previously regulated states. Consolidated Freightways, Inc. acquired many of these rights in regulatory proceedings which involved substantial expense to establish "public convenience and necessity". Consolidated Freightways also

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*/ Item A7, Page 10, "Allow Deduction for Intrastate Operating Rights of Motor Carriers," Joint Committee on Taxation, Description of Miscellaneous Tax Proposals (JCS-19-95), July 10, 1995

purchased rights either directly, as a purchase of all of the assets of another carrier, or indirectly, by the purchase of the stock of another carrier followed by an election to treat the stock acquisition as a purchase of assets.

Consolidated Freightways and affiliates reported their intrastate operating rights and authorities as assets in the financial statements.*/ Lenders, and others, relied upon the value or costs of these intrastate operating rights in evaluating the credit-worthiness of the company. The basis of intrastate rights held by Consolidated Freightways and affiliates is approximately $11 million.

Loss in Value of Operating Rights

These intrastate operating rights have been rendered worthless by federal preemption. The Conference Committee Report "recognize[d] that this [federal preemption] will eliminate the asset value of the operating authority of those affected motor carriers."

Preemption of state regulation of intrastate operations has eliminated the value of the intrastate operating rights held by Consolidated Freightways affiliates. This loss in value of the intrastate operating rights is similar to the result of the Motor Carrier Act of 1980 which deregulated interstate operating rights awarded by the Interstate Commerce Commission ("ICC").

For financial accounting purposes, Consolidated Freightways was required to write-off the basis of its intrastate operating rights as an extraordinary item in 1994. (Statement of Financial Accounting Standards No. 44.) This treatment was also required by the Financial Accounting Standards Board ("FASB") as a result of the deregulation of interstate operating rights in 1980. The basis for the FASB action was that the resale and collateral values of the operating rights had been substantially impaired resulting in an economic loss to the company which should be charged to income.

Historical Precedent for Legislative Relief

A similar solution was provided by Congress in 1981 after federal deregulation of the interstate motor carrier industry. The Motor Carrier Act of 1980, which preempted interstate regulation of motor carriers, also did not include tax relief for the industry. However, the legislative history then, as now, also recognized the loss in value of the operating rights due to deregulation.

Subsequently, in 1981, ERTA permitted carriers to amortize the total amount of their basis in the deregulated ICC operating rights over a 60-month period. In 1986,

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*/ Until the Revenue Reconciliation Act of 1993, which added section 197 to the Internal Revenue Code, such operating rights were nonamortizable for federal income tax purposes. Operating rights acquired after August 10, 1993 (or July 25, 1991 for certain electing taxpayers) may be amortized over 15 years. Consolidated Freightways' operating rights were acquired prior to that date and continue to be nonamortizable.

similar tax relief was provided to bus companies and freight forwarders following deregulation.

The arguments considered by Congress in 1981 and 1986 with regard to the loss in value of federal operating rights as a result of deregulation are equally applicable to the preemption of intrastate operating rights.

Write-Off For Intrastate Operating Rights May Not Be Uniformly Available under Current Tax Law

The IRS has not taken a position regarding the tax effects of the 1994 preemption of intrastate operating rights, or more specifically, the ability of a motor carrier to deduct its basis in intrastate operating rights rendered void as a result of federal preemption. Prior experience following deregulations indicates that the availability of a write-off for tax purposes may not be uniform or consistent among carriers. It is clear, however, that the motor carriers have a stronger position as a result of the federal preemption then was true in the case of deregulation because after deregulation, certificates continued to be required. Here federal law prohibits any such continuing requirement for economic regulation.

The IRS position typically has ignored the economic substance of the loss, instead focusing on the formal significance of the paper certificates. The rulings generally have concluded that the impact of deregulation only reduces the value of the operating rights but does not render them valueless. Absent a sale or abandonment of the asset (the operating rights or other state-granted right), or more particularly, the line of business in which the intangible asset was used, no loss deduction is permitted. See Consolidated Freight Lines, Inc. v. Commissioner, 101 F.2d 813 (9th Cir.), cert. denied, 308 U.S. 562 (1939). This analysis is reflected in numerous IRS rulings over the last 50 years, including rulings relating to the 1980 motor carrier deregulation and the 1978 airline deregulation. The IRS rulings following the 1980 deregulation denied any deduction unless a carrier could prove that it abandoned each interstate operating authority. The IRS position is heavily dependent on the facts and circumstances of each case, indeed, of each operating right. See CRST v. Commissioner, 92 T.C. 1249 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990). Nevertheless, in similar circumstances taxpayers have prevailed. George Freitas Dairy, Inc. v. United States, 502 F. 2d 500 (9th Cir. 1978), aff'g 407 F. Supp. 1395 (D. Haw. 1976).

Absent legislative relief, the ability of Consolidated Freightways or any carrier to obtain an immediate federal tax deduction is heavily dependent on the facts and circumstances regarding each intrastate operating right. For example, if a state were to declare its outstanding operating rights to be null and void, the IRS might agree that the company may deduct its basis in that operating right. However, if a state declares that existing operating authorities are temporary evidence that the carrier meets safety and insurance requirements, the IRS may contend that the operating right was devalued but not valueless and challenge the deduction upon audit. Similarly, so long as carriers remain in business, the IRS may challenge deductions, contending that there was no closed and completed transaction.

Without Congressional action, there likely will be substantial litigation and uncertainty regarding the right of carriers to deduct their costs in intrastate operating rights, as well as the timing of the deduction. This will result in inconsistent and inequitable treatment of individual carriers depending on how each state handles deregulation, the business activities conducted by the carrier before and after preemption, the timing of the claimed deduction, which court has jurisdiction, and how each carrier acts to prove its case. As a result, deductions may only be available to sophisticated carriers that structure their affairs to effect an abandonment of the intrastate operating rights and that have the resources to prove abandonment of each and every route in every state. This consequence undermines the fair and equitable treatment that the Congress was seeking to achieve through federal preemption.

The State Response to Deregulation

Not surprisingly, the states' response to the 1994 deregulation has been anything but uniform or consistent. To date, each state appears to be taking its own approach to the treatment of preexisting certificate holders. Some states have indicated that existing certificate holders may use their current certificates for purposes of temporarily evidencing compliance with safety and insurance requirements. Others require existing holders of intrastate operating rights to obtain new proof they meet safety and insurance requirements but afford them procedural advantages which may make the application process easier for existing rights holders *vis a vis* new applicants. Still others have cancelled the old certificates, and are requiring all carriers to reapply on an equal footing. A few states are resisting deregulation altogether, challenging the federal law. This spectrum of state response places carriers in a difficult and uncertain situation until new regimes which conform to the federal preemption are established and in place in each state.

The Simplification Proposal -- Uniform and Equitable Relief

This proposal, in effect, simply declares that as of January 1, 1995, the state operating rights and authorities are not only null and void for economic regulatory purposes, but also are null and void for tax purposes. The proposal will permit deduction of the adjusted basis in all such rights as of the effective date of preemption, that is, the date that Congress intended them to be invalid for all economic regulatory purposes. Consolidated Freightways believes that this proposal will provide uniform and equitable relief to all carriers holding intrastate rights in any state, thereby averting costly and time-consuming litigation over the fact or timing of deduction of numerous operating authorities in various states.

Under current law, Consolidated Freightways is firmly convinced that it will sustain deduction of all, or certainly the vast majority of its basis in intrastate operating rights. Nevertheless, this issue is of great importance to Consolidated Freightways. Under current law, it is likely the IRS will challenge claimed deductions. This will result in audit disputes and litigation. The final results may not be determined for many years and then

only at substantial costs of litigation. Consolidated Freightways wants to avoid these wasteful expenditures and to obtain certain and equitable results promptly. This proposal achieves that goal.

Respectfully submitted,

Linda Arnsbarger

Linda A. Arnsbarger
Morrison & Foerster, and

James E. Merritt

James E. Merritt
Morrison & Foerster

on behalf of

CONSOLIDATED FREIGHTWAYS, INC. AND AFFILIATES
3240 Hillview Avenue
Palo Alto, California 94304

July 27, 1995

WRITTEN STATEMENT OF

WARREN E. HOEMANN
Vice President -- Government Relations

on behalf of
YELLOW CORPORATION

HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS

House of Representatives

on the
Miscellaneous Tax Reforms

July 11-13, 1995

Yellow Corporation is a transportation holding company whose subsidiaries include Yellow Freight System of Overland Park, Kansas; Preston Trucking Company of Preston, Maryland; Saia Motor Freight of Houma, Louisiana, and WestEx of Phoenix, Arizona. Each of these subsidiaries is a less-than-truckload (LTL) motor carrier operating in both interstate and intrastate commerce. On their behalf, Yellow Corporation submits these comments to support the deductibility of the remaining tax basis for intrastate operating authorities held by the several companies prior to the passage of the Federal Aviation Administration Act of 1994. That Act in Section 601 preempts and prohibits state regulation of the price, route or service of intrastate operations of motor carriers, effective January 1, 1995.

Prior to the 1994 federal preemption of state economic regulation of motor carriers, 41 States to one extent or another regulated the ability of a motor carrier to enter the intrastate trucking market, the rates motor carriers could charge for their services, the types of services they could offer to the shipping public, the size and weight of the freight they could handle and the routes they could traverse in conducting their business. Commonly, any motor carrier wishing to enter an intrastate market in one of the 41 regulated States or wishing to expand its geographical coverage or scope of services was required to prove that "Public Convenience and Necessity" (PC&N) required the services of the applicant motor carrier. These applications were protested by other existing motor carriers, seeking to protect their own share of the intrastate trucking market. The state regulatory bodies who considered these applications for intrastate operating authority and who also set the rates that motor carriers could charge for their services commonly considered trucking companies to be public utilities that should be guaranteed a certain rate of return through restricted competition and minimum rates.

Because of the time and expense involved in obtaining intrastate operating authorities and because of the restricted competition and virtually assured profitability, intrastate operating authorities had great value that was reflected on the corporate books of motor carriers. That value is demonstrated by the active market which existed for the sale of intrastate operating authorities. For example, in 1991, Yellow Corporation, through subsidiary Yellow Transportation, paid $6 million for the intrastate operating authorities held by another motor carrier in various states. The purchase was solely for those state operating authorities, and a large portion of that $6 million purchase price is attributable to the intrastate operating authority for Texas, as Texas was one of the most heavily regulated and restrictive states at that time. These intrastate operating authorities were later transferred internally to Yellow's subsidiary, Saia Motor Freight, and formed the essential basis for Saia's expansion into a regional motor carrier.

While intrastate operating authorities were essential to the conduct of business in those markets and while they had great value, as demonstrated by the market for their purchase and transfer, the timing or the circumstances surrounding the granting or acquisition of those

intrastate operating authorities can result in tax basis for various motor carriers holding identical intrastate operating authorities having differing adjusted tax bases.

In 1980 when Congress passed the Motor Carrier Act, loosening the reins of Interstate Commerce Commission control over motor carrier entry and rates, Congress also recognized that motor carriers had lost a valuable asset (in that case, interstate operating authorities) and that the impact of that loss could differ according to the circumstances of each motor carrier. So, Congress followed up in the 1981 Economic Recovery Tax Act with permission for motor carriers to amortize the total amount of their tax basis in the deregulated operating authorities over a 60-month period. Today we are requesting that Congress similarly follow up the Federal Aviation Administration Authorization Act of 1994 with provision for motor carriers to deduct currently the remaining tax basis of their intrastate operating authorities.

There are two major differences between the situation in 1980 and 1981 and that which we have today: First, the federal "deregulation" of interstate operating authorities in 1980 was not nearly as complete as last year's federal preemption of state economic regulation. Under the Motor Carrier Act of 1980, the ICC retained jurisdiction and control over motor carrier entry and rates, although those controls were substantially loosened. It was not until the Trucking Industry Regulatory Reform Act of 1994 that the remaining ICC entry and rate controls were completely eliminated. Even today, vestiges of tariff filing remaining at the ICC.

By contrast, the federal preemption of state economic regulation of trucking immediately eliminated all state jurisdiction and control over motor carrier entry, rates, services, routes, and tariff filing. Confirming that fact are the subsequent actions of various state legislatures and regulatory bodies. Those state legislatures on the regulatory bodies are adjusting their laws or regulations, respectively, to conform to the preemptive provisions of the Federal Aviation Administration Act of 1994. Just as the Statement of Managers accompanying the Conference Report to the Act recognize that the deregulation of intrastate operating authorities would eliminate the asset value for affected motor carriers, and just as the Financial Accounting Standards Board (FASB) has already required motor carriers to take a charge against earnings for the remaining book value of these operating authorities, the various states and regulatory bodies are also recognizing that the old intrastate authorities now have no value by eliminating them from the legal framework in virtually all cases. State legislation and official state regulatory orders have used such terminology as "null and void," "valueless," "canceled," and "revoked" in prescribing the status of intrastate operating authorities held by motor carriers before the January 1, 1995 effective date of intrastate deregulation. For example, the Texas Legislature has passed S.B. No. 3, effective September 1, 1995, under which "all certificates of public convenience and necessity and permits issued to contract carriers under Chapter 314, Acts of the 41st Legislature, Regular Session, 1929 (Article 911b, Vernon's Texas Civil Statutes), are cancelled." This legislation has been signed by the Governor. As a further example, Louisiana has passed H.B. 2100, which cancels its operating authorities effective June 19, 1995.

For Yellow Corporation and its subsidiaries, various states in which Yellow operates and which have on their own already recognized the loss of value in intrastate operating authorities, account for over 92% of Yellow's remaining tax basis. Therefore, we believe there is a far more compelling case for tax deductibility today than there was in 1981.

Second, the potential revenue impact from the deduction of the remaining tax basis in these operating authorities is substantially less today than that considered by Congress in the 1981 ERTA. Where as in 1981, Congress estimated $356 million of revenue impact from the deductibility of interstate operating authorities, today the industry is estimating a revenue impact of only $10 million to possibly $25 million from the deductibility of the remaining tax basis of intrastate operating authorities. The revenue estimate by the Staff of the Joint Tax Committee may be even less under their "scoring" methods.

Yellow believes that Congress should eliminate the current uncertainty over how the deduction of these intrastate operating authorities would be treated by the IRS. On the assumption that the IRS will challenge the current deductibility of these operating authorities, action by this Committee to provide for the current deductibility of the remaining tax basis of intrastate operating authorities would obviate years of litigation and appeal, at considerable expense to both motor carriers and the IRS. This amendment would treat all motor carriers and all authorities equally, irrespective of the circumstances and timing that led to the acquisition of the authorities, and irrespective of the exact approach taken by a state in conforming to the federal legislation. For this reason, the provision would greatly simplify the Internal Revenue Code and the administration of the tax laws. Finally, by approving this amendment, the Committee will round out the intent of Congress that the movement of our Nation's freight should benefit from open and fair competition in the trucking industry, without the restraints of economic regulation or, here, the happenstance of tax status.

For these reasons, Yellow Corporation urges the Committee to provide for the deductibility of the remaining tax basis of intrastate operating authorities for motor carriers.

TESTIMONY OF THE INTERNATIONAL MASS RETAIL ASSOCIATION

The Proposal to Permit Taxpayers to
Estimate Shrinkage for inventoryAccounting
July 27, 1995

The International Mass Retail Association is pleased to provide its comments on, and support for, the proposal before the House Ways and Means Committee to mandate the development of a methodology to estimate accrued inventory shrinkage.

The International Mass Retail Association represents 170 mass retailers that include discount department stores, home centers, catalogue showrooms, dollar stores, variety stores, warehouse clubs, deep discount drugstores, specialty discounters and off-price stores. Collectively, IMRA retail members operate more than 54,000 stores in the U.S. and abroad and employ over a million people. The retail members represent the overwhelming majority of the $282 billion mass retail industry.

IMRA has been a leader in working toward a solution to the inventory shrinkage issue since 1989, when the IRS issued a proposed "Industry Specialization Program" paper that challenged the authority to accrue a deduction for inventory losses before confirmation occurred. IMRA has met with IRS and Treasury officials on numerous occasions and provided technical support for the deduction as well as evidence to support the methodology used by the majority of companies that accrue shrink.

Inventory shrinkage is the loss resulting from theft, breakage and error in bookkeeping. Typically, that loss occurs throughout the year and is verified when annual inventory is taken. Accrued shrinkage is the loss occurring between the date the inventory is taken and the end of the taxable year.

The original position of the IRS was based on a decision of the Tax Court in *Altec Corp. v. Commissioner*, T.C. Memo 1977-738, which denied a taxpayer's deduction for estimated shrink, based entirely on the fact that the taxpayer made no attempt whatsoever to substantiate its deduction. The decision is very similar to the denial of legitimate business expenses for lack of proper substantiation. In fact, the Government's trial briefs indicate that the accrual was acceptable if verifiable. Notwithstanding the grounds for denial, not to mention the fact that shrinkage has been accrued and unchallenged for at least fifty years, the IRS proceeded to adopt the position that *Altec* stood for the legal proposition that the accrual of shrinkage was not permitted in any case.

Even though the retailing industry has provided abundant evidence to the IRS and Treasury officials supporting the proposition that accrued shrinkage can be estimated statistically with a high degree of accuracy, the Government has maintained its position and has forced numerous companies into settlement of the issue and at least five companies into litigation. The first decision rendered on the issue upheld the taxpayer's position on the technical question of whether the accrual is permitted under the statutes. The summary judgment of the Tax Court in *Dayton Hudson and Subsidiaries v. Commissioner*, 101 T. C. 30, left open the question of whether the taxpayer's methodology for calculating the accrual clearly reflected income.

After the Tax Court's decision in *Dayton Hudson*, the only remaining issue concerns the methodology used to calculate a taxpayer's accrual. This issue has been discussed at length with IRS and Treasury officials over the last several years. A well-reasoned methodology was presented to the IRS in 1991. This proposal dealt with the Government's primary concern, which is assurance that over-accruals could not occur. The methodology recommended a "look-back" approach, whereby the accrual would be verified in the subsequent year and any amount accrued in excess of actual shrinkage would be returned by the taxpayer, with interest, as an audit adjustment. The Government was also provided statistical analysis that demonstrated that the assumptions used to calculate the deduction were valid.

The *Dayton Hudson* decision has also removed the shrinkage issue as a revenue concern for the government, and taxpayers are entitled to accrue shrinkage under present law. The question is whether the government will provide taxpayers with a simple way to estimate shrinkage such as a formula based on sales, or whether complexity will prevail.

In spite of the strength of the taxpayer' positions, the issue remains mired in litigation, which is wasting considerable time and expense for the Government and taxpayers alike. Additional resources will be wasted even if the Government should prevail on the clear reflection issue. A finding that certain taxpayers' methodologies do not clearly reflect income does nothing to settle the issue for hundreds of other taxpayers. The solution to this issue does not rest with the Tax Court. It would be exceedingly burdensome to decide each and every case through this highly inefficient process. The solution lies in a workable methodology that addresses the concerns of all parties.

The retail industry has a made a good-faith effort to settle this issue in an efficient and amicable manner. In the best interest of all concerned, it is now up to Congress to step in and settle the issue.

The members of the International Mass Retail Association, representing the largest and fastest growing segment of the retail industry, support the Ways and Means Committee's effort in proposing a solution. We would like to work with the Committee and its staff to structure the specifics of a method of estimating accrued shrinkage that is simple for taxpayers to use but protects the revenue concerns of the Treasury that shrinkage will not be over-accrued. We need to put this issue to rest once and for all. IMRA stands ready to provide the Committee with any assistance necessary.

Testimony of
Maurice Scully, Executive Director
Connecticut Municipal Electric Energy Cooperative
Submitted to
House Committee on Ways and Means
Hearings on Miscellaneous Tax Reforms
July 11-13, 1995

Explanation of the Proposed Amendment to the Internal Revenue Code to Enhance the Ability of Municipal Utilities to Prudently Fund for Future Nuclear Decommissioning Liabilities

Thank you, Mr. Chairman and members of the Committee, for this opportunity to submit written testimony on behalf of the amendment submitted by Congresswoman Nancy Johnson.

The Connecticut Municipal Electric Energy Cooperative (CMEEC) is a joint action agency that supplies wholesale electric power to all of the municipal utilities in Connecticut. CMEEC has a joint ownership interest in one nuclear power plant and purchases power from five other nuclear units under "life-of-the-unit, take-or-pay" contracts with Northeast Utilities (NU). CMEEC and its customers are legally responsible for a proportional share of the costs of decommissioning each of the nuclear units.

As permitted under current tax laws, CMEEC has established a separate decommissioning trust for the Millstone 3 nuclear unit, in which it has an ownership interest. The experience with this trust has been very favorable, it has enabled CMEEC to amass more funds for decommissioning Millstone 3, at a lower cost to CMEEC's ratepayers. Because municipal utilities are exempt from federal and state income taxes, CMEEC does not pay income taxes on annual deposits to the trust or on earnings from fund investments.

By contrast, when CMEEC makes payments into NU's decommissioning trusts for the five nuclear units under contract, a portion of those payments is subject to income tax. In addition, NU's trust fund investments are subject to income tax (except for investments in tax-exempt securities), whereas all earnings on investments made by the CMEEC trust for Millstone 3 are non-taxable. Thus, by paying into NU's decommissioning trusts instead of into a

separate CMEEC trust, CMEEC and its customers are bearing greater costs and accumulating less money for decommissioning the five units under contract.

Nuclear decommissioning cost estimates have increased dramatically in recent years, and there is a great deal of uncertainty about the ultimate magnitude of costs because of a lack of actual experience in decommissioning commercial nuclear power plants and unresolved questions about disposal of nuclear waste. Given these realities, CMEEC believes that it is prudent to plan for the possibility of higher decommissioning costs in the future. CMEEC could accumulate additional money for decommissioning, while achieving substantial savings for its ratepayers, by establishing separate trusts for the five nuclear units whose output it purchases under contract.

Assuring efficient funding of nuclear decommissioning is sound national policy and in the interest of all citizens of Connecticut. However, Treasury Regulation 1.88-1, issued by the IRS in 1988, makes it difficult, if not economically infeasible, to establish a separate decommissioning trust fund for the five nuclear units under contract. The IRS regulation requires that monies contributed to a separate trust fund by a customer utility (such as CMEEC) that buys power under contract from a taxpayer utility (such as NU) be assigned as income of the taxpayer utility in the same year and subject to income tax.

Therefore, we encourage Congress to amend Section 88 of the Internal Revenue Code to provide that amounts paid by a wholesale electric customer into a separate nuclear decommissioning trust shall not be included in the seller's gross income until the taxable year when the funds are paid to the seller. The proposed amendment would require that such a trust be consistent with the guidelines promulgated by the Nuclear Regulatory Commission and the Federal Energy Regulatory Commission, and consistent with restrictions on self-dealing in the Code.

CMEEC's preliminary analysis indicates that the amendment is not likely to result in a significant loss of revenues to the Treasury. Our best estimate is that the federal revenue loss would be less than $400,000 over the next five years.

Given the minimal fiscal impact of this amendment, we believe there is a strong public interest in providing for the efficient funding of ultimate decommissioning costs. In enacting the nuclear decommissioning amendments to the Internal Revenue Code in 1984, Congress recognized that tax policy should promote nuclear decommissioning funding. The Conference Report to the Deficit Reduction Act of 1984 stated:

> The conferees recognize the importance of ensuring that utilities comply with nuclear power plant decommissioning requirements. In view of this concern, the conferees believe it may be appropriate for the tax-writing committees to study further the merits of providing tax incentives for establishing decommissioning funds.[1]

CMEEC participants are Groton, Jewett City, Norwich, South Norwalk, Wallingford and Norwalk.

The text of the proposed amendment is attached, followed by a brief revenue impact estimate.

House Conf. Rept. No. 98-861 on H.R. 44170, 98th Cong., 2nd Sess. (June 23, 1984), p. 879.

The Proposed Amendment

§88. **Certain amounts with respect to nuclear decommissioning costs.**

(a) In the case of any taxpayer who is required to include the amount of any nuclear decommissioning costs in the taxpayer's cost of service for ratemaking purposes, there shall be includible in the gross income of such taxpayer the amount so included for any taxable year, unless the requirements of subsection (b) are met.

(b) In the case of any taxpayer who sells nuclear energy pursuant to a contract or rate schedule which provides for payment of nuclear decommissioning costs to the taxpayer at the time when decommissioning occurs rather than at the time when the electric energy is supplied and consumed, amounts paid by a customer into a separate nuclear decommissioning trust, or customer contribution and earnings on such contributions currently, shall not be included in the gross income of the taxpayer until the taxable year when the trust funds are paid to the taxpayer, provided that the customer's nuclear decommissioning trust is funded and administered in a manner consistent with the decommissioning funding guidelines promulgated by the Nuclear Regulatory Commission for licensees and by the federal Energy Regulatory Commission for public utilities, and also provided that the customer's nuclear decommissioning trust satisfies the requirements of section 468A(e)(4) and (5). Such amounts shall include all payments made subsequent to this amendment, and all amounts on account for an affected customer in any qualified trusts established by the taxpayer transferred to a nuclear decommissioning trust as provided for herein

Estimate of Revenue Impact to the Treasury

The attached represents CMEEC's estimate of the revenue impact of the establishment of separate municipal trusts for CMEEC's decommissioning liability for the Millstone 1 and Millstone 2 nuclear units. CMEEC has been advised by Connecticut Light and Power (CL&P) that all contributions to the trust are tax-qualified (*i.e.*, there is a tax deduction for these contributions). Therefore, the impact to the U.S. Treasury attributable to the annual contribution to the trust is zero. The actual revenue impact results from earnings on the trust itself. We have been advised by CL&P that all but a very small percentage (five percent) of the investments in the fund are tax-exempt securities. For our analysis we assumed a much higher level (50 percent) to be invested in taxable securities. We made this assumption in recognition of the fact that trusts ae taxed at a relatively low tax rate (20 percent) and that the new FERC guidelines for investments will most likely provide an economic basis for investing more in taxable investments. Even with this generous assumption, the net impact on the treasury is less than $400,000 over the five-year period. If 100 percent of the trust is invested in taxable securities and earnings are at 10 percent, which is highly improbable, the maximum impact on the treasury would be approximately $1,000,000 over the five-year period.

WRITTEN COMMENTS
OF
COMMONWEALTH EDISON COMPANY
REGARDING
MISCELLANEOUS TAX PROPOSALS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Commonwealth Edison Company ("ComEd") appreciates the opportunity to submit written comments concerning one of the miscellaneous tax proposals considered in your recent hearings held on July 11 and 12, 1995. In particular, ComEd submits comments on the proposal that would repeal the ruling requirement for nuclear decommissioning costs. In addition, ComEd respectfully encourages the Committee to enact those provisions of the miscellaneous tax proposals that would simplify the tax of complying with the tax law and promote fair and open competition.

ComEd is located in Chicago, Illinois, is an investor-owned electric utility which ComEd services more than 3 million customers in the northern third of Illinois.

ComEd owns and operates 13 member electric generating units, one of which is retired. As a result, ComEd maintains 13 separate qualified nuclear decommissioning funds. ComEd is the nation's leader in nuclear electric generating capacity. Because of that, ComEd is concerned with the efficient funding of the future cost of nuclear decommissioning.

In the interest of simplifying and reducing the cost of compliance for both government and taxpayers, ComEd strongly supports the proposal to eliminate the current statutory requirement that a utility company seek and obtain an advance ruling from the Internal Revenue Service ("Service") before being permitted to make deductible contributions to a qualified nuclear decommissioning fund under Code Section 468A.

This proposal, described on page 12 of Description of Miscellaneous Tax Proposals (JCS-10-95) July 10, 1995, in contained in H.R. 1637, the Nuclear Decommissioning Cost Simplification Act of 1995, which was introduced in this Congress by Representative Phil Crane (R-Illinois).

This legislation has a simple, single purpose -- to reduce the unnecessary administrative cost incurred by both the Service and taxpayers to comply with the advance ruling requirement of Section 468A. This change will reduce compliance cost for both taxpayers and the Internal Revenue Service with no revenue loss of the federal government and will have no adverse effect on public health or safety considerations.

Code Section 468A, permits a utility company to deduct contributions to a qualified nuclear decommissioning fund. A qualified nuclear decommissioning fund is a trust that is used to accumulate monies collected from utility customers and contributed by utilities to pay for the decommissioning of a nuclear plant at the end of its useful life. A utility is required to establish a separate qualified nuclear decommissioning fund for each nuclear plant unit that it owns or in which it has an ownership interest.

The amount of payment that may be contributed to a qualified nuclear decommissioning fund is limited to the lesser of (i) the amount of nuclear decommissioning costs allocable to the fund which is included in the taxpayer's cost of service for ratemaking purposes for such taxable year, or (ii) the ruling amount applicable to such taxable year. If the fund accepts any payment other than payments which represent allowed deductions, the nuclear decommissioning fund may be disqualified and treated as having distributed all of its funds. In order to determine the allowable payment amount for purposes of Section 468A, the taxpayer must request and receive a Schedule of Amounts ("SRA") from the Secretary of the Treasury. This requires taxpayers to prepare and submit a detailed application to the Secretary for each separate qualified nuclear decommissioning fund.

Section 468A is the only provision of the Internal Revenue Code in which a deduction is made conditional upon pre-approval by the Secretary of the Treasury. The process of preparing and filing for the SRA is entirely computational and presents no unusual issues requiring a change from the normal practice and policy which allows taxpayers to claim deductions on their tax returns subject to a subsequent audit by the Service.

The proposed legislation would simply eliminate the current requirement to seek and obtain an advance ruling from the Service. The computation of the allowable deduction and the rules governing the operation of qualified nuclear decommissioning funds would not change in any respect.

This simplification would merely conform Section 468A to the rest of the Internal Revenue Code which allows taxpayers to compute and claim deductions on their tax returns subject to audit by the Service. Given the fact that all Federal income tax returns of nuclear electric utilities are audited each year by the Service as part of the Coordinated Examination Program, all deductions claimed under Section 468A will be examined by the Service. Taxpayers would be required to keep documentation to support deductions claimed and, if the documentation did not justify the amount of the deduction, the Service would subject the taxpayer to additional tax payments, interest and penalties. The taxpayer would not however, be required to go through the current pre-clearance procedure, and the fund would not be deemed to have made a complete distribution of the amount of the payment, or a portion thereof, which was not allowed as a deduction under Section 468A.

The current requirements for obtaining a Schedule of Ruling Amounts are extremely burdensome and expensive and provide no benefit to the government or to taxpayers. Each request for a ruling requires a user fee of $3,575 and most nuclear utilities have ownership interest in multiple nuclear plant units. In addition to user fees, taxpayers incur substantial compliance cost to hire outside counsel and other resources to prepare and process the ruling requests. The ruling process is also recurring, adding to the cost and burden. Utilities must seek a revised Schedule of Ruling amounts for each nuclear unit each time is regulatory commission adjusts the amount of decommissioning costs included in electric service rates.

In summary, Commonwealth Edison Company urges the Committee to adopt the provisions of H.R. 1637 which will eliminate a costly and burdensome provision of the Code that provides not benefit to the government, taxpayers or the public at large. This provision will have no detrimental revenue impact to the government and will in no way compromise public health or safety.

WRITTEN COMMENTS
OF THE
SOUTHERN CALIFORNIA EDISON COMPANY
REGARDING
MISCELLANEOUS TAX PROPOSALS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 24, 1995

The Southern California Edison Company ("Edison") appreciates the opportunity to submit these written comments concerning one of the miscellaneous tax proposals considered in your recent hearings held on July 11 and 12, 1995. In particular, Edison submits comments on the proposal that would repeal the ruling requirement for nuclear decommissioning costs. In addition, Edison respectfully encourages the Committee to enact those provisions of the miscellaneous tax proposals that would simplify the task of complying with the tax law and promote fair and open competition.

Edison, which is headquartered in Rosemead, California, is the nation's second-largest electric utility based on number of customers. Edison, a 108-year old investor-owned utility, services more than 4.1 million customers in Central and Southern California. Our service territory covers over 50,000 square miles and has a total population exceeding 11 million. Edison is a subsidiary of SCEcorp, which is primarily an energy services company.

Southern California Edison owns a majority interest in the San Onofre Nuclear Generating Station, consisting of two operating units and one retired unit, located in California. The Company also owns a minority interest in three operating units at the Palo Verde Nuclear Generating Station located in Arizona. As a result, the Company maintains six separate qualified nuclear decommissioning funds and is very interested in assuring that nuclear decommissioning funds are collected and available to meet our decommissioning and decontamination obligations on the most efficient and least cost basis.

In the interest of simplifying and reducing the cost of compliance for both government and taxpayers, the Company strongly supports the proposal to eliminate the current statutory requirement that a utility company seek and obtain an advance ruling from the Internal Revenue Service ("Service") before being permitted to make deductible contributions to a qualified nuclear decommissioning fund under Code Section 468A.

Repeal Treasury Ruling Requirement for Nuclear Decommissioning Funds

This proposal, described on page 12 of Description of Miscellaneous Tax Proposals (JCS-19-95) July 10, 1995, is contained in H.R. 1637, the Nuclear Decommissioning Cost Simplification Act of 1995, which was introduced in this Congress by Representative Phil Crane (R-Illinois).

This legislation has a simple, single purpose—to reduce the unnecessary administrative cost incurred by both the Service and taxpayers to comply with the advance ruling requirement of Section 468A. This change will reduce compliance cost for both taxpayers and the Internal Revenue Service with no revenue loss to the federal government and will have no adverse effect on public health or safety considerations.

Code Section 468A, which was enacted in 1984, permits a utility company to deduct contributions to a qualified nuclear decommissioning fund. A qualified nuclear decommissioning fund is a trust that is used to accumulate monies collected from utility customers and contributed by utilities to pay for the decommissioning of a nuclear plant at the end of its useful life. A utility is required to establish a separate qualified nuclear decommissioning fund for each nuclear plant unit that it owns or in which it has an ownership interest.

The amount of payment that may be contributed to a qualified nuclear decommissioning fund is limited to the lesser of (i) the amount of nuclear decommissioning costs allocable to the fund which is included in the taxpayer's cost of service for ratemaking purposes for such taxable year, or (ii) the ruling amount applicable to such taxable year. If the fund accepts any payment other than payments which represent allowed deductions, the nuclear decommissioning fund may be disqualified and treated as having distributed all of its funds. In order to determine the allowable payment amount for purposes of Section 468A, the taxpayer must request and receive a Schedule of Ruling Amounts (SRA) from the Secretary of the Treasury. This requires taxpayers to prepare and submit a detailed application to the Secretary for each separate qualified nuclear decommissioning fund.

Section 468A is the only provision of the Internal Revenue Code in which a deduction is made conditional upon pre-approval by the Secretary of the Treasury. The process of preparing and filing for the SRA is entirely computational and presents no unusual issues requiring a change from the normal practice and policy which allows taxpayers to claim deductions on their tax returns subject to a subsequent audit by the Service.

The proposed legislation would simply eliminate the current requirement to seek and obtain an advance ruling from the Service. The computation of the allowable deduction and the rules governing the operation of qualified nuclear decommissioning funds would not change in any respect.

This simplification would merely conform Section 468A to the rest of the Internal Revenue Code which allows taxpayers to compute and claim deductions on their tax returns subject to audit by the Service. Given the fact that all Federal income tax returns of nuclear electric utilities are audited each year by the Service as part of the Coordinated Examination Program, all deductions claimed under Section 468A will be examined by the Service. Taxpayers would have to submit documentation to support deductions claimed and, if the documentation did not justify the amount of the deduction, the taxpayer would be subject to additional tax payments, interest and penalties consistent with all other deductions claimed on tax returns. The taxpayer would not, however, be required to go through the current pre-clearance procedure, and the fund would not be deemed to have made a complete distribution of the amount of the payment, or a portion thereof, which was not allowed as a deduction under Section 468A

The current requirements for obtaining a Schedule of Ruling Amounts are extremely burdensome and expensive and provide no benefit to the government or to taxpayers. Each request for a ruling requires a user fee of $3,575 and most nuclear utilities have ownership interests in multiple nuclear plant units. In addition to user fees, taxpayers incur substantial compliance cost to hire outside counsel and other resources to prepare and process the ruling requests. The ruling process is also recurring, adding to the cost and burden Utilities must seek a revised Schedule of Ruling Amounts for each nuclear unit each time its regulatory commission adjusts the amount of decommissioning costs included in its rates.

In summary, the Southern California Edison Company urges the Committee to adopt the provisions of H.R. 1637 which will eliminate a costly and burdensome provision of the Code that provides no benefit to the government, taxpayers or the public at large. This provision will have no detrimental revenue impact to the government and will in no way compromise public health or safety. This provision is a win for the Service and for taxpayers and should be enacted as a component of your tax simplification efforts.

U.S. Department of Justice

Federal Bureau of Investigation

Office of the Director

Washington, D.C. 20535

July 11, 1995

Honorable Bill Archer
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C.

Dear Mr. Chairman:

Over the last two decades, the FBI has seen criminal enterprises and activities become more complex and sophisticated. Our ability to successfully pursue these criminals is due in large part to our willingness to commit our investigative and support resources to these cases...cases which can take years as investigators review thousands of pages of financial documents; undertake 24-hour-a-day, seven days a week surveillances, participate in long-term undercover assignments; or assist in long-term monitoring of court-authorized interceptions of oral communications. Our Agents and professional support assigned to these long-term investigations are often selected because they have a particular specialty, training, or experience considered critical to the successful conclusion of the case. These employees willingly disrupt their personal lives to work such important long-term cases.

Since October 1992, 560 FBI Special Agents have been on Temporary Duty (TDY) assignments, 79 of which have lasted more than one but less than two years. However, this number could very well have been larger but for the fact that the FBI rotated personnel in some cases to avoid the tax liability from reimbursements paid to the employee for travel and related expenses associated with the temporary assignment. Those assigned to TDYs do so at no small sacrifice - they are away from friends and family in a strange city working long hours all with a goal of seeing criminals brought to justice. Some face another burden - a tax burden because of these long-term assignments.

As you know, current law [Title 26, U.S.C. Section 162 (a)] permits the deduction from income of travel expense reimbursements received by an employee while away from home in the pursuit of a trade or business. However, the Energy Policy Act of 1992 amended the statute to limit the deduction to only those instances where the period of travel does not exceed one year.

This limitation has had an adverse effect on our ability to staff investigations that last more than one year. To avoid the adverse tax consequences to our employees on extended TDY assignments, the FBI will attempt to rotate the employee out of the assignment before the end of one year. If the employee is removed from his temporary assignment before the case has concluded, the investigation is hurt by the loss of knowledgeable personnel. This is a costly disruption to our law enforcement efforts. The employees removed from the assignment are most familiar with the investigation and all the facts and nuances associated with it. Their relocation results in a serious loss of institutional knowledge. Although new employees will be assigned to the case, there is a negative impact on the investigation as these employees expend many hours familiarizing themselves with what has occurred prior to their arrival so they can pick up the reins and move the case forward. In the alternative, we face the expense of permanently reassigning the employee to the investigation's locale knowing that when the case concludes and there is no longer justification for the additional resources in a field division, the employee will again be relocated.

To require a changeover in personnel just to alleviate personal tax consequences to an employee is both inefficient and unproductive. It also increases costs since new personnel require time to become familiar with the case. The alternative, a permanent transfer of the employee until the conclusion of an investigation in order to avoid the tax consequences of an extended TDY, is also a needless expense for the government. It also disrupts the employees' and their families' lives.

I do not believe the concerns I have raised are unique to the FBI - any federal agency which undertakes the investigation of federal crimes would face similar concerns with assigning employees TDY to long-term investigations.

I appreciate your interest in this law enforcement-related problem. If you should have any questions concerning this matter, please do not hesitate to contact me.

Sincerely yours,

Louis Freeh

Louis J. Freeh
Director

TESTIMONY OF

THE AMERICAN MOVERS CONFERENCE

REGARDING MISCELLANEOUS TAX PROPOSALS

BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

JULY 11, 1995

[written testimony submitted for the record]

Mr. Chairman and members of the Committee:

The American Movers Conference (AMC) is pleased to comment on the miscellaneous tax proposal to increase from 50 percent to 80 percent the deductibility of business meal expenses for individuals subject to Federal hours of service limitations.

AMC is the largest national trade association of household goods movers. AMC is the principal voice for an industry employing over 450,000 people and generating over $7 billion per year in revenues. AMC represents nearly 3,000 members nationwide and represents all facets of the moving industry including national van lines, their affiliated agents, independent regional and national carriers, and owner-operators.

Our members employ or contract with 30,000 drivers who own their own tractor-trailer and move goods coast-to-coast. These drivers are essential to the moving business. Other than occasionally hiring temporary employees, these independent owners not only drive their own trucks but load and unload their trucks as well. Being a long-haul truck driver often means spending months at a time on the road and requires innumerable "necessary and ordinary" meals.

DEDUCTIBLE BUSINESS MEALS

Presently, 50 percent of necessary and ordinary (not lavish or extravagant) meal expenses are deductible under Internal Revenue Code Section 274. The deduction was reduced from 80 percent to 50 percent as part of the *Omnibus Budget Reconciliation Act of 1993* (P.L. 103-66). This is in addition to the 20 percent reduction already suffered as part of the *Tax Reform Act of 1986* (P.L. 99-514).

This reduction to 50 percent has greatly hampered the ability of our drivers to survive economically during a time when their costs are increasing, their income is decreasing, and their tax burden has increased when their income has not.

PROPOSAL

The proposal currently before the Committee would provide that 80 percent of meal expenses would be deductible with respect to food or beverages consumed by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation (DOT). The proposal would be effective for taxable years beginning after December 31, 1994. It would apply to four general categories of individuals who are currently subject to the hours of service limitations: (1) interstate truck and bus drivers; (2) certain air transportation employees; (3) certain railroad employees; and (4) certain merchant mariners.

This proposal is currently embodied as H.R. 1003, the *Fairness for Workers on the Road Act*, a bi-partisan bill introduced by House Ways and Means Oversight Subcommittee Chairwoman Nancy Johnson (R-CT) and Committee Member Richard Neal (D-MA). Senator Herb Kohl (D-WI) has introduced companion legislation (S. 434) in the Senate.

Chairwoman Johnson's introductory statement in the Congressional Record reflects her acknowledgement of the significant burden that the changes enacted in 1993 place on the trucking industry. Ms. Johnson states, "Long-haul truck drivers spend over 200 days per year away from home. They eat at roadside diners and truck stops and sleep in their trucks or modest hotels. In doing so, they incur the legitimate and necessary business expenses required in their work and do not enjoy the expense-account lifestyles of the individuals originally targeted in the 1993 legislation." [1]

WHY THE CHANGE IS NECESSARY

No Martini Lunches

Long-haul truck drivers from moving companies often spend eight to ten months on the road each year. The expenses incurred for meals are not the "three martini lunches" that Congress intended to curb in 1986 and 1993, but rather, are quick meals at truck stops. They are not optional personal expenses since there is scarcely a substitute for eating on the road in this occupation.

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1 *Fairness for Workers on the Road Act*, Congressional Record, pg. E391, February 21, 1995.

For example, one of our drivers logged in 310 days on the road during a 12 month period. He spent on average $25 per day for meals, for a yearly total of $7,750. Another driver was on the road for a total of 290 days and spent an average of $20 per day on meals. These meals are almost exclusively eaten at facilities spacious enough to accommodate tractor-trailers.

On a rare occasion, a truck driver may seek to enjoy a "nice sit-down meal"; however, the areas where these restaurants are located are usually not accessible to a truck pulling a 50 foot trailer.

The end result of the reduced deductibility enacted in 1993 is significant. For a driver with $6,000 a year in meal expenses, the change means an additional $1,800 in legitimate and necessary, yet non-deductible, expenses. This increased expense can mean the difference between success and failure in a highly and economically distressed industry.

DOT Federal Service Limitations

To further compound the situation. DOT Federal hours of service limitations require that a driver cannot spend more than 10 hours per day or 70 hours during a seven day period on the road. Under these rules, truck drivers are required to take layovers that force them to spend additional days on the road.

For example, after six weeks on the road, a driver may be only one day's drive from home. However, because the driver drove 70 hours during the previous seven days, the hours of service limitations require that the driver take a layover for an additional day before finishing the trip. This extra day on the road results in the driver buying additional meals that cannot be fully deducted.

Costs Are Rising

AMC conducts extensive surveys of the moving industry annually to determine average expenses and revenues of our members. The trend that we have discovered is not surprising. Over the past decade, expenses as a percentage of total revenue are going up and net income is going down.

For example, in 1980, the average travel expenses (including meals and lodging) as a percentage of total revenue equaled 8.3 percent. This average rose to 9.5 percent in 1992. Total expenses rose during this period from 72.6 percent to 78.9 percent of revenue. Conversely, total net income as a percentage of revenue dropped during this period from 27.4 percent to 21.1 percent.[2]

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[2] Movers Statistical Profile for 1994, American Movers Conference, March 1994.

This tax cost has become, in essence, an uncontrollable cost, much like our fuel expense, and has worsened an already bleak cost picture. In light of these figures, restoration to the pre-OBRA 1993 deductibility level of 80 percent is essential to the economic well-being of this vital component of our industry.

Other Exceptions to Current Law

Full deductibility is currently allowed for meal expenses incurred by individuals on certain oil and gas platforms or drilling rigs who do not have access to restaurants or other eating facilities.[3]

In providing the exception, the Ways and Means Committee acknowledged the high cost of supplying meals to crews located offshore and stated, "it is appropriate to allow full deductibility of such food and beverage costs." [4]

We respectively submit that the same argument applies to long-haul truck drivers. The Federal hours of service limitations, coupled with the logistics of maneuvering a 50 foot trailer through city streets, severely limits our drivers to truck stops and other facilities that are accessible to large vehicles. These facilities understand the location advantage they possess and generally charge far higher prices for fuel, meals and beverages. It is no wonder that the costs associated with legitimate business meals are so high when our drivers experience $7 hamburgers and $3 soft drinks at truck stops.

Furthermore, Federal law generally restricts large tractor-trailers to interstates and highways with only a few exceptions. For example, an interstate household goods mover is only allowed to leave the interstate long enough to proceed to the destination point to load or unload goods. Upon completion of this service, the mover is required to proceed back to the interstate.

CONCLUSION

The moving industry provides a vital and necessary service to the nation. AMC believes that the reduction in the business meals deduction from 80 percent to 50 percent amounts to a tax increase on these hard-working middle-class Americans. This tax burden has further eroded the ability of our drivers to serve the millions of people who change residences each year.

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3 The Conference Report to Accompany H.R. 4333, the *Technical and Miscellaneous Revenue Act of 1988* (H.Rept. 100-1104), pgs. 134-135, October 21, 1988.

4 *The Miscellaneous Revenue Act of 1988* (H.Rept. 100-795), pgs. 526-527, July 26, 1988.

More importantly, long-haul drivers have no choice but to eat on the road. One cannot pack a lunch to cover three consecutive months on the road. Our drivers often move household goods and tradeshow materials coast-to-coast taking only the Federally required breaks. Tight scheduling and potential hazards such as weather or mechanical difficulties leave little time to shop at a grocery store when they are on the road.

When introducing S. 434, Senator Kohl summed it up best when he stated, "The reduced business meal deduction is a tax on workers who have no control over the length of their trips, the amount of time they must rest during a delivery, or, in many cases, the places where they can stop to eat." [5]

AMC urges the Committee to act soon on this proposal. Each day without the ability to deduct legitimate business meals means additional pressure on drivers in an industry facing increased fuel costs, taxes, and regulatory requirements.

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[5] *The Business Meal Deduction Fairness Act of 1995*, CR, pg. S2828, February 16, 1995.

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

Statement for the Record of

AMERICAN TRUCKING ASSOCIATIONS

on

RESTORING 80% DEDUCTION FOR MEAL COSTS OF INDIVIDUALS SUBJECT TO FEDERAL HOURS-OF-SERVICE LIMITATIONS

July 27, 1995

The American Trucking Associations (ATA) submits these comments in support of legislation to restore the deductibility of meal expenses for truck drivers and others subject to federal hours-of-service limitations. Specifically, ATA supports H.R. 1003, which would restore 80% deductibility for these costs, the level that prevailed in 1987-93. We commend Reps. Nancy Johnson (R-CT), Richard Neal (D-MA) and William Jefferson (D-LA), the original cosponsors of H.R. 1003, as well as the dozens of Ways and Means members and other Representatives who have signed onto the bill.

Who We Are

ATA is the national association of the trucking industry. Over 34,000 carriers, ranging from individual owner-operators to multinational companies, belong directly to ATA or to our 51 state and 12 specialized national affiliates. Thousands of these businesses send trucks on medium-to-long hauls that require drivers to be on the road from one night to weeks at a time. These companies and their drivers, whether they are employees or independent contractors, have a strong interest in the tax treatment of business meals.

Prior and Current Law

Until 1987, meals consumed while on business away from home overnight were fully deductible. From 1987 through 1993, these meals were 80% deductible. However, since January 1, 1994, business meals have been only 50% deductible.

The cutbacks in the deduction enacted in 1986 and 1993 were billed as a way of curbing lavish business deductions for entertainment and, to a lesser extent, meals. The provision was sometimes characterized as affecting mainly executives and lobbyists living high on expense accounts.

Impact on Truck Drivers

But the harsh reality is that the 1993 reduction in particular struck squarely at hard-working, middle-class truck drivers whose meal expenses are anything but lavish. Tens of thousands of truck drivers, whose only choice of eatery is which truckstop to pull into, were suddenly told their meals were now just 50% deductible.

The burden is compounded by federal hours-of-service regulations, which limit the amount of time a truck driver can be on the road. Drivers must remain away from home until they have accumulated sufficient off-duty hours to resume driving and complete their trip. This can necessitate additional nights on the road.

Rather than keep receipts for every cup of coffee, most drivers or their companies follow the IRS guidelines for meal and incidental expense (M&IE) allowances. Currently these rules allow transportation workers $32 per day for meals and incidentals.

For a truck driver who is on the road 300 days a year, the allowance comes to $9600 per year. Only $4800 of that is deductible, a stiff reduction ($2880) from the $7680 that was formerly deductible. For a driver in the 28% tax bracket, this reduction in allowable expenses means a tax increase of $806--quite a wallop in the wallet of a worker who may be netting $35,000 per year.

Furthermore, truck drivers are nicked on "incidental" nonfood expenses as well as meals. Executives on business trips stay in hotels in which showers are included in the price of the room. They typically get home often enough that they do not have to pay for laundry on the road. Not so with drivers. Drivers must often pay as much as $5 for a shower and inflated rates for coin laundries. Yet under IRS rules, for workers who use M&IE allowances instead of keeping track of every item, these incidental costs are subject to the same 50% limitation as actual meal expenses.

Treatment of other workers

Congress has recognized that other workers who have no discretion over where to eat their business meals should not have to suffer a denial of deductibility. Internal Revenue Code section 274(n)(2)(E) allows full deductibility if

(E) such expense is for food or beverages--
(i) required by any Federal law to be provided to crew members of a commercial vessel,
(ii) provided to crew members of a commercial vessel--
(I) which is operating on the Great Lakes, the Saint Lawrence Seaway, or any inland waterway of the United States, and
(II) which is of a kind which would be required by Federal law to provide food and beverages to crew members if it were operated at sea,

(iii) provided on an oil or gas platform or drilling rig if the platform or rig is located offshore, or
(iv) provided on an oil or gas platform or drilling rig, or at a support camp which is in proximity and integral to such platform or rig, if the platform or rig is located in the United States north of 54 degrees north latitude.

In many parts of the country, a truck driver's rig limits choice of eatery almost as much as the oil worker's rig. The tax code should not treat truck drivers as second-class citizens when it comes to meal costs in comparison to either executives or oil, gas and vessel crews.

Although truck drivers are as deserving of full meal deductibility as these other workers, ATA recognizes that revenue considerations may make only 80% deductibility feasible this year. Accordingly, ATA supports enactment of H.R. 1003.

H.R. 1003

H.R. 1003 is a narrowly drawn bill, designed to restore partial equality among different categories of transportation workers, yet mindful of the severe revenue pressures facing the Committee. The bill returns workers covered by federal hours-of-service rules to the 80% deduction they received in 1987-93. These workers include long-distance truck and bus drivers plus aircraft, rail and merchant marine crews. Each of these categories of workers is constrained by federal regulations and the nature of their workplace as to when and where they can stop to eat, much as vessel and offshore or North Slope oilfield crews are. (Other transportation workers are subject to hours-of-service regulations but do not normally perform their jobs away from home; thus, they would not qualify for any meal deduction under IRS regulations.)

Because truck drivers and other affected workers already receive meal allowances for travel away from home, this bill would not entail any additional paperwork burden. Individuals (or their employers) would merely claim an 80% deduction for meals (or M&IE allowances) that currently qualify for a 50% deduction. As under current law, on those days in which the individual is not away from home, no deduction would apply.

Conclusion

ATA urges you to restore at least 80% deductibility for business meals of truck drivers and others subject to federal hours-of-service limits that constrain their choice of where to eat and when to get home. When revenues permit, we hope you will again allow these hard-working individuals the full deduction they deserve for their modest meal costs.

Daniel P. Gaither
1111 Smelter Avenue
Black Eagle, MT 59414

July 10, 1995

Committee on Ways and Means
Attn: Mr. Philip D. Moseley, Chief of Staff
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: Deductibility of business meals for truckers (H.R. 1003)

Dear Committee Members:

I am writing as a small businessman to call your attention to an extreme and unfair tax increase that has been imposed on me and thousands of other hard-working truckers. I'm writing about the cutback in the deduction for business meals that took effect last year, and to the fact that U.S. Department of Transportation (DOT) regulations limiting hours of service make this cutback especially unjust for truckers. I urge the Committee to restore for truckers at least the 80% deduction that existed from 1987 to 1993, as included in H.R. 1003. Full deductibility would be even fairer, if revenues permit.

I am an owner-operator. I own and drive my own tractor and trailer, which I lease to North American Van Lines (NAVL)--Alaska Highway Division. I haul household goods throughout the continental United States and Canada. In 16 years, I have traveled 2 million accident-free miles, and I have been awarded NAVL's Hauler of the Year in 1990, 1991 and 1992. This year I'm one of 11 spokespersons for America's Road Team, teaching highway safety to motorists and truckers and representing the industry to news media, transportation officials and government leaders from coast to coast.

As you can imagine, my schedule keeps me on the road a lot--275 to 320 days a year. DOT regulations limiting driving and on-duty hours often dictate when and where I stop to eat. This can force me to spend another night on the road instead of getting home. Also, there are restrictions imposed by city, county, state and federal governments on where an 18-wheeler can travel or park. As a result, I sometimes end up paying monopoly prices in truckstops for foods most people buy for much less, even when I eat in my cab. Just last week, I had to pay $4.98 at a truckstop for a box of Cheerios.

It is unfair that the tax law says I can deduct only half the cost of my meals on the road, even when the sole reason I am on the road sometimes is because of the DOT hours-of-service rules.

My meals are not fancy, since often my only choice is which truckstop to park at, but the costs are significant to me. Under current IRS rules, I can claim only $32 per day for meals <u>and</u> incidental expenses. (My actual expenses are probably much higher, but it's hard to get receipts from most coffee vending machines and coin-operated laundries.) In a typical year, when I'm on the road for 300 days, that comes to $9600. The $9600 used to be fully deductible, which seems only right to me. In 1987, that deduction was trimmed to 80% of actual cost, or $7680. Last year, the deductible portion fell to 50%, or $4800, a drop of $2880. That's a tax increase of more than $800 if I'm in the 28% tax bracket.

Adding insult to injury, I have to count my shower and laundry expenses on the road as part of my meal allowance and take only a 50% deduction for those. You may not realize it, since you probably are never billed separately for showers and usually get to do laundry at home, but drivers sometimes pay as much as $5 for a shower at a truckstop, along with inflated prices for detergent, laundry and other "incidental" costs.

Maybe most members of Congress thought they were only going after lobbyists and executives when they cut back the meal and entertainment deductions. It's hard to believe they <u>meant</u> to punish struggling small-businessmen like myself or the thousands of employee drivers who were hit by these cutbacks. In fact, I understand that boat crews and oilfield workers offshore or in Alaska can still deduct 100% of their meal costs. But the fact remains that DOT regulations and the size of our tractors restrict long-haul truckers' choice of eateries almost as much as those other workers. Yet we are now "eating" half the cost of our meal, shower and laundry expenses on the road because of the 1993 change in law, even when we are still on the road because the DOT rules keep us away from home an extra night.

I hope you will give individuals subject to hours-of-service rules the same fair treatment as workers who have no choice but to eat on ships or oil rigs. At a minimum, I urge you to adopt H.R. 1003, which allows truckers and others under hours-of-service limits to deduct 80% of meal costs. Thank you.

Sincerely,

Daniel P Gaither

Daniel P. Gaither

Leading the Foodservice Hospitality Industry

1200 SEVENTEENTH STREET N.W., WASHINGTON, DC 20036-3097 202/331-5900 FAX: 202/331-2429

NATIONAL RESTAURANT ASSOCIATION

Testimony of

Elaine Z. Graham, Senior Director of Government Affairs

July 27, 1995

Thank you for the opportunity to submit testimony with regard to the Ways and Means Committee hearing on miscellaneous tax provisions.

As the leading trade association for America's foodservice industry, the National Restaurant Association applauds your consideration of H.R. 1003, legislation which would restore the deductibility of business meal expenses for individuals who are subject to federal hours of limitation under Department of Transportation regulations. Further, we support the restoration of the deduction to 100% for all business meals and entertainment.

The reduced business meal and entertainment deduction has affected users of the deduction as well as restaurateurs who have experienced decreased sales. The recently concluded White House Conference on Small Business, which was composed of men and women from around the country, made restoration of the deduction a priority issue. Business meals are a legitimate marketing tool and a necessary expense for a wide variety of people. Many businesses, particularly the small ones, rely on the one-on-one relationships that are forged over a meal. For these businesses, other types of advertising are either too expensive or not effective.

In addition, restaurateurs have seen decreased consumer spending in their establishments. Lower business lunch sales have been reported, which, from conversations with customers, can be traced to the decreased business meal deduction. For example-and there are many-the mid-priced Via Real Restaurant in Irvine, Texas has seen a 10-12% drop in its business since June 1994, despite an upswing the region's economy. Polls of the restaurant's customers indicate some reasons: bigger companies in and around Irvine are cutting back on large-scale business dining events. Jay's Restaurant, in Dayton, Ohio, closed its doors for lunch July 14, 1994, following a 15% decrease in lunch business—a loss of 2,000 lunch customers—during the previous six months. One Dayton company that provided the restaurant over $200,000 in business each year is no longer reimbursing employees for any business lunch expenses. As further evidence, a September 1994 American Express study indicated that small and medium-sized companies have either taken or anticipate taking some action that potentially reduces restaurant spending, including changes in travel and entertainment guidelines.

Unfortunately, the 1993 decrease in the business meal deduction amounted to nothing less than a $15 billion tax increase on the foodservice and entertainment industries. We strongly urge the Committee to consider full restoration for the business meal and entertainment deduction.

Before the

U.S. HOUSE OF REPRESENTATIVES

Committee on Ways and Means

Comments of the
Owner-Operator Independent Drivers Assn., Inc.

On Proposal For
Miscellaneous Tax Reforms

These comments are submitted on behalf of the Owner-Operator Independent Drivers Association, Inc. ("OOIDA" or "Association") and its members. OOIDA is the national trade association representing the interests of the nation's more than 350,000 owner-operators and small business truckers. The Association is a not-for-profit corporation incorporated in 1973 under the laws of the State of Missouri. Its principal place of business is in Grain Valley, Missouri. The mailing address of the Association is:

Owner-Operator Independent Drivers Assn., Inc.
P.O. Box L
Grain Valley, Missouri 64029

Owner-operators represent up to half of the total number of Class 7 and 8 trucks operated in the United States. The more than 29,000 members of OOIDA are small business men and women that live and work in all 50 states and Canada. Collectively, OOIDA's members own and operate more than 48,000 individual heavy duty trucks and small truck fleets. On average, these individuals drive approximately 100,000 miles per year and spend more than three hundred nights away from home.

The Association advocates the views of small business truckers on issues that affect their interests. These interests range from economic and highway safety issues to those directly affecting

their health and welfare. As part of its representation, the Association regularly presents the views of small business truckers to Congress. Its representatives also serve on various committees of the National Governors' Association, the Commercial Vehicle Safety Alliance, the Professional Truck Driver Institute of America, the American Association of State Highway and Transportation Officials, and other groups.

As small businesses, over the past several years owner-operators have been directly affected by efforts to reduce federal budget deficits. In general, small business truckers are concerned with the size of the deficit and its overall impact on the economy. The trucking industry is very sensitive to economic fluctuations, hence, anything that tends to stabilize the economy is generally good for trucking. However, small business truckers feel that they have been disproportionately singled out to pay more than their fair share of the bill for reducing the deficit and have borne the brunt of substantial increases in highway taxes.

As a result of previous attempts to control the deficit, small business truckers are paying far higher amounts in taxes earmarked for deficit reduction than are other segments of the population. A typical owner-operator truck consumes 20,000 gallons of fuel each year while delivering the nation's goods. At the current rate of 6.8¢ per gallon in fuel taxes dedicated to deficit reduction, each of our members is paying nearly $1,400 per truck per year toward deficit reduction. Even when this amount is reduced by 2½¢ per gallon on October 1st, our members will still be paying, on average, nearly $900 in increased fuel taxes each year toward deficit reduction. The economic condition of the trucking industry precludes owner-operators from passing this cost on. For small business owners that typically have adjusted gross incomes of $20-25,000 per year, the fuel tax increase was the equivalent of a direct five percent loss of income. In addition to tax increases, small business truckers have been squeezed

in the other direction by reduction in, or elimination of, certain tax deductions for items necessary for conducting business.

The Committee has before it a measure that could provide substantial relief with regard to meal deductions. The Committee should also consider other measures which would aid small businesses; in particular the small business truckers that have shouldered the burden of the fuel tax increase. These measures concern full deductibility of health care premiums and complete deductibility of home office expenses.

As previously noted, a typical owner-operator drives nearly 100,000 miles per year. He or she spends more than 300 nights per year, sleeping on the road and away from home. While they are on the road, small business truckers incur living expenses that, under recent amendments, are no longer fully deductible. Further, these individuals' work schedules are governed by federal hours of service regulations that force them to spend even more time away from home which adds to their operation costs.

Currently, there is a pending provision that would change the present law which allows 50 percent deductibility of meal and entertainment expenses in conjunction with a trade or business. According to the new proposal, the owner-operator could deduct 80 percent of his or her meal expenses while on the road. This 30 percent increase in deductibility for meal expenses would significantly help the small business trucker recover their business related costs while on the road.

Moreover, these individuals are regulated by federal hours of service regulations that force them to stop driving and spend a night away from home when they may otherwise be within a one to two hour drive of home. Others not subject to these regulations, such as outside salesmen, would be able to return home and not incur the expense. Unlike the discretionary spending that the provision was

aimed at correcting, small business truckers do not have the ability to reduce their spending by choosing to eat more meals at home. This inability to control costs is based on both their work schedules and compliance with federal regulations. Under the circumstances, they should be allowed to deduct these meal expenses.

Owner-operator businesses revolve around the operation of the truck. For the owner-operator, it is both workplace and living quarters for a large portion of the work year. However, there are functions that cannot be performed in the truck. Typically, they are performed at the small business owners' home. These include filing of quarterly tax reports, accounting functions, maintenance of records, etc.. In many cases, records such as state fuel tax reporting forms, drivers' daily logs, and tax receipts must be kept on file for specific lengths of time in order to comply with federal and state requirements. These records cannot be transported on a truck; nor would that be an efficient way to conduct business. Because they are small businesses that operate on relatively thin profit margins, owner-operators are not afforded the luxury of having a fixed office site; rather, these functions are performed in the home. If the functions were performed in another location, the related expenses would be fully deductible. It is simply not fair to permit one class of businessmen to deduct expenses because their economic circumstances allow them to have an office outside the home while penalizing others who maintain a home office for fulfilling government mandates. For that reason, the Association urges the adoption of legislation that would ensure that home office expenses are fully deductible.

The Association also wishes to comment on the deductibility of health insurance premiums by self-employed individuals. During the recent debate on health care reform OOIDA surveyed its members in order to determine their health care insurance status. The Association found that approximately 40 percent of small business truckers had no health care coverage. The overwhelming

reason cited by these individuals for not having insurance coverage was cost. This cost would be dramatically reduced if self-employed persons were able to fully deduct their health insurance. Ironically, if they provided health insurance to their drivers and other employees, they would be permitted to deduct the full amount. However, as individual small business owners they are precluded from doing so under current law.

The cost of treating a serious illness today can be devastating for a family, even if the individual recovers and returns to work. Some families are never able to recover financially from a major medical expense for which there was no insurance coverage. The Association is deeply concerned that such a large portion of its members operate their businesses with inadequate health care insurance for themselves. OOIDA believes that permitting self-employed individuals to fully deduct the cost of their own health care (as they already can for their employees) is not only good policy, but also is morally necessary. For that reason, the Association encourages the Committee to address this issue in its legislative proposal. The Association believes that the Committee might also wish to consider approving the implementation of "medical savings accounts." Such accounts could be treated in a manner similar to an Individual Retirement Account ("IRA"), such that individuals would be able to invest monies at a reasonable rate to cover future medical expenses.

As the Committee considers various tax reform measures, it will be unable to accommodate all interests. Though these tax reforms will affect a wide range of individuals, we urge the Committee to keep in mind the concerns of the small business person; namely the owner-operator. With continued regulation of the trucking industry and requirements for federal hours of service, OOIDA believes that adjustments should be made to encourage small businesses. OOIDA fully supports H.R. 1003 and any legislation that benefits our owner-operators.

July 20, 1995

To: Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515-6384

From:
Janet Cornish
201 West Granite
Butte, Montana 59701

Representing:
Butte Historical Society
Community, Culture and Heritage

Reference: HR 1662
Date of Hearing: July 11,12 and 13, 1995

Dear Mr. Moseley:

I am writing in support of HR 1662, the Historic Homeownership Assistance Act, which provides for a tax credit for the rehabilitation of historic homes. For nearly 20 years, Federal income tax incentives have been available for the rehabilitation of historic, income producing properties. This tax credit has provided an important incentive for the revitalization of these structures and has served as a catalyst for the renewal of many of our nation's downtowns. However, this incentive has not been available to owners of private residences.

Historic homes, if listed on the National Register of Historic Places (or in an Historic District), were eligible to receive matching grants from the National Park Service for restoration activities. However, there has been little or no funding of the program which provides these grants for more than a decade. Community Development Block Grants through HUD (the Department of Housing and Urban Development) and newer affordable housing programs have provided some assistance to low and moderate income individuals and families in eligible neighborhoods. However, these programs are highly competitive and don't begin to address the large stock of homes which were built before 1940. Overall, our nation's older neighborhoods continue to face deterioration and disenfranchisement.

In Montana, approximately one third of all residences were built prior to 1940. While age is not necessarily an indication of condition, according to the 1992 Montana Comprehensive Housing Affordability Strategy (CHAS), homes of that age have potential problems "related to inadequate foundations, floor supports, and roofs which inevitably grow worse over time". Of those, 25% are owned by elderly residents, who are often less able to afford upkeep. Butte, Montana is home to one of the largest National Landmark Districts in the United States, made up of more than 4000 structures, most of which are private residences. Existing assistance programs are simply not adequate to address this enormous need.

A tax incentive for homeowners to restore their historic homes would serve to begin "filling the gap" between need and available resources to restore these important elements of our American heritage. I heartily encourage your support of HR 1662 and appreciate your thoughtful consideration of this statement.

Sincerely,

Janet A. Cornish

C A L I F O R N I A **P** R E S E R V A T I O N **F** O U N D A T I O N

1615 Broadway – Suite 705
Oakland, California 94612
Telephone: (510) 763 0972

A Statewide Non-Profit Organization
Promoting Historic Preservation

July 24, 1995

Phillip D. Moseley
Chief of Staff, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515-6384

Dear Mr. Moseley,

The California Preservation Foundation strongly supports HR 1662, the Historic Homeownership Assistance Act of 1995, hearings for which were held July 11, 12, and 13, 1995.

The California Preservation Foundation is a statewide, nonprofit, tax-exempt educational organization, representing 100,000 Californians through its members and member organizations, and is concerned with encouraging historic preservation and neighborhood revitalization in California.

HR 1662 is of prime importance because it promotes stability in older neighborhoods which are traditionally disadvantaged and underpopulated. By allowing lower income families to convert the credit into a mortgage credit certificate, and by providing tax credits to middle class homeowners and potential homeowners, HR 1662 will revitalize neighborhoods. Areas which had not been attractive to families will draw new residents and convert renters to homeowners, taxpayers who can support local government and businesses, creating construction and permanent jobs. A valuable side-effect is that homeownership in fringe neighborhoods strengthens the community and motivates residents to combat urban problems including vandalism and crime. For people who rent apartments, these problems can be abandoned by moving to a different building, but homeowners have strong motives for improving life in their neighborhoods.

Ownership of a historic building fosters a stronger sense of community and a sense of pride in one's place in that community. The history of the building and the neighborhood becomes a source of identity for the owners, motivating them to appreciate and take better care of their environment. A neighborhood like West Oakland, for example, is rich in ethnic and architectural history. West Oakland is a mix of modern housing projects and the Victorian houses which have made San Francisco famous. These houses, now in poor repair, could form a base for a thriving neighborhood. Although rental units in housing projects

CALIFORNIA PRESERVATION FOUNDATION

1615 Broadway - Suite 705
Oakland California 94612
Telephone (510) 763-0972

A Statewide Non-Profit Organization
Promoting Historic Preservation

can provide shelter, owner occupied historic structures contribute identity and continuity.

The Federal Government has already recognized that tax credits are useful in the preservation of structures used for commercial, industrial and rental residential purposes. Tax credits for these types of use encouraged diversity in and the continued use of our cities' downtowns, as well as affordable housing. HR 1662 makes available the same benefits for owner occupied properties, stabilizing older neighborhoods and ensuring that a diverse portion of the populace has access to our cultural heritage.

Because of the pressing need to stabilize lower income and middle class communities, we urge that the Historic Homeownership Assistance Act be included in current tax reform proposals being considered by Congress.

Thank you for your consideration of our position.

Most sincerely,

Jeff Eichenfield
Interim Executive Director

EW:JE

CORNERSTONE
RESTORATIONS
EST 1989

July 20, 1995

Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515-6384

Dear Mr. Moseley:

My name is David Nathans and I am president of Cornerstone Restorations, Inc.

I have been involved in Investment Tax Credit restoration in Wilmington, N. C. since 1990.

I have completed projects at 114 N. Eighth Street, 317 N. Fourth Street, 110 N. Eighth Street and 721 Chestnut Street. These projects have sparked the rehabilitation of other houses located in economically depressed inner-city neighborhoods. They have created affordable housing in areas that had no new construction being done at all. We have tried to use as much local labor as possible.

HR 1662 will accomplish the same economic benefits in these same neighborhoods for an individual home-owner. Therefore, this bill would encourage home ownership in these same neighborhoods.

Sincerely,

David Nathans
Cornerstone Restoration, Inc.

114 N. 8TH STREET UNIT A • WILMINGTON, NC 28401 • (910) 763-3169

FLORIDA DEPARTMENT OF STATE
Sandra B. Mortham
Secretary of State

July 26, 1995

Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515-6384

Dear Mr. Moseley:

This letter is for the official record of the Ways and Means Committee hearing held on July 11, 12 and 13, 1995, regarding the revenue and cost estimates for a number of proposed tax bills including the proposed Historic Homeownership Assistance Act, HR 1662.

We are writing to express our unqualified support for the proposed Historic Homeownership Assistance Act. This important measure would amend the Internal Revenue Code to provide a credit against income to home owners who rehabilitate their historic homes or who are the first purchasers of rehabilitated historic homes for use as their principal residence. It will promote historic preservation, home ownership and neighborhood revitalization.

Healthy historic neighborhoods are valuable assets to our cities. Not only do they embody the unique heritage of our communities and regions, they provide established, stable and secure environments, architectural variety and the "sense of place" often lacking in contemporary suburban development, and a quality living environment which fosters community pride.

In Florida, every major city has one or more historic neighborhoods which are in decline or need assistance. Examples include Springfield in Jacksonville; Ybor City, West Tampa and Tampa Heights in Tampa; East Hill in Pensacola; Pleasant Street in Gainesville; Parramore in Orlando; Roser Park in St. Petersburg; Overtown in Miami; and Bahama Village in Key West. Dedicated citizens and local governments are working together to return the vitality and security to many of these neighborhoods. Regrettably, these efforts are not always enough. In some neighborhoods, the struggle is for survival.

Florida has recently established a local option ad valorem tax exemption for improvements to historic properties. While this, for the first time, offers some assistance to homeowners, it is certainly not as effective as a federal income tax credit would be. Since Florida has no state income tax, it is difficult for Florida to offer many other financial incentives to homeowners or developers of historic properties.

Based on the record of other states which have a tax credit on state income taxes, we can estimate what the impact of this federal tax credit might be in Florida. The average qualified investment in the six states which offer an income tax credit or deduction is approximately $50,000 per building. The National Park Service estimates that of the 23,719 contributing National Register properties in Florida, approximately 21,000 of these are residential properties. If only 1% of these required substantial rehabilitation and qualified for the credit offered by the proposed Act, expenditures for labor, materials and fees would be $10.5 million. Using a conservative economic multiplier of four, the estimated impact of this investment on the local economy is an increase in gross output (earnings, personal income taxes, corporate income taxes and state and local sales taxes) of $41 million. Furthermore, a 1994 University of Rhode Island study shows that every

$32,922 in rehabilitation costs generates one full-time annual job. If this ratio holds true in Florida, the $10.5 million estimate given above would create 1,275 full-time jobs.

While incentives have been provided by the federal government to encourage private investment in the rehabilitation of historic income-producing properties for almost three decades, never has there been a program offering significant encouragement for private investment by owners or purchasers of historic homes. The proposed Act recognizes the potential of our historic neighborhoods, and their importance to the well-being of the state and nation.

The incentive offered by the Historic Homeownership Assistance Act would substantially offset the feared increase in ad valorem taxes which has caused many property owners to put off needed improvements and would provide a substantial boost to the local construction industry. With the ability to pass the incentive on to the purchaser of a rehabilitated home, developers will find historic house rehabilitation more attractive.

It is particularly important to note that the proposed Act offers assistance to homeowners at all income levels. Lower income homeowners who cannot make use of the tax credit would be able to secure a Mortgage Credit Certificate, in lieu of the tax credit. This Certificate would be used to reduce the interest rate on the mortgage securing the purchase and rehabilitation of the historic home. This could mean the difference between continued rental housing and home ownership for many families.

Also important are the special provisions for historic homes in enterprise and empowerment zones and targeted distressed areas which are aimed at making rehabilitation of homes in these areas more economically feasible. Through these provisions, we believe that the proposed Act holds great promise in helping to meet our growing demand for decent and affordable housing.

The Historic Homeownership Assistance Act, HR 1662, would make a major contribution to the preservation of significant historic resources, home ownership and family security, and the rebirth of declining older neighborhoods. We urge your support of this bill.

Sincerely,

George W. Percy

George W. Percy, Director
Division of Historical Resources

GWP/sw

WRITTEN TESTIMONY
IN SUPPORT OF THE HISTORIC HOMEOWNERSHIP ASSISTANCE ACT
TO THE WAYS AND MEANS COMMITTEE
OF THE HOUSE OF REPRESENTATIVES
JULY 11, 12, AND 13, 1995

I am Mark R. Edwards, Director of the Historic Preservation Division, Georgia Department of Natural Resources (500 The Healey Building, 57 Forsyth Street, NW, Atlanta, GA 30303). I am also Georgia's State Historic Preservation Officer. I urge you to support passage of H.R. 1662 - the Historic Homeownership Assistance Act.

For almost twenty years, owners of income-producing, historic buildings have been able to apply for federal tax incentives. In Georgia alone, we have seen nearly a thousand historic buildings rehabilitated and put back into use, largely due to opportunities created by tax credits. These projects have resulted in approximately $500 million invested into the state's economy.

Even with this success, there has been a constant, overriding source of concern. I cannot tell you the number of inquiries we receive from individuals who are trying to buy a historic house and who want to make it their home. Or the calls from individuals who have bought an old house in a historic neighborhood and are tackling the financial realities of rehabilitation costs. All of their questions are basically the same: "Are there any programs available to help me purchase a historic house or to help me make it liveable for my family?" Regrettably, we can offer only very limited assistance.

Many of these calls and inquiries have been from middle-class Georgians. While some have been supporters of preservation activities for years, many are individuals who simply have found a historic house or older neighborhood in which they wish to live and raise their families. These citizens - the backbone of our society - need encouragement and support as they take on the sometimes difficult task of bringing buildings and neighborhoods back to life.

The Georgia General Assembly tried to address this problem and passed a property tax assessment freeze during its 1989 session. Since then, over 500 historic buildings, either residential or income-producing, have benefited from this incentive. This represents over $52 million dollars invested in Georgia communities. This is a reflection, however, of only a small number of the residential buildings listed on Georgia's statewide inventory of historic properties. Of 60,000 historic buildings identified, 70% are residential. If the Historic Homeownership Assistance Act passes, the possibilities for neighborhood revitalization, affordable housing opportunities, and for preservation of buildings representing our American heritage will be tremendous.

If passed, this legislation will help bring life back into our historic residential neighborhoods. It will benefit individuals working to buy their first home and provide opportunities for individuals seeking decent affordable housing. It will help young families striving to create homes, and it will encourage safer, more liveable older neighborhoods in our cities. Costs to taxpayers will be minimal since most of these buildings are in areas with infrastructure already in place. Construction and rehabilitation activity will generate jobs, and money for building materials and supplies will often be spend in local neighborhoods.

I ask that you please support the Historic Homeownership Assistance Act. It will benefit Americans of varying economic status - all working toward a goal of home ownership, and it will insure the preservation of America's historic houses for another generation. Thank you.

STATEMENT OF JAMES A. GLASS, DIRECTOR, GRADUATE PROGRAM IN HISTORIC PRESERVATION, COLLEGE OF ARCHITECTURE AND PLANNING BALL STATE UNIVERSITY, MUNCIE, INDIANA 47306

Submitted for the Record of Hearings Held by the Committee on Ways and Means
July 11, 12, and 13, 1995

I am writing in support of HR 1662, the Historic Homeownership Assistance Act of 1995, which has been introduced by Representative Clay Shaw of Florida.

In a twenty-year career in the field of historic preservation, I have witnessed the dramatic impact of federal income tax incentives for revitalizing the commercial areas of downtowns in Indiana, first as staff historian of the Indianapolis Historic Preservation Commission from 1975 to 1982, then as the Deputy State Historic Preservation Officer for Indiana from 1990 to 1994, and since 1994 as Director of the Master of Science in Historic Preservation degree at Ball State University.

Prior to the creation of the current historic rehabilitation tax credit for income-producing historic buildings under the Economic Recovery Tax Act of 1981, the older buildings in the downtown areas of Indiana cities and towns were deteriorated and often vacant or marginally occupied. Few historic preservation advocates were hopeful prior to adoption of the 1981 act that many of these buildings had an economic future. Although of key importance to the history and identity of Indiana communities, the historic commercial buildings could not attract developer and investor interest. The federal tax code favored new construction and development, and capital flowed to new projects for which the maximum amounts of tax incentives were available.

After 1981, an amazing transformation in the marketplace took place in Indianapolis and other cities. Investors and developers learned of the new 25% investment tax credit for rehabilitating income-producing buildings listed in the National Register of Historic Places, and rehabilitation projects soon were taking place all over downtown Indianapolis. The tax credit was a key element during the 1980s in the economic feasibility of the $50 million Union Station rehabilitation, the Lockerbie Marketplace rehabilitation of the historic Sears, Roebuck and Co. department store, the rehabilitation of the historic Marott and Severin Hotels, and the rehabilitation of at least a dozen historic apartment buildings in the downtown area.

In more recent years, the tax credit, though reduced to 20% and of less appeal to investors because of changes in the passive loss rule in the 1986 Tax Reform Act, still has been the deciding element in feasibility for rehabilitation projects in smaller cities and communities in Indiana. These have included the rehabilitation of the former Central High School and Stephenson Mill in South Bend as mixed market-rate and affordable apartments, the rehabilitation of the historic Knightstown Academy in Knightstown, Indiana as elderly housing units, and the rehabilitation of the former Shelbyville, Indiana High School as housing. In all these cases, these buildings were abandoned and deteriorated before rehabilitation began; they were eyesores that were detracting from the neighborhoods in which they were located. They were contributing nothing to the property tax base of their communities.

In a similar fashion, I believe that the Historic Homeownership Assistance Act has the potential to spur private individuals to invest in residential neighborhoods. Everyone has seen the substantial deterioration of older neighborhoods in cities and towns across the United States. Many of these areas are important parts of the heritage of their communities, as well as home to thousands of residents. Although tax incentives have been available for income-producing historic buildings for twenty years and spurred the substantial private investment mentioned above, there have been no comparable federal tax incentives for private homeowners.

Restoring and rehabilitating a historic house can often be a time-consuming and costly undertaking. Although many individuals take on such projects in order to enjoy the high qualities of space, craftsmanship, and character, based on our experience with the income-producing tax credit, I believe that many others might invest in historic homes in older neighborhoods if there were federal tax incentives to encourage them.

Although there is some discussion in Congress regarding a flat income tax, which might mean elimination of most tax credits and deductions, the need for private investment in older neighborhoods is reaching a critical point in many cities and towns. The marketplace is tending to focus almost exclusively on opportunities in new residential construction in suburban areas.

The Historic Homeowners Assistance Act could make a significant impact in stimulating private investment in neighborhoods, and I urge the Ways and Means Committee to include the provisions of the Shaw bill in a Miscellaneous Tax Reform bill this year.

Thank you for the opportunity to comment.

HISTORIC DISTRICTS COUNCIL

45 WEST 67th STREET, NEW YORK, NEW YORK 10023 212-799-5837 FAX 212 875-0209

July 21, 1995

Hon. Bill Archer, Chairman
c/o Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 1662, Historic Homeownership Assistance Act
Hearing dates: July 11, 12, & 13, 1995

Dear Congressman Archer:

The Historic Districts Council is a community-based organization dedicated to strengthening New York City's historic neighborhoods. We strongly support H.R. 1662, the Historic Homeownership Assistance Act, heard by your committee on July 11, 12, and 13.

The Historic Districts Council believes that this proposal could substantially benefit New York City's 66 designated historic districts, which comprise over 20,000 buildings. These historic districts are singled out for protection by the city's Landmarks Preservation law because of their special architectural, social, cultural, or historic significance. Through landmark designation, the city seeks to stabilize communities that are important to the long term economic and social health of New York as a whole.

The Historic Homeownership Assistance Act is based on the very successful Historic Rehabilitation Investment Tax Credit, extending it to owner occupied homes. It would stimulate economically sound reinvestment in existing buildings in communities across the country, encouraging homeownership for the rising middle class and potentially reviving fragile neighborhoods. The legislation has been very thoughtfully written to encourage the involvement of the real estate professional, who can pass on the tax credit earned to the buyer of a rehabilitated cooperative or condominium.

Nothing strengthens neighborhoods more than the commitment of resident homeowners who will be encouraged by this legislation to invest, financially and morally, in their communities. While fostering local stability, this investment will also promote an increased tax base for municipalities, and generate jobs in the labor intensive rehabilitation industry.

We urge you to support this legislation.

Sincerely,

Frances Eberhart

Frances Eberhart
Executive Director

STATEMENT OF J. MARSHALL DAVIS, DIRECTOR OF COMMUNITY SERVICES
HISTORIC LANDMARKS FOUNDATION OF INDIANA
340 WEST MICHIGAN STREET
INDIANAPOLIS, INDIANA 46202

Submitted for the Record of Hearings Held by the Committee on Ways and Means
July 11, 12, and 13, 1995

On behalf of Historic Landmarks Foundation of Indiana, I am writing in support of HR 1662, the Historic Homeownership Assistance Act of 1995. By assisting home owners through a Federal income tax credit, this Act would provide incentive for preserving a vast and rich part of our national heritage: the American home.

As a organization representing over 3,700 members, with staff located in seven offices throughout Indiana, I can attest to the high level of support for the proposed Historic Homeownership Assistance Act. In fact, one could call it a groundswell.

The strong, bi-partisan support already expressed for the Act further indicates its widespread appeal. We feel that it is only right to extend to home owners--who are the stewards of so many historically and architecturally significant properties--similar benefits to those long enjoyed by owners of income-producing properties.

I urge you to consider this Act favorably in light of the tremendous potential it holds for encouraging responsible investment in our homes and communities.

Written Testimony Submitted for the Record
to the
Ways and Means Committee
of the
United States House of Representatives

IN SUPPORT OF H.R. 1662

Date of Hearings: July 11, 12, 13, 1995

Testimony Submitted by:
J. Myrick Howard, Executive Director
The Historic Preservation Foundation of North Carolina, Inc.
P.O. Box 27644
Raleigh, NC 27611
919/832-3652

Joining in Support of This Statement:

New Bern Historical Society Foundation, Inc.
P.O. Box 119
New Bern, NC 28563

New Bern Historic Preservation Commission
P.O. Box 1129
New Bern, NC 28560

Capital Area Preservation
One Mimosa Street
Raleigh, NC 27604

Hickory Landmarks Society
P.O. Box 2341
Hickory, NC 28603

Alliance for Historic Hillsborough
150 E. King Street
Hillsborough, NC 27278

Historic Wilmington Foundation
209 Dock Street
Wilmington, NC 28401

In Support of H.R. 1662

The Historic Preservation Foundation of North Carolina, Inc., (Preservation North Carolina) and the aforementioned organizations enthusiastically support the passage of H.R. 1662, the Historic Homeownership Assistance Act. This act would create a powerful boost for private sector rehabilitation of historic properties, especially in downtown areas, whether in large cities or small towns.

The Rehabilitation Investment Tax Credits created in 1981 (and, unfortunately, seriously weakened in 1986) have been a powerful tool for reinvestment in older areas of America's cities and towns. More than $16.7 billion of private sector investment ($300 million in North Carolina) has been stimulated by these tax credits, which are limited to income-producing properties. The tax credits program has by far been the most successful downtown revitalization

program ever created by the Federal government, in large part because it has catalyzed private investment.

If H. R. 1662 is passed, the tax incentives will create a new and substantial burst of rehabilitation activity throughout older areas in the United States. The results will be enormously beneficial:

- Jobs will be created.
- Public expenditures for new infrastructure (roads, schools, water and sewer lines, etc.) will be reduced.
- Homeownership will increase, as less expensive urban properties become better investments.
- Crime, *de facto* suburban segregation, and other social problems will be lessened as older areas are reclaimed.
- Urban sprawl will be abated.
- Energy will be saved.
- Pressure will be reduced on our landfills.
- Our cities and towns will become better places to live and work.
- And, our Nation's heritage will be preserved.

The leverage rate for Federal funds spent on a homeowner tax credit will be enormous. When the State of North Carolina added a 5% rehabilitation tax credit to supplement the Federal tax credit, a study showed that the tax incentive would actually result in a *net gain* for the State's coffers because of added revenue generated from income taxes on labor and sales taxes on materials. The study did not take into account the savings which result from reduced demands for new infrastructure.

Prominent legislators in North Carolina have agreed to introduce a 5% supplemental State income tax if H.R. 1662 becomes law.

Preservation North Carolina, a private nonprofit organization that tries to find sympathetic buyers for endangered historic properties, can attest first-hand to the number of people who would respond positively to the passage of the Historic Homeownership Assistance Act. Literally on a daily basis, Preservation North Carolina receives numerous calls from people requesting information on available incentives. Unfortunately, no incentive currently exists for the private rehabilitation of a historic house for owner occupancy. Current Federal laws allow a 20% federal tax credit for rehabilitation of historic structures, but only if they are used to generate income. The Historic Homeownership Assistance Act would offer these same incentives to individuals interested in rehabilitating a historic property as a primary residence. A powerful incentive for restoring a historic home would be available to a much larger group of people. The act would make the "American Dream" of homeownership affordable and attractive for millions of young people and others who cannot afford the steep prices of new construction.

Restoration of historic properties makes good economic sense for many reasons. Local tax bases can be substantially enhanced by the rehabilitation of historic structures without public expenditures for new roads, sidewalks, water and sewer lines, schools and fire stations. Historic buildings also tend to appreciate at a better rate than most new construction. The superior materials and craftsmanship as well as the unique characteristics of older structures make them enjoyable and desirable as residential choices.

Rehabilitation and restoration conserve energy by recycling existing construction, rather than encouraging costly demolition and the landfilling of otherwise viable materials. Furthermore, local economies are stimulated by rehabilitation. In a community which spends $1 million on rehabilitation over new construction, the following are true:

- Five to nine more construction jobs will be created than with new construction.
- Retail sales in the community will increase $34,000 more than with new construction.
- $120,000 more will initially stay in the community, because rehabilitation is more labor-intensive than materials-intensive.

Finally, the availability of tax credits for residential properties will encourage the revitalization of communities, both urban and rural, across the nation. Many North Carolina towns and cities have already recognized and benefited from the preservation of their historic architecture. Tourists from all over the nation visit historic sites from our coastal plain to the mountains.

Communities not only reap the rewards of tourist dollars but they enjoy the beauty and pride of place which historic neighborhoods instill. Both wealthy and poor citizens can share in the satisfaction of seeing their familiar surroundings revitalized. Community pride is fostered by historic preservation.

Preservation North Carolina has been involved with numerous properties rehabilitated under the existing tax credit program for income-producing properties. The passage of this act will take the successes of that program and expand it to include a vastly greater number of properties and tax payers. Our society will benefit enormously. We urge your support of H.R. 1662.

Submitted for the record to
the Ways and Means Committee of the U. S. House of Representatives in
support of HR1662, the Historic Homeownwership Assistance Act, by:

The Historical Commission of Metropolitan Nashville and Davidson County
222 Third Avenue, North, 4th Floor
Nashville, Tennessee 37201

Supporting organizations
East End Neighborhood Association
East Nashville Caucus
Lockeland Springs Neighborhood Association
Hillsboro-West End Neighborhood Association
Richland-West End Neighborhood Association
Woodland in Waverly Neighborhood Association

Hearing dates July 11, 12, and 13, 1995

STATEMENT

Nashville, like many cities, benefited greatly from the tax credit which became available in 1976 for the rehabilitation of income-producing historic properties. By stimulating private investment of more than $120 million, the tax credit has proven crucial in the revitalization of downtown Nashville. Thanks to the credit, we continue to see the economic impact of millions of private dollars invested.

HR 1662 promises comparable potential to revitalize historic neighborhoods by placing home ownership within the reach of many who could not otherwise afford it. At the same time, passive investment rules would minimize federal tax revenue loss.

The effects we anticipate in Nashville include:
- Significant increases in private investment and construction in historic neighborhoods.
- Stabilization and improvement of property values, based on increased investment and home ownership. From local experience, we know that such stability always encourages spin-off investment by other homeowners and makes banks more likely to lend.
- Increased local tax revenue from economically healthy neighborhoods.
- Making redevelopment a more viable competitor to building on undeveloped land, resulting in better use of existing infrastructure, improving chances for open space preservation, and discouraging expensive sprawl.
- Preservation of viable housing stock close to commercial areas, reducing transportation costs for everyone.

There are equally important, if less quantifiable, reasons to support the bill: Community is nurtured by home ownership and investment in historic districts. Several of our most active neighborhood associations began with urban pioneers rallying to save their streets -- house by house. Such people invest in a community, not just a house. They know and take responsibility for their neighbors. To see democratic values at their best, look at the Nashville neighborhoods that have already been revitalized. Passage of this bill could be a watershed event for aging and historic neighborhoods in Nashville and throughout the country, empowering more Americans to invest in home and community.

We encourage you to support HR 1662.

TESTIMONY OF DONNA DIAZ
COMMUNITY/EDONOMIC DEVELOPMENT
LAKE CUMBERLAND AREA DEVELOPMENT

Statement in Support of HR 1662

Among the issues involved in the hearings last week on Miscellaneous Tax Reforms is HR 1662, the Historic Homeownership Assistance Act. This measure deserves to be in the major tax bill under consideration.

As Director of Community and Economic Development for a 10-county planning agency in rural Kentucky, a major concern is condition of housing stock and ways to preserve and improve housing stock in the entire area. The Historic Homeownership Assistance Act, a tax credit for rehabilitation of historic homes, would act as an incentive to preserve our historic housing and give preservation efforts additional visibility. It will encourage investment and homeownership in our disinvested neighborhoods. This in turn will increase the tax base for local taxing districts and will go far in strengthening the local economy by providing construction jobs and through the increased sales of building materials and goods.

This bill will create circumstances under which people of diverse income levels can become homeowners for the first time and/or rehabilitate older housing stock which is currently substandard. Standards of living can be elevated using only this incentive, without the commitment of federal dollars to a cumbersome and expensive federal program. The Historic Homeowner's Tax Credit is an attractive initiative, developing pride and encouraging private action. The appearance of neighborhoods will be improved. Utilization of existing infrastructure will save additional taxpayer dollars.

In rural Kentucky it is becoming more and more difficult to achieve home ownership. Poverty levels coupled with high construction costs make home ownership cost prohibitive for many families. These families, because of poverty level, often have little or no tax liability. To be able to convert earned tax credit into a mortgage credit certificate to obtain a reduced interest rate from the mortgage lender, would make the Historic Homeowners Tax Credit even more effective in a widespread accomplishment of the benefits outlined in these comments.

Representatives Clay Shaw and Barbara Kennelly and Senators John Chafee and Bob Graham are to commended for introducing the Historic Homeownership Assistance Act of 1995, which will be a significant economic stimulator in rural Kentucky as in all other parts of the United States.

LANDMARKS HARLEM, INC.

201 West 138 Street
Suite 1
New York, NY 10030
(212) 862-9552
Fax (212) 862-9189

July 26, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Historic Homeownership Assistance Act
Hearing: July 11-13, 1995

Dear Mr. Moseley:

Landmarks Harlem is pleased to support passage of the federal Historic Homeownership Assistance Act.

Harlem's buildings and neighborhoods have suffered from neglect, unnecessary demolition and abandonment for far too long. The Historic Homeownership Assistance Act will provide an opportunity to focus on the architectural and cultural significance of those buildings that gave rise to Harlem's prominence in the Twenties.

Communities survive when there is a turnover in homeownership. While Harlem has been attracting young professionals to purchase homes, the areas of choice have been restricted, mainly, to those areas where historic districts exist -- Mt. Morris Park, Strivers' Row, Hamilton Heights. The need is to populate the multiple dwellings that line Harlem's avenues and streets. These buildings were once home to generations of Harlem residents who raised their families and formed strong neighborhood and community ties.

The fact that the bill allows, among other things, for rehabilitation of older apartment buildings for condominiums and co-operatives is very encouraging. Since these buildings contributed to the cultural growth of Harlem, it is hoped that the Historic Homeownership Assistance Act will spur interest in families returning to many of our historic structures.

Best of luck on your hearing.

Respectfully,

Thomas J. Bess
Executive Director

Statement in Support of HR 1662

Judith B. McDonough
Executive Director
Massachusetts Historical Commission
State Historic Preservation Officer

Massachusetts Historical Commission
Massachusetts Archives Building
220 Morrissey Boulevard
Boston, MA 02125

The Massachusetts Historical Commission, the historic preservation agency for the Commonwealth of Massachusetts, encourages your committee's favorable consideration on HR 1622, the Historic Homeownership Assistance Act, hearings for which were held by the House Committee on Ways and Means on July 11, 12, and 13, 1995.

Massachusetts leads the nation in the number of properties listed in the National Register of Historic Places and owner-occupied historic residential buildings comprise the single largest category of National Register listed properties in our state. Unfortunately, Massachusetts and many other states have no form of financial or economic incentive to encourage the sensitive rehabilitation of privately owned historic residential properties. In 1994 a special state legislative commission on historic preservation noted that the lack of meaningful economic incentives to assist private property owners was perhaps the single biggest obstacle in advancing historic preservation in the Commonwealth HR 1622 would help address an obvious gap in the nation's historic preservation program by recognizing the important fundamental relationship which exists between historic preservation and private property ownership. When private property owners make a decision to preserve their historic property, their private actions have enormous public benefit.

The appropriate rehabilitation and restoration of historic homes often costs more than non-historic properties, given the special knowledge, skills, and materials sometimes required of preservation projects. These costs are generally borne almost exclusively by private homeowners, even though their investment has broader public benefit. Unlike commercial properties, the preservation of historic residential properties is not presently supported by federal grants or tax incentives. HR 1622 would provide a meaningful and long overdue economic incentive to encourage the preservation of historic residential properties nationwide.

At a time when many states and municipalities are meeting with increased resistance to official designations of historic properties, the provision of a tangible benefit to National Register listing would help balance the real and perceived regulatory impacts associated with such designation. In addition, there is the potential for widespread economic benefit resulting from the increased rehabilitation activity generated by the incentive. By its nature historic preservation is labor intensive, generating building activity employing carpenters, painters, masons, plasterers and a host of other building trades. The rehabilitation of properties through historic preservation also employs the services of architects, landscape architects and other design professionals.

HR 1622 will assist residential property owners in preserving many of our nation's historic resources, and provide a stimulus for historic preservation activity nationwide. I encourage your committee to act favorably on this legislation.

This statement in support of HR 1622 is also submitted on behalf of the following Massachusetts organizations:

Massachusetts Historical Commission
Historic Massachusetts Incorporated

STATEMENT SUBMITTED AS WRITTEN TESTIMONY
TO THE WAYS AND MEANS COMMITTEE
OF THE U.S. HOUSE OF REPRESENTATIVES
IN SUPPORT OF HR 1662: HISTORIC HOMEOWNERS' ASSISTANCE ACT

Submitted to:

Phillip Moseley, Chief of Staff, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515-6384

By:

The Historic Preservation Commission
of the Township of Montclair, New Jersey
205 Claremont Avenue
Montclair, New Jersey 07042

July 26, 1995

TO THE MEMBERS OF THE WAYS AND MEANS COMMITTEE:

The Montclair Preservation Commission offers its most enthusiastic support for the Historic Homeownership Assistance Act of 1995. Having just completed the nomination process for approximately 650 properties in the Township for landmark status under a recently enacted local historic preservation ordinance, the testimony offered during the public hearings on these nominations have made us well aware of the need for such legislation. We have been closely monitoring the progress of this bill since it was first introduced in November of 1994, just prior to the end of that year's session.

During public testimony at our hearings, homeowners expressed great fears that preservation would cost them more dollars, at a time when federal and state budget cuts have thrown an enormous financial burden on the shoulders of local governments to maintain services and programs. As a result, property taxes in our town have skyrocketed in recent years, and homeowners who have been longtime residents are finding it extremely difficult to remain here. As a result, we have lost many who have been important contributors to the civic and cultural life of our town -- from those who live in affordable housing, no longer so affordable, to those who live at middle and higher income levels.

Montclair is a town possessed of a rich architectural heritage that includes public buildings, churches, commercial buildings, and, most crucial to this legislation, a large number of residences -- both high style mansions and vernacular workers' housing -- that are considered to be

architecturally and/or culturally significant. We have five historic districts and 91 individual landmarks that are on the New Jersey State Register or National Register of Historic Places. All of the properties that were nominated for landmark status in recent Commission action were listed on one or both of those Registers. Our citizens share a great appreciation for the history and architecture of the township, and yet, when faced with regulation under a local ordinance at a time when township taxes were already extremely burdensome to many, citizens drew the line to safeguard their pocketbooks from what they thought would be costly regulation without benefit.

Since last year, our Commission has looked to this legislation as a possible benefit not only to the owners of landmark residences, but also to our efforts to preserve these buildings. Anything that will help property owners, especially those owning affordable housing, to maintain their buildings in a sensitive way would help us safeguard the heritage of this township. In order to assess exactly how it would affect various types of housing in our town, we walked through the provisions with a tax attorney, and concluded that the benefits from such legislation could be felt across the board, in a variety of circumstances, although certainly the greatest effect was felt at the sector that was most in need of assistance: owners of affordable housing. This sector is one that in our town has had the most difficulty maintaining its buildings, resulting to a loss in the township not only in buildings demolished, but substandard living conditions for those who wish to remain here at whatever cost they can afford. For those of this income group who cannot remain, we feel the loss to our community in an increasing lack of diversity -- long a cherished characteristic of our civic life.

The Montclair Historic Preservation Commission encourages reinvestment into already established communities such as Montclair, and considering the successful rehabilitation efforts supported by the commercial tax credit for qualified expenditures on historic buildings, it sees only a positive outcome for such relatively small tax expenditures for residences. We urge the members of the House Ways and Means Committee to vote in favor of this legislation that would encourage reinvestment in our older residential neighborhoods, and offer to homeowners of many types of residences a benefit to the sensitive preservation of their homes.

Respectfully submitted:

The Montclair Historic Preservation Commission

By: ______________________

Mary Delaney Krugman, Chair

Date: July 26, 1995

STATEMENT OF
DAVID M. DOMINICK, MAYOR,
CITY OF MUNCIE, INDIANA, 47305

Submitted for the Record of Hearings Held by the Committee on Ways and Means
July 11, 12, 13, 1995

I am writing in support of the Historic Homeownership Assistance Act of 1995 (HR 1662), a bill that was introduced in the House of Representatives by Clay Shaw (R-FL) and co-sponsored by Barbara Kennelly (D-CT).

If passed, the Act will create a twenty percent federal income tax credit available to homeowners who rehabilitate their home (or buy a qualified rehabilitated historic home), limited to $50,000 for each principal residence. Taxpayers with little or no tax liability may convert the credit into a mortgage credit certificate to obtain a mortgage interest rate reduction from their lender.

In Muncie, the credit would help reverse the disinvestment and blight in our older residential neighborhoods. It would provide an incentive for private property owners to rehabilitate their homes which would help strengthen our cities' tax base. The tax credit is not another large federal program but an incentive for people committed to turning decaying buildings into their primary residences. The credit would reach out to current homeowners as well as the many middle class families currently on the verge of homeownership. Furthermore, rehabilitation activities would provide jobs for area residents of diverse incomes.

I believe that if the Historic Homeownership Assistance Act is passed, it will encourage revitalization efforts already underway in Muncie's inner-city neighborhoods. Attached, please find a copy of a proclamation passed by the Muncie Historic Preservation and Rehabilitation Commission last month. I join the Commission in strongly urging the Committee on Ways and Means to include the provisions of H.R. 1662 in a Miscellaneous Tax Reform bill this year.

Thank you for the opportunity to comment on this important issue.

City of Muncie

Proclamation

WHEREAS, the abandonment and destruction of older and historic buildings presents a growing threat to public safety and the social and financial well-being of the citizens of Muncie, Indiana; and

WHEREAS, there are not, at present, sufficient financial incentives to attract homeowners to rehabilitate older buildings in Muncie's distressed and declining neighborhoods; and

WHEREAS, a strong base of homeowners is essential to the civic and economic health of this community and its tax base; and

WHEREAS, there has been introduced in the Congress the "Historic Homeownership Assistance Act" which would provide homeownership incentives for the rehabilitation of older buildings in historic districts through a Federal Historic Rehabilitation Tax Credit specifically for homeowners; and

WHEREAS, the "Historic Homeownership Assistance Act" would stimulate the revival of decaying neighborhoods and the preservation of historic buildings and districts in Muncie through homeownership:

NOW, THEREFORE, we, the members of the Muncie Historic Preservation and Rehabilitation Commission, do proclaim our endorsement of the

HISTORIC HOMEOWNERSHIP ASSISTANCE ACT

and that with this proclamation, we encourage its prompt enactment.

IN WITNESS WHEREOF, we have hereunto set our hands and caused the Seal of the City of Muncie to be affixed this 22nd day of June, 1995.

Gretchen Bookout Cheesman	Tony Costello, Chair
Betty Pogue Hadley	Mike Mavis
Frank Meeker	Barbara Quilling, Vice Chair
John Rust	Kathy Scott
Patsy Smith	Scott Berger, Secretary/Treasurer

NCSHPO

National Conference of State Historic Preservation Officers
444 North Capitol Street, N.W. - Suite 342
Washington, D.C. 20001

202-624-5465 (voice)
202-624-5419 (FAX)

Statement in Support of H.R. 1662
Historic Homeownership Assistance Act

TO: Philip D. Moseley, Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515-6384

FROM: Eric Hertfelder, Executive Director

DATE: 27 July 1995

RE: Ways and Means Committee Hearings on July 11-13, 1995

The National Conference of State Historic Preservation Officers wishes to go on record in strong support of H.R. 1662, the *Historic Homeownership Assistance Act*.

The National Conference represents the gubernatorially appointed officials that carry out the national historic preservation program for the Secretary of the Interior (National Historic Preservation Act, 16 USC 470). Included among the responsibilities of the State Historic Preservation Officers is assisting the Secretary in certifying qualifying projects for the current Historic Rehabilitation Tax Credit applicable to income producing properties.

H.R. 1662 would extend, in a limited way, the benefits of the current tax credit to qualified owner occupied dwellings. There are several benefits to this proposal. First, H.R. 1662 would extend the incentives for reinvesting in historic properties to an important group left out of the current tax credit: homeowners. The availability of this credit will help both urban and rural neighborhoods to resist decay, improve property values, and thereby help municipalities to stabilize their tax base. The special provisions in the bill for distressed areas (Section 2.d.2.) and for a mortgage credit certificate (Section 2.h.) will ensure that some of the neediest homeowners and neediest historic properties will not be excluded from the program.

Second, the addition of homeowners to the program will extend the economic benefits associated with the reuse of historic structures. As has been proven with the existing tax credit, rehabilitation of existing structures is labor intensive, creates new tax revenues, and can reduce the strain on municipal budgets by not having to build and maintain new infrastructure.

Third, at a time when direct public assistance is shrinking, incentives to spur private investment become even more critical to preserving the nation's historic buildings and neighborhoods. Such places, when properly rehabilitated, offer high quality living environments with more character and often more convenience than new construction.

H.R. 1662 contains several provisions important to the States concerning administration of the program. The provision in Section 2.d.3. for certifications made under a cooperative agreement or contract between a State and the Secretary is a great improvement over the current system, and will provide much more efficient service to the public. Under the terms of the National Historic Preservation Act, such agreements are operative only within the context of the Secretary's overall certification and oversight of the State's entire historic preservation program, thus assuring quality control and consistency.

H.R. 1662 also permits the collection of fees provided such fees are dedicated to the work of processing the applications (Section 2.k.). Since the administration of the new credit will add to the workload of States and participating local governments, this provision is needed to help defray costs.

Statement of Richard Moe
President
National Trust for Historic Preservation

Presented to the House of Representatives
Committee on Ways and Means
in support of
H.R. 1662, the Historic Homeownership Assistance Act
July 11, 12, and 13, 1995

I am pleased to have this opportunity to present to the House of Representatives Committee on Ways and Means the views of the National Trust for Historic Preservation on H.R. 1662, the Historic Homeownership Assistance Act, which would provide an income tax credit based on expenditures related to the certified rehabilitation of a qualified historic property as an owner-occupied home. The National Trust for Historic Preservation, chartered by Congress in 1949, is a nonprofit organization with more than 265,000 members. As the leader of the national historic preservation movement, the Trust is committed to saving America's diverse historic environments and to preserving and revitalizing the livability of communities nationwide.

I. The Need for a Historic Homeowner Tax Credit

America's historic resources are at risk. In the decades since World War II, in tragic counterpoint to the growth of the sprawling new suburbs, we have witnessed the progressive erosion and loss of older neighborhoods and communities all across the country.

I believe that all Americans are committed at heart to the preservation of our heritage. As preservationists, we have developed tools to save the individual treasured building from the wrecker's ball. We do not always succeed, but we are not without the means to show the way and make the case for preservation.

What we lack are the tools to address the problems of blight and abandonment that threaten entire older neighborhoods and communities. In the decade from 1980 to 1990, Chicago lost 41,000 housing units to abandonment, Philadelphia 10,000 and St. Louis 7,000. Smaller communities have suffered the same fate, and the trend continues. Some of these houses were architectural gems; many were ordinary houses in which ordinary people lived. But taken together they constituted the physical fabric of a way of life which is now gone.

Clearly, this is no time for massive government programs which might or might not be successful in helping to preserve these resources. What is needed is an incentive which will involve a minimum of government involvement and a maximum of individual initiative, one that is modest in cost and limited in scope but that can spark broad private activity. We believe H.R. 1662 is a fair, feasible and effective answer.

H.R. 1662 is designed to work in a broad range of contexts; each community is likely to find its own applications. For example, in many of the small towns of New England and the Midwest, older housing that would qualify for the credit has suffered from blight and abandonment as the mills and retail businesses upon which those communities depended declined and closed. Enterprising developers could buy up abandoned homes, rehabilitate them so as to qualify them for the credit, and sell them to young families, passing on the credit to the purchaser. These families might prefer living in a renovated older home in town, with the amenities of an earlier era and the convenience of in-town living. The result would be new life for the town, new customers for the town's small businesses, and new tax revenues for the town's hard-pressed treasury.

At the other end of the spectrum, many cities, large and small, possess older office buildings that would qualify for the credit, but which can no longer attract commercial tenants. Many of these buildings are architectural assets, but without an economic function they are targets

for the wrecking ball. However, a federal homeownership credit could make these buildings economically attractive to a developer who could rehabilitate them as residential condominiums. The developer would, in effect, be selling the unit along with the credit. In this way these buildings could be saved, and the homeowners attracted to them would provide new customers for local merchants and new taxpayers for the city.

II. Major Provisions of H.R. 1662

Rate of Credit

The credit, which would equal 20% of qualified rehabilitation expenditures, would be available to homeowners in condominiums and cooperatives as well as single-family homes. It could be used by the do-it-yourself rehabber, or someone who purchases a home rehabilitated by a developer. In the latter case, the credit would accrue not to the developer, but to the purchaser of the home.

Eligible Structures

The universe of buildings eligible for the tax credit is a limited one. Only buildings that are listed in the National Register of Historic Places, are contributing buildings in National Register Historic Districts or in nationally-certified state or local districts, or are individually listed on a nationally-certified state or local register would qualify. The National Park Service has estimated that slightly in excess of 800,000 buildings nationwide presently fall in those categories.

To insure that their historic character is preserved, buildings receiving the credit would have to be rehabilitated in accordance with the Secretary of the Interior's Standards for Rehabilitation. However, the bill provides that certification of compliance may be performed by states or even localities under cooperative agreements entered into with the Secretary of the Interior. In addition, the bill authorizes the states to charge processing fees, the proceeds of which would be used to fund the costs of processing the applications for certification.

Maximum Credit, Minimum Expenditures

The maximum credit allowable would be $50,000 for each principal residence, subject to Alternative Minimum Tax provisions. As with the current credit, rehabilitation must be substantial--the greater of $5,000 or the adjusted basis of an eligible building, with an exception for buildings in census tracts targeted as distressed for Mortgage Revenue Bond purposes under I.R.C. Section 143(j)(1) and Enterprise and Empowerment Zones, where the minimum would be $5,000. At least five percent of the qualified rehabilitation expenditures would have to be spent on the exterior of the building

III. Homeownership and Historic Preservation

Central to the American dream is the desire to own one's own home. But home ownership is more than just a personal goal; by giving residents a true stake in their community, it promotes the qualities of neighborliness needed to heal and revive threatened and decaying residential areas.

The existing federal tax credit for historic rehabilitation is not available to homeowners, but applies only to commercial property or other property held for the production of income. H.R. 1662 fills that gap. Moreover, because the tax credit that H.R. 1662 would create is limited to persons who occupy the building for which the tax credit is claimed as their personal residence, there are no tax shelters, no "passive losses" and no syndications.

Opportunities for Low and Moderate Income Home Buyers

There is a widespread misperception that historic districts are places where only rich people live. While it is true that some of the better known districts on the National Register have been rehabilitated by or for affluent people, it is equally true that the older housing stock in the

United States tends far more to be occupied by the poor than by the rich. Indeed, according to an analysis of 1990 census data, 29% of the 8,700 National Register historic districts lie within or contain tracts with poverty rates greater than 20%.

This legislation has been drafted to provide homeownership opportunities in rehabilitated historic buildings to Americans at all income levels. For those who do not have sufficient income to be able to use a tax credit, the bill creates a Historic Rehabilitation Mortgage Credit Certificate that can be used to reduce the interest rate on their mortgage loan.

Rehabilitation would have to be substantial. As I stated earlier, the bill would follow existing law by requiring a minimum investment in qualified rehabilitation expenditures equal to the greater of $5,000 or the adjusted tax basis of the building. However, an exception would be made for economically distressed census tracts where the minimum investment required would be $5,000. Taxpayers at all income levels would be permitted to use the credit, but the amount of credit available to a homeowner would be limited to $50,000.

Consider, as an example, a hypothetical home rehabilitated by a developer which qualifies for the credit. Assume that the home has a selling price of $150,000 and contains $100,000 in qualified rehabilitation expenditures. The credit on this home is $20,000 (20% of $100,000). This would more than cover a down payment of 10% on the home. In this case the credit would have the effect of reimbursing the home purchaser for the down payment. Although this example involves a developer, the credit could also be used by an individual homeowner to help defray the cost of rehabilitating his current or newly-purchased residence.

IV. Costs and Benefits

Because of the constraints on eligibility that I have described, the revenue implications of H.R. 1662 would be modest. Nevertheless I believe it can make a real difference in communities all across the county-- from decaying small towns to threatened big-city neighborhoods. By providing an incentive for Americans at all income levels to invest in the rehabilitation of deteriorated buildings and become home owners in older neighborhoods and communities, it can provide the following benefits:

- saving invaluable historic resources, which would otherwise be lost through decay, abandonment and demolition.

- stabilizing and rescuing endangered communities through the infusion of new home owners, who will make a commitment to the enhancement of community life through their purchase of a home.

- providing cities and towns with the chance to strengthen their tax bases by attracting middle-income and more affluent residents.

- creating jobs and stimulating economic activity in areas where economic opportunities are scant.

When preservation begins in a community, good things follow. H.R. 1662 is not a cure-all for ailing communities. Change for the better, if it is to come, will be incremental. It will result from decisions made by individual Americans, one family at a time. But H.R. 1662 can be a spark that ignites those private decisions to the benefit of our families, our communities, and our heritage as Americans. On behalf of the 265,000 members of the National Trust for Historic Preservation, I strongly urge the prompt enactment of this legislation.

PRESERVATION
Action

**TESTIMONY OF NELLIE L. LONGSWORTH
PRESIDENT OF PRESERVATION ACTION
ON THE HISTORIC HOMEOWNERSHIP ASSISTANCE ACT OF 1995
HEARING: JULY 11, 12, 13 1995**

Preservation Action, the national citizens lobby for historic preservation and neighborhood issues, strongly supports the Historic Homeownership Assistance Act of 1995 - HR 1662 - introduced by Clay Shaw and Barbara Kennelly on May 17, 1995. Our grassroots organization has a membership that includes 1,000 organizations, corporations, and individuals active in preservation from coast-to-coast. We act as their eyes and ears in Washington, DC, keeping them abreast of legislative and administrative agendas that impact the preservation of their older communities and neighborhoods. Since historic preservation is one of the few urban policies that seems to work these days, we ardently request that the Ways and Means Committee give serious consideration to including HR 1662 in the tax bill which is scheduled for introduction this summer.

Preservationists have been deeply involved in the revitalization of older neighborhoods from coast-to-coast, cultivating experience in their own community as to what produces results - and what does not. We have seen commercial historic areas blossom anew with renovated buildings and renewed tax base in the '80's, thanks specifically to the federal rehabilitation tax credit. We have been dismayed that there have been almost no incentives to support the improvement of adjacent residential areas except where there were rental properties. While everyone agrees that homeownership is the answer to pulling older neighborhoods up by their bootstraps, no one has found the means to make it happen with a minimum of overhead and freedom from governmental involvement.

Unfortunately, many federally appropriated programs, including some of HUD's, have not created the long term improvements in older urban neighborhoods that encourage homeownership. Agencies have exhibited little or no interest in adopting policies that convert existing structures for homeownership, despite our efforts to the contrary. We have learned the hard way that throwing public dollars at projects does not necessarily spawn responsibility and pride, in fact, it often leads to administrative waste, corruption, and futility. In the end, neighborhoods are about people: what they want; what they need; and how they can make it happen. It is about community: a safe place to live and work. The homeowners tax credit for rehabilitation is a tool targeted to assist people in making "community" happen.

There are many reasons to focus efforts on revitalizing historic neighborhoods. The infrastructure is in place and functioning saving communities and local governments millions of dollars through avoiding the expense of building new streets and sewers and adding to the cost of doing business. Jobs will be created - permanent as well as temporary - which are labor intensive also providing opportunities for training young people in skills with lifelong professional value. The tax base can be revitalized producing savings for everyone.

The Historic Homeownership Assistance Act provides the answer. It is NOT another large federal program but an incentive for people committed to turning decaying buildings in primary residences. The credit would reach out to current homeowners as well as the many middle class families currently on the cusp of homeownership. It is also attractive to those in lower tax brackets who can transfer the credit to a lending institution in return for a reduced interest rate loan.

Simply the credit provides for the following:

A 20% federal income tax credit is available to homeowners who rehabilitate or buy a qualified rehabbed historic house. The credit is limited to $50,000 for each principal residence. Expenditures must be greater than $5,000 or the adjusted basis, with exceptions

for buildings in low income census tracts targeted as distressed, and Enterprise or Empowerment Zones where the minimum would be $5,000. 5% of the rehabilitation expenditure must be spent on the exterior.

Single-family and multi-family residences, condominiums, and cooperatives listed on the National Register would qualify and the credit could be taken for a portion of a qualified building used as a principle residence.

A developer may rehab a qualifying property and sell it to a homeowner with the credit. The homeowner may apply the credit to tax liability over a number of years but, **if the property is sold before 5 years, the credit is subject to ratable recapture.** To avoid recapture, a homeowner is making a 5 year commitment to the community.

Taxpayers with little or no tax liability may convert the credit into a mortgage credit certificate to obtain a mortgage interest rate reduction from the lender.

- The Secretary of Interior's Standards are required, but final certification will consider such factors as location in a "targeted area", Enterprise Zone, or Empowerment Zone.

This bill can impact and reverse the fortunes of historic neighborhoods in every member's district. The credit will attract people of diverse incomes. The credit rebuilds neighborhoods by attracting people willing to make a 5 year commitment to a historic house as their primary residence; these are our model community-makers. On behalf of the membership of Preservation Action, we ask the Ways and Means Committee will take action of this important measure promptly.

PRESERVATION ALLIANCE OF VIRGINIA

Post Office Box 1407 Staunton, Virginia 24402-1407 (540) 886-4362

July 23, 1995

TO: Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515-6384

FROM: Preservation Alliance of Virginia
David J. Brown, Executive Director
P.O. Box 1407
Staunton, VA 24402-1407

DATE OF HEARING: July 11, 12, and 13, 1995

RE: Support for HR 1662

The Preservation Alliance of Virginia, a consortium of over 150 preservation and conservation groups representing over 40,000 Virginians, strongly supports HR 1662, "The Historic Homeownership Assistance Act of 1995." We believe that HR 1662 will provide major incentives to encourage much needed reinvestment in our central cities and older residential neighborhoods. Since the program is designed to encourage individuals and families to turn decaying buildings in their primary residence, we feel it will bring our ailing cities a rejuvenated tax base, take advantage of existing infrastructure, and save taxpayer dollars.

In our work with a variety of older residential neighborhoods, we constantly see the need for new investment in these areas. HR 1662 will bring that investment. More importantly, with the mortgage credit certificate" feature of the bill, lower income families can also use the credit and join the ranks of homeowners.

We believe this bill is a win-win situation. Homeowners benefit by the credit that encourages investment. Builders and contractors benefit by the increased rehabilitation activity. Our central cities and older residential neighborhoods benefit from a much-needed infusion of new investment. Government at all levels see the benefits that will come from more stable and secure neighborhoods.

The Preservation Alliance encourages the members of the Ways and Means Committee and the House of Representatives to support this very important bill.

Shelby Development Corporation

316 Main Street • P.O. Box 1256 • Shelbyville, Kentucky 40066-3256 • (502) 633-5029

Gateway to the Bluegrass

J[illegible] 18, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington, DC 20515-6384

Dear Mr. Moseley,

As Chairman of the Shelby Development Corporation, I felt it urgent to write and encourage you to support the HR 1662 Historic Homeownership Assistance Act, the tax credit for rehabilitation of historic homes. This Act is essential to continuing our successful work in downtown Shelbyville. As you may know, our approach to downtown management follows the direction of the Kentucky Main Street Program.

As a local banker, I felt it extremely important to encourage you to look favorably on this Act. The assistance provided by this tax credit could stimulate improvements and investments that might otherwise go undone.

The bill was introduced in the House by Rep. Clay Shaw (R-FL) and is critical to the developments of historic structures in our community. This bill would provide a powerful incentives for business owners who wish to live downtown over their stores or offices or for people who wish to purchase upper-floor downtown spaces. This is a project that the Shelbyville 2000 Plan supports and has pushed for in the past 5 years.

It will also encourage homeowners to re-invest in their historic properties. (Our City recently passed an ordinance that allows for a tax moratorium for re-habs in the Historic District of Shelbyville - another incentive that SDC lobbied for to encourage local development.)

As you know, the continuing support of programs such as ours is critical to the growth and development of our downtown communities. In Shelbyville we have over 50 volunteers that are currently working on issues pertaining to downtown Shelbyville-it is for them that I ask for your support!

Sincerely,

Billie Wade

Billie Wade
Citizens Union Bank, CEO
SDC Chairman

WRITTEN TESTIMONY IN SUPPORT OF THE HISTORIC HOMEOWNERS ASSISTANCE ACT TO THE WAYS AND MEANS COMMITTEE OF THE HOUSE OF REPRESENTATIVES JULY 11, 12, 13

I am Nancy H. Bell, the executive director of the Vicksburg Foundation for Historic Preservation (P.O. Box 254, Vicksburg, MS 39181), and I write this statement on behalf of the Vicksburg Foundation for Historic Preservation, Vicksburg Landmarks, Inc., the Vicksburg Historic Preservation Commission, the Vicksburg Board of Architectural Review, the Vicksburg Downtown Conservation Commission, and the Vicksburg Main Street Program. These six organizations support the passage of HR 1662- the Historic Homeownership Assistance Act.

Vicksburg has a wealth of historic residences in its low and moderate income neighborhoods that are in serious need of rehabilitation. The Historic Homeowners Tax Credit would provide a catylist for the owners of these houses to rehabilitate them thereby providing additional jobs for area residents, increasing property values and enhancing neighborhoods which will help to increase tourist activity as well as pride in our community. In addition, there is a large percentage of middle class non-homeowners who can only afford to purchase older residences in need of repair. However, without some financial assistance, such as a tax credit, these individuals cannot afford the purchase price and the amount necessary for rehabilitation.

We work every day, with varying success, to bring people back to the inner city area to live. The Historic Homeowners Tax Credit would, we believe, be just the incentive we need in order to rejuvenate what was once the "Gibraltar of the South" and what is today decaying at an alarming rate.

As everyone knows, the economic benefits of rehabilitating buildings far outweights the benefits provided through new construction. Using existing buildings recycles natural resources and requires little additional use of natural materials, utilizes infrastructure that is already in place and paid for (therefore saving resources and taxpayer dollars), and is more labor intensive thereby providing jobs for a more diverse segment of the workforce. The rehabilitation of historic buildings is not only economically beneficial, but it should also be considered "patriotic." The most tangible link to our past is the built environment. Saving and reusing these buildings helps us remember who we are and where we came from and, therefore, what a great country we have.

Forty percent of Vicksburg's housing is considered to be substandard due to disinvestment in certain historic neighborhoods. We believe that this Act will provide low to moderate income residents with the financial ability to rehabilitate their homes, provide non-homeowners with an incentive and financial ability to purchase homes and rehabilitate them in these neighborhoods, and as a result, the City's tax base will increase, neighborhood businesses will flourish from increased patronage, unemployment will decrease through the employment of artisans and those in the construction field, and the Federal government will reap the benefit of increased income taxes.

We ask that you please support the Historic Homeowners Assistance Act as it will help many people secure the American dream-- the ownership of a safe, secure home and the knowledge that they are preserving the heritage of our Nation.

STATEMENT OF
THE HONORABLE RICHARD M. DALEY,
MAYOR OF CHICAGO,
IN SUPPORT OF THE
ENVIRONMENTAL REMEDIATION TAX CREDIT
AND TAX-EXEMPT FINANCING PROPOSAL
UNDER CONSIDERATION BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

JULY 13, 1995

The City of Chicago strongly supports the Environmental Remediation and Tax-Exempt Financing proposal which creates a demonstration program to clean up and redevelop abandoned, contaminated industrial properties across the country. I am a longtime advocate of utilizing the tax code to encourage the private sector to involve itself in cleaning up contaminated industrial sites and returning them to productive use. The current tax proposal before the Committee is essentially identical to the provisions of HR 2340 from the 103rd Congress which was developed by the City of Chicago and introduced at my request. This program, through a combination of federal tax incentives and local contributions, will help to stem the abandonment and the waste of already developed industrial facilities and infrastructure, and to provide economic growth and job creation without consuming more open land. I strongly urge that this proposal be enacted this Congress.

Cleaning up contaminated industrial sites and returning them to productive use poses a vexing problem for governments at all levels. The costs of environmental remediation are usually too great for state and local governments, and the federal Superfund program cannot even begin to cover all the sites across the country that need to be cleaned up More sites are severely contaminated than Superfund has the resources or staffing to remediate promptly, and many sites are contaminated enough to pose health and safety issues, but not enough to rank high on the National Priorities List and be eligible for Superfund dollars.

The private sector, by and large, refrains from purchasing and cleaning up these properties because of the potential large costs, liability questions, and other uncertainties involved. Current owners in many cases are under severe financial stress, and sometimes out of business altogether. Although many of these properties are located in the nation's older industrial cities, examples can be found throughout the United States.

The current situation produces several damaging consequences:

- The properties remain contaminated for years, with no clean-up on the horizon. There can be a substantial risk of migration of the contaminants to adjacent sites and into aquifers where the risk of human exposure and the risk to health and safety may increase.

- Where the owner's financial condition is particularly bad, the owner may be forced to abandon the property because the owner can neither afford to clean up the property nor find a buyer willing to purchase the property in its contaminated state. The structures on the property deteriorate. Fly-dumping, scavenging, and other illegal activities occur on the site, which frequently compound the environmental problems at the site.

- Cities with deteriorating industrial bases find that they cannot replace the economic activity, the jobs, and the tax revenue when an industrial firm goes out of business at a particular site, because the site cannot be re-used for an economically productive purpose without first being cleaned up. Thus, as

unemployment rises, government revenue shrinks, crippling government's ability to provide the services necessary to retain businesses and industry or to respond to growing problems of unemployment and poverty related to the departure of industry.

- Where sites within a city cannot be redeveloped, new development will occur on the fringes of urban areas. The resulting development follows a pattern of "urban sprawl" that leads to accelerated consumption of open land and agricultural areas for development, and to greater dependence on automobile transportation compared to the city sites, which are generally accessible by public transportation to large numbers of potential workers, and which are generally served by existing infrastructure.

This Environmental Remediation proposal involves a two prong tax incentive: tax credits and tax exempt financing. In addition to cleaning up the property, a participating party would have to redevelop the site for commercial or industrial use. The program would be available in a limited number of cities and states, based on a selection process targeting those areas that have high manufacturing job loss. The environmental remediation tax proposal would work in the following way.

- <u>Tax Credit</u>: A tax credit of 25 percent of the total clean up costs, over a five year period, would be allowed to taxpayers who are "qualified" parties (persons not responsible for the condition of the site). To ensure compliance of the program, the first year the tax credit is available to the taxpayer would be the year of completion of an approved clean up plan. The national annual aggregate tax credits allocation would be $75 million.

- <u>Tax Exempt Financing</u>: Government units with bonding authority could issue tax exempt Environmental Remediation Bonds (ERBs). ERBs would be subject to the volume cap for tax exempt bond issues. ERB proceeds could be used for acquisition of contaminated property and remediation expenses (60 percent of the proceeds would have to be used for remediation expenses).

- <u>Local Contribution</u>: A participating jurisdiction must have an established program that would contribute to the environmental remediation of a selected site. The local participation may take the form of grants, loans, property or income tax abatement contributions, donation of property, or other direct or indirect financial assistance.

The City of Chicago is one of many cities in the United States with many contaminated sites that could benefit from such a policy. Under the program, Chicago could be eligible for about $6 million in federal tax credits. The $6 million in federal tax credits could leverage $24 million in private funds, which is enough to restore a dozen or more industrial sites in the first year of the program. A federal contribution in the form of tax incentives would make even better Chicago's local remediation program which has already experienced early successes.

The essential virtue of the program is that it uses the federal tax system to enlist the private sector in the cause of job creation and environmental clean-up. It trades $375 million in tax credits in the future for $1.5 billion in private sector investment over the next five years. By creating a partnership among the private sector, local governments and the federal government, this program not only distributes the burden of the clean-up costs, it also builds on our common interests in retaining and creating employment in our cities and towns.

In conclusion, simple modifications to federal tax policy, along with local assistance, will encourage private clean-up and redevelopment of environmentally contaminated properties. Such a policy will bring four major advantages to the public:

- It will help clean up and return to productivity sites that currently might never be cleaned up, providing jobs and tax revenue for state and local governments and their residents.

- It will promote private sector involvement in clean-up efforts to lessen the need for government funding of environmental remediation.

- Development will again occur where existing, underutilized infrastructure can be used, rather than being forced to new areas where significant expenditures must be made to construct new highways, transit, and other infrastructure in undeveloped areas.

- This proposal will help reverse the trend of increasing urban sprawl and curb the consumption of prime agriculture land and the environmental damage to open lands and air quality produced by such trend.

Without these tax incentives, properties such as these will remain contaminated and economically unproductive for an indefinite period of time. The economic base of industrial communities will remain impaired, while the need for new growth will push urban areas ever outward, with negative consequences for air quality, farmland, and open space.

On behalf of the City of Chicago I strongly urge the Ways and Means Committee and Congress to support and pass this Environmental Remediation and Tax-Exempt Financing proposal.

Written Statement
of the
Synthetic Organic Chemical Manufacturers Association
on
Miscellaneous Tax Reforms Hearings
July 11-12, 1995

Introduction

The Synthetic Organic Chemical Manufacturers Association (SOCMA) appreciates the opportunity to submit this written statement for inclusion in the printed record of the House Committee on Ways and Means' hearing on Miscellaneous Tax Reforms, held on July 11-12, 1995 in Washington, D.C. Prior to that hearing, the Committee outlined a number of miscellaneous tax proposals on which it was open to comment. SOCMA's comments will focus on tax reform measures related to three broad categories outlined by the Committee: business tax credits; depreciation and amortization; and, minimum tax. Specifically, SOCMA will urge the Committee to enact tax incentive legislation which encourages accelerated installation of pollution abatement and pollution prevention systems by providing: tax credits and/or accelerated depreciation allowance; alternative minimum tax exemption; and, a five-year minimum term per system to reflect design, permitting, construction and startup time. SOCMA believes that these incentives should apply equally to C and S corporations.

SOCMA is the national trade association of batch and custom chemical manufacturers, the highly innovative, entrepreneurial and customer-driven sector of the U.S. chemical industry. More than 2,000 batch processing facilities produce over 95% of the 50,000 chemicals produced in the U.S. at an annual value in excess of $60 billion. SOCMA's 260 members are representative of these facilities which are typically small businesses, with fewer than 50 employees and less than $50 million in annual sales.

SOCMA supports public policy initiatives which result in jobs creation, international competitiveness and cost effective environmental protection. U.S. manufacturers, workers and consumers alike will benefit from enhanced competitiveness of U.S. products in the world marketplace, creation of additional high paying jobs and expedited environmental protection.

Background

Industry in the United States is subject to environmental laws which are among the most stringent in the world. Many U.S. companies, and particularly small specialty chemical manufacturers, find that their products traded in the world market are competitively disadvantaged, not only because of stringent environmental regulations per se, but also because of the disparity between U.S. tax policy and that of our international trading partners. The disparity is documented in a study prepared by the Law Library of Congress.[1] That study of eleven foreign countries, who are major U.S. trading partners, revealed:

- o U.S. tax law is far more complex and punitive.
- o No comparable foreign alternative minimum tax.
- o Competitors from these foreign countries commonly have more liberal depreciation allowances, tax incentives and subsidized financing.

In light of the recently enacted North American Free Trade Agreement (NAFTA), it is instructive to compare the tax policies of Mexico and Canada with those of the U.S. as related to pollution prevention investments. Mexico provides a first-year deduction of 91% of acquisition cost on equipment used to control and prevent air, water or noise pollution. Under Canadian tax law, antipollution equipment can be depreciated at the rate of 25% using the declining balance method. By contrast, U.S. companies can only depreciate comparable investments at 8% to 17% annually depending upon their Alternative Minimum Tax (AMT) status.

As a result, U.S. products traded in world markets are competitively disadvantaged because the capital cost recovery provisions for the plants and equipment needed to produce these products are less favorable than those of other countries. Moreover, pollution prevention initiatives may be delayed or canceled because of high cost burden, and by force of economic necessity, may delay a company's installation of abatement equipment until mandated to do so. German and Japanese companies enjoy a comparable advantage relative to their U.S. competitors.

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[1] Steven F. Clarke, "The Tax Treatment of Expenditures on Antipollution and Facilities in Selected Foreign Countries," as exerpted in U.S. Environmental Policy and Economic Growth: How Do We Fare? (Washington, D.C., ACCF Center for Policy Research), March 1992, pp. 53-61.

SOCMA's Pollution Prevention Tax Incentives Initiative

Recognizing the critical nature of these issues to the chemical industry, and particularly to small batch and custom chemical manufacturing facilities, SOCMA initiated efforts to revise U.S. tax policy for capital recovery of pollution abatement devices. Specifically SOCMA has sought to convince policy makers to provide tax incentives to companies which invest in pollution abatement prevention systems. The benefits to be derived from properly crafted legislation include:

- o Level global playing field for U.S. companies
- o Cleaner environment.
- o Retention and creation of more U.S. jobs.

In the 103rd Congress, two bipartisan bills were introduced to provide such incentives: H.R. 2456 and S. 1684. H.R. 2456, a bill to provide more rapid depreciation of pollution abatement equipment in accordance with a sliding scale based upon a company's annual sales, was introduced by Rep. Donald M. Payne (D-NJ-10). "The Environmental Protection Encouragement Act of 1993", S. 1684, which was introduced by Senator Frank Murkowski (R-AK), provided that the cost of any environmental improvement property could be treated as a deduction for the taxable year in which such property was placed into service.

In 1994, to facilitate SOCMA's support of these two legislative proposals, the Association surveyed its 150 chemical manufacturing members to obtain quantitative, real world data of the impact of tax incentives in accelerated installation of pollution abatement and pollution prevention systems. The following is one of the 41 responses by SOCMA member companies:

TAX INCENTIVES FOR INVESTMENT IN POLLUTION ABATEMENT EQUIPMENT

Background

The Synthetic Organic Chemical Manufacturers Association (SOCMA) has been working for the past two years to convince policy makers of the need to provide tax incentives to companies which invest in pollution abatement equipment to achieve pollution prevention results through end of pipe controls, recycling, process redesign, source reduction, etc. Such incentives would create the promotion of jobs, particularly among smaller businesses; would enhance environmental quality; and would level the playing field for U.S. companies relative to their international trading partners.

To date, two bills have been introduced in Congress to provide such incentives. H.R. 2456 would accelerate the depreciation period for pollution abatement equipment from the current seven year write-off period to one year expensing for companies with less than $100 million in annual sales; three years for companies with annual sales of $101 million to $250 million; and, five years for companies with more than $250 million in annual sales. S. 1684, the "Environmental Protection Encouragement Act of 1993", would provide expensing of the cost of any environmental improvement property in the taxable year in which it is placed into service (i.e., *first year expensing*).

To facilitate SOCMA's efforts in moving these bills forward, it would be very helpful to have an understanding of the dollar value which such accelerated depreciation or expensing would have for our member companies. You can assist SOCMA in quantifying the impact that tax incentive legislation would have by completing the following brief survey and returning it to Mary Legatski by no later than February 18, 1994.

Capital cost of the following for	**1993**	**1994**	**1995**
Pollution abatement devices	$131,000	$200,000	$200,000
Pollution abatement installed systems	$554,000	$1,000,000	$1,000,000
Source reduction installed systems, including recycling	$275,000	$550,000	$1,050,000
Actual or anticipated number of employees	# 215	# 220	# 230

What tax-related incentive would cause you to accelerate two (2) future years' expenditures into one year or five (5) years' into three (3), etc.?

	Engineering & Design Credit Yes	Engineering & Design Credit No	Accelerated Depreciation Yes	Accelerated Depreciation No	Tax Credit Yes	Tax Credit No	Other (specify)
Pollution Abatement	☐	X	X	☐	X	☐	with ATM exclusion
Source Reduction including recycling	☐	X	X	☐	X	☐	with ATM exclusion

*Engineering design credit would also help accelerate, but not as great as the other 2 categories

Would you prefer a larger incentive for source reduction/recycling X or for pollution abatement ___ investments?

Available to any facility with less than 500 employees

Would you prefer that the incentive be tied to sales or number of employees per facility X or by company _?

Forty-one (41) companies, representing 27% of SOCMA's manufacturing members, completed and returned the tax incentives survey form. Of the 41 respondees, 28 were companies with fewer than 200 employees; 7 were companies with between 201 and 1,000 employees; and, 6 were companies with between 1,000 and 12,000 employees.

Actual and anticipated capital costs of specified pollution abatement equipment and systems for the period 1993, 1994 and 1995 for the total 41 respondents are summarized below:

CAPITAL COSTS FOR 41 COMPANIES

	1993	1994	1995
Pollution Abatement Devices	$ 30,603,000	$ 28,925,000	$ 35,075,000
Pollution Abatement Installed Systems	$ 78,706,000	$ 91,345,000	$125,907,000
Source Reduction Installed Systems	$ 40,155,000	$ 44,760,000	$ 74,085,000

To put these expenditures into perspective, it is useful to look at the average cost per employee of these various pollution abatement investments. The following table depicts the anticipated 1995 capital costs on a per employee basis by size of company based on total number of employees.

CAPITAL COSTS Per Employee (anticipated for 1995)

	Small Company (0-200)	Medium Company (201-1,000)	Large Company (1,001-12,000)
Pollution Abatement Devices	$ 8,910	$ 980	$ 370
Pollution Abatement Installed Systems	$ 22,080	$ 1,360	$ 1,820
Source Reduction Installed Systems	$16,680	$ 820	$ 930

Note that small companies anticipate spending nearly $31,000 per employee on pollution abatement and pollution prevention systems in 1995. If the average employee pay is roughly $30,000 per year, these small companies are paying fully 100% upcharge in pollution prevention and pollution abatement investments.

With regard to those tax-related incentives which would prompt a company to accelerate two (2) future years' expenditures into one year or five (5) years' expenditures into three (3) years, SOCMA members responded as follows:

	YES	NO
POLLUTION ABATEMENT		
Engineering/Design Credit	29%	39%
Accelerated Depreciation	58%	24%
Tax Credit	85%	7%
SOURCE REDUCTION		
Engineering/Design Credit	31%	34%
Accelerated Depreciation	41%	24%
Tax Credit	75%	7%

CONCLUSIONS

From the results of its 1994 survey, SOCMA has been able to draw the following conclusions with regard to its membership's interest in incentives to accelerate pollution prevention and pollution abatement systems installation, as well as quantitative evaluation of the value of that incentive to their specific facilities.

- Survey results indicate that the chemical industry, which employs approximately 1,100,000 workers, will in 1995 spend

  $2,739,000,000 on pollution abatement expenditures
  and
  $1,617,000,000 on pollution prevention expenditures.
- The expense burden is heavier for smaller companies, and the expenses are trending upward
- Incentives such as tax credits and accelerated depreciation would encourage companies to accelerate expenditures on pollution prevention and pollution abatement systems

RECOMMENDATIONS

SOCMA urges the 104th Congress to promote the goals of jobs creation, international competitiveness and cost effective environmental protection by enacting tax incentives legislation with key elements of :

- Accelerated depreciation and/or tax credits for installed systems.
- Exemption from the alternative minimum tax.
- Specification of a five-year minimum window to reflect permit and construction time requirements.

A miscellaneous tax reform bill, such as that under current consideration by the Committee on Ways and Means, would provide an effective vehicle for achieving these important societal goals. SOCMA urges the Committee on Ways and Means to consider the data submitted in these comments, and the more extensive data points contained in the attached February 1995 SOCMA "Pollution Prevention Tax Incentives Initiative: Initial Findings and Recommendations", and to proceed to enact these recommendations as expeditiously as possible.

SOCMA is aware that the Committee is looking beyond the immediate to a more extensive overhaul of the U.S. tax system, a process which might take a number of years to implement. However, as the Committee on Ways and Means moves forward on a miscellaneous tax reform bill, or a "tearing out by the roots" overhaul of the existing tax system, SOCMA believes that the issues of retaining and creating U.S. jobs, leveling the global playing field and promoting a cleaner environment should remain at the forefront of the debate.

Should the Committee have any questions regarding the SOCMA study and recommendations, please contact Mary James Legatski, SOCMA's Vice President of Public Affairs at (202) 414-4198.

[THE FEBRUARY 1995 SOCMA STUDY REFERRED TO ABOVE IS BEING RETAINED IN THE COMMITTEE FILES.]

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UNITED STATES
HOUSE OF REPRESENTATIVES

July 11, 1995

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[illegible]
HOUSING [illegible] OPPORTUNITY

STATEMENT BY THE HONORABLE JERRY WELLER

MISCELLANEOUS REVENUE HEARINGS HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee, thank you for allowing me to speak on behalf of my colleague Congressman English from Pennsylvania to testify concerning my strong support of the Environmental Remediation Tax Credit and Tax-Exempt Financing of which I am an original co-sponsor.

Currently, the private sector does not play a substantial role in the clean-up of contaminated sites. Open land is continually being developed for industrial purposes while contaminated sites are left abandoned because it is not advantageous to the private sector to engage in clean-up efforts. It is in our best interest to curb this consumption of open land. Furthermore, it is clearly unsafe for humans to be exposed to abandoned contaminated property.

Now is the time for action to involve the private sector. The federal Superfund program does not have the resources to remedy this ever-growing problem. This program encourages the private sector to begin re-development of the already urban areas, and stimulates clean-up efforts while providing economic growth.

The proposal is a combination of federal tax provisions and local contributions that provide incentives for the private sector to clean-up and re-develop abandoned, contaminated industrial sites. The program is open to those areas that meet pre-determined criteria and are best served by this process, aimed primarily at areas with high manufacturing job loss.

The proposal involves a two-pronged tax incentive: Tax Credit and Tax Exempt Financing. A tax credit of 25 percent of the total clean-up costs, over a five year period, would be allowed to taxpayers who are considered "qualified" parties. Meaning that they were not responsible for the contamination of the site. The tax credit would be reduced in the event that the amount of the tax is less than that specified in the audit. The taxpayer is not entitled to the tax credit until the year of completion of the approved clean-up plan. Thus ensuring compliance with the program. This Environmental Remediation Tax Credit would be allowed in annual installments over a five year period.

An additional incentive for site clean-up is to make it possible for the private sector to acquire property and pay for the clean-up with tax-exempt financing. A tax-advantaged financing policy could be established with a tax credit program and used in combination to provide clean-up incentives. For example, Environmental Remediation Bonds could be issued by Governmental units with bonding authority. The proceeds could then be used for acquisition of contaminated property. These bonds would be subject to the volume cap for tax-exempt bond issues. Thus involving very little or no additional cost.

It is necessary, however, that the participating city or state must have an established program that would contribute to the environmental remediation. This local participation may take one of many forms: grants, loans, property or income tax abatement, contributions by another non-federal government agency, donation of property, private party contributions, or other direct or indirect financial assistance.

This program uses the federal tax system in conjunction with the private sector to cause job creation, economic growth, and environmental clean-up. All these benefits are combined with the lessening of our open lands being used for industrial purposes. Not only will development occur where existing sites lay, but the contamination will be cleaned up and the risks to society as a whole will be lessened. Furthermore, environmental and agricultural damage will decrease.

On behalf of myself and Congressman English, I strongly urge The Ways and Means committee to pass this Environmental Remediation and Tax-exempt Financing Proposal.

July 24, 1995

Phillip D. Mosley,
Chief of Staff
Committee on Ways and Means,
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Request For Statements, Miscellaneous Tax Reforms Dates of Hearing: July 11-13

Dear Mr. Mosley:

My name is Mark Greenstein and I do not submit this comment on behalf of any client. I urge the Committee to approve legislation that fulfills the stated intent of the Tax Reform Act of 1986, to minimize the effect of taxes upon economic decision making. This can best be accomplished by adopting a provision which provides the taxpayer the lower of a tax on a percentage of the total amount realized upon disposition of a capital asset or the tax computed in the standard manner. This would introduce into our system of taxation a marketplace mechanism which utilizes the same self interest which makes capitalism the world's dominant economic system.

Capital gains are generally recognized only when the person who owns the asset decides to dispose of it. The influence of capital gains taxes on this decision is based, in large part, on the amount of tax relative to the value (amount realized on disposition) of the asset.

For example, Amy has a building that cost $50,000, is worth $1,000,000, and yields $70,000 in rent net of expenses. If Amy lives in a high-tax state, such as New York, more than one-third of the value of the building would disappear in taxes on disposition. To obtain the $70,000 she was receiving, Amy would have to obtain a yield of over 10 percent on the roughly $650,000 she would receive, net of taxes, if she sold the building. Because of this disincentive, it is likely that Amy will never sell her building. Instead, she will simply leave it to her heirs and, under current law, the gain will never be subject to an income tax. However, if the building cost $950,000, capital gains taxes would be unlikely to influence Amy's decision whether or not to sell it because less than 2 percent of the value of the building disappears in capital gains taxes.[1]

The solution is to formulate an alternative method of taxing capital gains that recognizes the perspective of the taxpayer. This approach would limit the capital gains tax to a set percent-

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[1] While the disincentive is the most obvious in the case of income-producing property, the disincentive is also present in other property. If the property in the example were raw land, Amy would have the appreciation potential of a $1,000,000 property if she did not sell it; if she did sell, she would be left with only $650,000 to invest.

age of the amount realized on disposition of an asset. For example, if the limit were 10 percent in the first situation posited, Amy would pay $100,000 in federal tax on disposition, but her taxes would not be affected in the second and the full tax rate would apply.[2]

The beauty of this approach is its flexibility. By choosing the appropriate rate, the goal of enhancing revenue could be achieved or, if more mobility of capital were desired, a rate designated to bring in the same or even less revenue could be enacted. In either case, these two major policy goals of a capital gains tax are best served by this approach as it targets a capital gains reduction to those transactions that are least likely to occur in the absence of a reduction in the tax payable on disposition. Thus, if the limit is set at an appropriate percentage, tax revenue will be enhanced by the same mechanism that encourages mobility of capital to different (and presumably more effective) uses, by those very persons whose economic judgment has proven to be astute.

I note that this topic was initially examined in an article which I wrote for Tax Notes which was published in the issue dated December 26, 1994, a copy of which I have enclosed for your convenience. I have also enclosed draft legislation to assist you in your consideration.

If you desire any further clarification of the above I would be delighted to discuss this subject at your convenience.

Very truly yours,

Mark Greenstein

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[2] Because, for individuals, the disincentive is greater the closer to death the owner is (because assets are valued at fair market value at date of death, or the alternate valuation date) it may be appropriate to reduce the limit for those with a limited life expectancy. This disincentive is already implicitly recognized by the exclusion of gain on the sale of a residence for those age 55 or older.

viewpoint

A Fresh Approach to Capital Gains Taxation

by Mark Greenstein

Mark Greenstein is an attorney in the Tax Department of Rosenman and Colin, New York. He previously worked in the Pension and Welfare Benefits Administration.

The two policies central to how capital gains should be taxed, which are typically characterized as in conflict, are raising revenue and encouraging the mobility of capital. This article will propose a novel approach to the taxation of capital gains that attempts to harmonize these objectives.

Capital gains are generally recognized only when the person who owns the asset decides to dispose of it. The influence of capital gains taxes on this decision is based, in large part, on the amount of tax relative to the value (amount realized on disposition) of the asset.

For example, Amy has a building that cost $50,000, is worth $1,000,000, and yields $70,000 in rent net of expenses. If Amy lives in a high-tax state, such as New York, more than one-third of the value of the building would disappear in taxes on disposition. To obtain the $70,000 she was receiving, Amy would have to obtain a yield of over 10 percent on the roughly $650,000 she would receive, net of taxes, if she sold the building. Because of this disincentive, it is likely that Amy will never sell her building. Instead, she will simply leave it to her heirs and, under current law, the gain will never be subject to an income tax. However, if the building cost $950,000, capital gains taxes would be unlikely to influence Amy's decision whether or not to sell it because less than 2 percent of the value of the building disappears in capital gains taxes.[1]

The solution is to formulate an alternative method of taxing capital gains that recognizes the perspective of the taxpayer. This approach would limit the capital gains tax to a set percentage of the amount realized on disposition of an asset. For example, if the limit were 10 percent in the first situation posited, Amy would pay $100,000 in federal tax on disposition, but her taxes would not be affected in the second and the full tax rate would apply.[2]

This illustrates how both aspects of the debate can be addressed. The two policy objectives of a capital gains tax are furthered by targeting the reduction to those transactions that are least likely to occur in the absence of a reduction in the tax payable on disposition. Thus, if the limit is set at an appropriate percentage, tax revenue will be enhanced by the same mechanism that encourages mobility of capital to different (and presumably more effective) uses, by those very persons whose economic judgment has proven to be astute.

[1]While the disincentive is the most obvious in the case of income-producing property, the disincentive is also present in other property. If the property in the example were raw land, Amy would have the appreciation potential of a $1,000,000 property if she did not sell it; if she did sell, she would be left with only $650,000 to invest.

[2]Because, for individuals, the disincentive is greater the closer to death the owner is (because assets are valued at fair market value at date of death, or the alternate valuation date) it may be appropriate to reduce the limit for those with a limited life expectancy. This disincentive is already implicitly recognized by the exclusion of gain on the sale of a residence for those age 55 or older.

The Election Results: A Mandate For Change or a Window of Opportunity for Tax Simplification

by J. David Mason

J. David Mason is an assistant professor in the Department of Accounting, School of Business, at East Carolina University in Greenville, N.C.

The election results are in and the results are a Republican-controlled Congress for the first time in four decades. The political prognosticators are interpreting the results of the election as a message from the people of a mandate for change. In tax circles, there is talk about reviving the capital gains deduction, among other tax law changes. But wait a minute! Why waste this mandate for change on reinstituting the capital

The Internal Revenue Code of 1986 is amended by adding a new section (i) to section (1):

(i) (A) Alternate Maximum Capital Gains Rate. If a taxpayer which is a natural person disposes of a capital asset during the year, the tax imposed under this subtitle shall not exceed the applicable percentage of the amount realized.

(B) Applicable Percentage - the Applicable Percentage, for purposes of this section shall mean --% and except that for each five years of age the taxpayer attains in excess of 60, as of January 1, of the taxable year the applicable percentage shall be reduced by --%.

(C) Coordination with Other Sections. Any capital gain to which this section is applicable shall not be considered in determining any other taxable amount under this Subtitle.

JOHN P. RENSHAW
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May 9, 1995
Re-Evaluated 6/30/95

AT NO COST, A SIMPLE CAPITAL GAINS OPTIONAL SALES TAX CAN GREATLY BENEFIT ONGOING TREASURY RECEIPTS AND PAINLESSLY CUT THE FEDERAL DEFICIT

SUMMARY

- This is not a "tax-cut" proposal because present Treasury tax receipts are not reduced; constructively, there is voluntary creation of additional tax receipts not otherwise now available, and that will disappear if not used.

- Recently ('90-'92) the total Treasury gains-tax receipts from equity plus real estate were $25-$28 billion/year.

- Now, the Congressional Budget Office estimates a future additional federal deficit of a bit over $20 billion/year -or $100 billion over the next 5 years.

- To help appreciably cut that future deficit, legislate a capital-gains-related 10% optional sales tax aimed at encouraging sale during their life-time of very low-cost "locked-up" unrealized gains from assets held over 5 years by taxable investors. That optional 10% sales tax is not advantageous for taxable investors when relative costs are high or moderate, and when stated capital gains rates are about 20% or above as they have been for 40 years. However, the optional sales tax gets increasingly advantageous as those relative costs decline towards zero. Judging from IRS-derived data, unrealized low-cost gains are now very large, and (if unused) disappear for tax-calculation purposes upon death. Such unrealized gains have been increasing for a long time -- but especially over the past 10-15 years. If investors see fit to federally unlock those large very low cost gains at 10% of sale price (instead of deciding not to sell at current judgementally prohibitive stated 28% gains tax or effectively yet higher federal Alternate Minimum Tax rates), then (starting in '95) at least $120 billion/year average (600 billion over 5 years) are the potential Treasury receipts. That is in addition to actual past gains taxes such as in '90-'92. If even a fraction of the potential is added to other deficit-cutting efforts, those presently unrecognized benefits should still be of very meaningful additional size relative to those '90-'92 receipts, and to future estimated yearly deficits.

  Concerning the above "unlocking" potentials, even stated capital gains tax rates as low as 20% (which historically meant about 15% effective because of tax-calculation State-payment deductions, etc.), in the past have still been judged prohibitive by taxable individuals.

  Such overall potentials should be carefully evaluated immediately, either as independent legislation, or as an addition to the current House Ways & Means capital gains proposal, so as to add very large Treasury receipt benefits. In that W. & M. proposal, very-low-cost sales are not encouraged. Data justification, available upon request, is conservatively derived from IRS studies.

Such a simple, voluntary optional 10% gains-related sales tax would eliminate the need for calculating asset costs, and should uniquely hurt no one. The optional sales tax specific title should facilitate ear-marking such tax receipts (possibly with a yearly "cap") for specific application to deficit reduction. Overall, the optional 10% sales tax proposal could be the most attractive bargain in the Budgetary area.

The above proposal is different because it expands past small tax-rate-capping suggestions in a numerically logical and advantageous manner not now generally thought possible. In reality, from the point of view of moderate tax-payers and the needy, those new funds at no cost are the equivalent of vast new "pocket-book" national savings benefits.

Ten Percent Optional Sales Tax on Capital Gains

Fact Sheet

3/4/95
Re-evaluated 6/30/95

Background on Capital Gains Taxes

The original GOP "Contract With America" contained three capital gains provisions (1) Individual and corporate taxpayers would exclude 50 percent of their capital gains from income. The new effective capital gains tax rates would have been 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent for individuals, depending upon the individual's tax bracket. Corporations would have been subject to a top effective capital gains tax rate of 17.5 percent. (2) The basis of capital assets (the original cost) would have been indexed for inflation occurring after 1994. (3) A deduction for the loss on the sale of a principal residence would have been allowed. Furthermore, the Alternative Minimum Tax would no longer enter into capital gains tax calculations. In recent years the A.M.T. effectively exceeded stated gains tax rates.

New proposals may alter the above.

The Ten Percent Optional Sales Tax on Capital Gains

The GOP proposal for capital gains tax relief could be beneficial to the U.S. economy. It should reduce the cost of capital and encourage saving and entrepreneurial activity. It would not, however, provide a strong incentive for taxpayers to realize capital gains on the large segment of old, *very* low cost assets now "locked up." For many individual taxpayers, a 19.8 percent capital gains tax (which in the past was associated with continuing "locking-up") would historically be too high to make them want to realize a gain. Instead, they would let the asset pass into their estates. Their heirs would inherit the asset with a "stepped up" basis, valued at the market price at the time of the original owner's death. Thus the Treasury would lose out because it receives no related previous gains-related revenue unless the heir sells the asset above its new estate cost.

The option of paying a 10 percent tax on the sales price of the asset should be provided for taxpayers who have held assets for at least five years. The optional sales tax, which I have further developed from previous such "cap" efforts, *almost uniquely would hurt no one*. Most tax bills merely take from one group to give to another. This optional tax would make capital gains realizations attractive to investors holding old, <u>very</u>-low-cost assets. It should encourage legislative approval by voluntarily adding to related Treasury receipts at no cost. <u>In accordance with the presently-recognized urgent need to soon begin serious federal deficit reduction, the optional 10% sales tax proceeds could be so targeted</u>; there could be limitations such as for at least 5 years, and limited to $10 bil /yr Furthermore, that optional sales tax <u>would eliminate the need to calculate the cost of assets</u>, which can be difficult and expensive.

> For an example of an asset of almost zero cost, it may produce a total yield of 10%/yr for an investor in a high-tax State such as California or New York. If it were sold now, more than a third of the market value would disappear in taxes. Therefore, net proceeds re-invested in a similar asset would only have a total yield of perhaps 6 1/2% on the previous holding. So, the investor may not sell - and would leave that asset for heirs, with the gain not soon producing any additional voluntary Treasury receipt.

The Optional 10 Percent Sales Tax on Capital Gains Should Be Adopted

- *Revenues Would Increase from Sale of Old 'Locked up' Assets* Until '95, taxable investors had an estimated present $1,200 billion in unrealized equity gains. Conservatively, if only half of these assets are soon sold, the optional sales tax could yield an additional $60 billion within 5 years. If 30 percent of perhaps $1,200 billion real-estate were sold (with no recapture of past depreciation), the 5 year potential sales-tax could be about $35 billion.

  See Note A
  See Note B

- *Revenue Increase from Sale of Equity Assets at Future Higher Prices* Equities (the Wilshire 5000 Index) historically have increased in value by at least 7 percent per year through 1992 With early '95 levels reflecting only a current historically low 14 P/E ratio* for a low foreseeable real inflation, that translates into gains of $175 billion per year accruing to taxable stockholders. Many investors with these gains would be more likely to realize them under the optional 10 percent sales tax than under the GOP proposal. By allowing the taxpayer a choice, tax receipts are likely to be much larger since the decision to realize a capital gain is strictly voluntary at a lower rate.

  Starting with '95, a far more optimistic equity outlook appears plausible over the next 5 years. As of 1989, and derived from the Wilshire 5000 equity Index and IRS data, there was an estimated $5,200 bil., total market value of equities - of which, through '94, taxable individuals owned about half or $2,500 bil. At present (6/30/95) that individual market value portion largely because of additional locked-up market value was almost $6,000 billion with about $1,100 bil. in the first 6 months of '95. With the S&P 500 quality/growth index now selling for about 16 P/E on an impressive consensus basis for '95, and 15 P/E for '96, I believe these equity markets are still reasonably priced for long-term taxable investors Following is my reasoning - despite the great interest in locked-up, unrealized capital gains in recent years. Enclosed are two charts: Capital Gains Related (Numerical) Data, and an adaptation of a long-term Securities Research C Line chart.

  As a 40 year historical market-price-trend influence for quality/growth investors, perhaps the two most important factors have been U.S. active participation in Middle-East-oil-related wars (see "Line Chart") and the adjusted status of inflation. The end of the Vietnam War and the leveraged buyout era ('84-'89) bear separate discussions, which in the interest of time I will not here evaluate.

  For 15 years from 1955, equity prices generally were 20-35% above "normal" largely because of low inflation (sometimes 1%/yr. compared to an adjusted possible (and satisfactory) 2%/yr. increase now. During that period, their price lows (lasting less than 2 years) were during our active participation which reflected about 16-17 P/E for the S&P 500 and DJIA long-term trend. Otherwise, the above equity indices could have continued the 20-35% above the satisfactory 16-17 P/E long-term trend. The simplified historical inference: unless drastically changed major negative international balances occur, present market levels for taxable investors with more than a few years time horizon objectives, look reasonable. With good fortune, equity index price levels (capital only) could soon be perhaps 15% higher during '95 and '96 or about $700 bil./yr. ongoing over 5 years. At 10%/yr, that could be up to $70 bil. above present gains receipts. If we become actively involved (and this Administration shies away from such direct action), history indicates only a short down period to something close to present levels. Thus, the 16-15 P/E on near-term earnings seem reasonable as does inflation.

For more information please contact John P. Renshaw, chairman, Van Strum & Towne, Inc. 505 Sansome Street, Suite 1001, San Francisco, California 94111 415/981 3455 (p) 415/981 3425 (f)

The above proposal for an optional sales tax on assets held over 5 years so as to unlock large unrealized gains, should enrich the Treasury which greatly needs such an infusion - yet it costs that Treasury nothing, and should help low tax-bracket tax-payers - and the needy.

Revenue Increases from Sale of Real Estate Assets at Future Higher Prices.

See Note C If real estate starts to slowly recover (after a presumed drop of 25% since 1989), that could be a 5 year $35 billion sales tax potential.

✿✿ *Total Revenues Including the Optional Sales Tax*: This generally large and unrecognized total of past and future additional direct, cash-receipt Treasury potential from both equity and real-estate voluntary sales could easily approach $350 billion over the FY 1995 2000 period, or an average of $70 billion per year. Most of this is described in the text and attributable to equity increases starting in '95. Just a portion of this realized could be of tremendous national benefit in reducing budgetary deficits. Aside from direct cash Treasury benefits, substantial indirect but related benefits could also accrue. And taxing States could advantageously conform. All this *additional* compares to under $30 billion per year actually received in 1990 1992, and which could at least separately continue.

See Note D

See Note E

✿ *Optional Sales Tax Would Provide an Additional Strategy for Economic Growth*: Although the economy is expanding, worries about the future appear to be multiplying. A cut in the capital gains tax to a top marginal rate of 19 8 percent plus the option of paying only 10 percent on the sales price instead could be a very effective economic and budgetary panacea in view of the steady past and foreseeable future increase of unrealized, "locked-up" gains of long-held, very-low-cost taxable investor assets. The combination of these two proposed gains-tax-reducing options would surely give a strong boost to useable Treasury receipts and to values of capital assets (e.g., real-estate and the stock market). That should further increase potential gains sales taxes for Treasury use. It should also encourage investment by both mature and new business. If (within the total promised time constraints of the legislative "Contract With America's first 100 days" ending April 14th) the House Ways & Means does not see fit to carefully evaluate the capital-gains related optional sales-tax add-on, then later the Senate may more effectively do so with its influential filibuster powers giving more time to evaluate for members of either party.

John P. Renshaw

SCR Century-Plus Chart retained in Committee Files.

Calculation Appendix.
These Are Notes to "The Optional 10 Percent Sales Tax on Capital Gains Should Be Adopted"

March 4, 1995
Re-evaluated 6/30/95

Note A. Concerning "$60 bil." From past equity appreciation to date ("old holdings"): $1,200 bil. = 1/3 of $2,500 bil. of IRS estimated taxable investor locked-up unrealized holdings in 1989*, plus a further 50% Wilshire 5000 equity increase from '89 to the present. If only half of $1,200 bil. is liquidated within 5 years to be voluntarily subject to 10% optional sales tax, that results in $60 bil. additional Treasury revenues. Past gains-related asset sales by taxable investors were of relatively high-cost assets. Thus, especially over the past 10-15 years, very-low-cost, "locked-up" assets continued to increase in current market dollars as growth and inflation-aided earnings trended higher, and may so continue until assets enter estate status.

Note B. Concerning "$35 bil." From past real-estate locked-up, unrealized appreciations: from 2/3 of $2,500 bil. estimated by the IRS to be locked-up gains in 1989, presume a subsequent market value drop of 25% to the present (i.e., from about $1,600 bil. to $1,200 bil.) Then assume 30% of $1,200 bil. past unrealized gains are voluntarily sold subject to 10% gains sales tax. Therefore $36 bil. (say $35 bil.) sales tax could result within 5 years. ($1,200 x 30% x 10%). The absence of recapture of past depreciation, etc. upon sales, should be conducive to real-estate unlocking and therefore greater net Treasury receipts.

Note C. Concerning "$35 bil. over 5 years" from future real-estate appreciation: If (See Note B) a present $1,200 bil. locked-up market value (after the 25% assumed drop from '89) starts to increasingly recover and averages perhaps a 6%/yr. recovery over 5 years, that is $360 bil. of additional locked-up unrealized market values for the period. At 10% optional gains sales tax, the 5 year Treasury potential is therefore $36 bil. (say $35 bil. rounded out).

Note D. Concerning over a $600 bil. 5 year total" starting in '95 of additional Treasury receipts ($45 bil./yr average): that consists of $60 bil. from Note A, plus $35 bil, from Note B, plus $600 bil. from Note C, plus $35 bil from Note D -- or $600 bil. over 5 years.

Note E. Substantial associated indirect - but difficult to determine - benefits to the $230 bil. direct Treasury receipts in Note E should be additionally derived from general economic stimulus (e.g.: deficit-reduction progress leading to lower interest rates, greater savings, sounder economic growth, etc.).

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* IRS Office of Tax Analysis study dated 3/14/89

CAPITAL GAINS RELATED DATA

August, 1994

Individual Federal Capital Gains Taxes

	YEAR	TOTAL GAINS*	CG TAXES PAID *	ACTUAL % TAXES PAID	STATED CG TAXES RATE	INDICES FROM 1954 CPI	INDICES FROM 1954 EQUITY AT 6%/YR.**	INDICES FROM 1954 EQUITY AT 10%/YR.**	MEAN PRICES VALUE LINE 18 REITS	MID-YEAR WILSHIRE 5000 (BIL) ***
	1954	$ 7.2 BIL.	$ 1.0 BIL.	14%		1.0	1.0	1.0		
	'55	9.9	1.5	15%	26%					
	'56	9.7	1.4	14%	25%					
	'66	21.3	2.9	14%	25%	1.2	2.1	3.1		
	'67	27.5	4.1	15%	25%					
	'68	35.6	5.9	17%	25%					
	'69	31.4	5.3	17%	25%					
	'70	20.9	3.2	15%	29.5%					
	'71	28.3	4.3	15%	32.5%	1.5	2.9	5.1		922
	'72	35.9	5.7	16%	35%					1,010
	'73	35.8	5.4	15%	35%					915
	'74	30.2	4.3	14%	35%					740
	'75	30.9	4.5	15%	35%					840
	'76	39.5	6.6	17%	35%	2.1	3.8	8.1		915
	'77	45.3	8.1	18%	35%					919
	'78	50.5	9.1	18%	35%					918
	'79	73.4	11.7	16%	28%					1,028
	'80	74.6	12.5	17%	28%					1,165
	'81	80.9	12.7	16%	20%	3.4	5.1	13.1		1,391
	'82	90.2	12.9	14%	20%					1,125
	'83	122.0	18.5	15%	20%					1,792
L	'84	140.5	21.8	16%	20%				175	1,571
B	'85	173.4	26.5	15%	20%				200	1,978
O	'86	(100.7) 328.3	? (21) ? 49.7	15%	20%	4.1	6.8	21.1	226	2,578
E	'87	144.1	32.9	23%	28%				223	3,005
R	'88	161.9	39.0	24%	28%				228	2,73[illegible]
A	'89	153.5	35.8	23%	28%				224	3,13[illegible]
	'90	123.8	27.8	22%	28%				178	3,424
	'91	111.4	24.9	22% E	28%	5.1	9.2	34.0	173	3,546
	'92	125.0 MAX	28 MAX		28%				194	3,930
	'93				28%				206	4,450

About 22% of Equities Removed by Sales

Wilshire Increased 4 Times

John P. Renshaw

* Source: American Council for Capital Formation Tabulation of U.S. Treasury Data.

** Over 20 years Wilshire 5000 equity index prices rose about 7%/yr. cumulative.

*--> *** Wilshire 5000 index is probably about 90% of all U.S. equity market values. For instance, 3,000 on index would be $3,000 bil. ($3 Tril). In 1992, individuals own almost half.
On 6/30/95 Wilshire 5000 was $5,360 bil.

LBOs = Leveraged Buyout Era often mandated capital gains

* 1971–1993 represents a long–term complete equity price–index cycle; The Wilshire 5000 index rose over 7%/yr. cumulatively. Thus, on that trend, an equity sale represents a cost" (or market value) 5 years before of about 70% of the "sales" price.

Commentary

on events at home and abroad

By Caspar W. Weinberger, *Chairman*

AN ELEGANT NEW PROPOSAL

RECENTLY, A NEW PROPOSAL to improve the capital gains tax has been made that is elegant in its simplicity and is astonishing in that it helps the taxpayer, the Treasury and the economy while hurting no one.

The capital gains tax illustrates better than any other issue the difference between Republican and Democratic economic policies. Historically, Democrats favor a high capital gains tax because they believe that it primarily hits the rich (thinking only the rich own stocks or real property), that it brings a fair amount of revenue into the Treasury for politically popular spending programs, and that favoring it brings little political pain.

Republicans think, generally, that the capital gains tax discourages development and, because people keep their assets "locked up" to avoid the tax, discourages the realization of gains that could be used for new job-producing investment, thereby helping the economy and people of all income levels.

John Renshaw: Designer of a new capital gains proposal.

The new proposal, devised after many years of study by John P. Renshaw, an MIT graduate and an investment counselor in San Francisco, offers taxpayers an alternative to the 28% capital gains tax. This alternative is a 10% sales tax on the amount anyone receives for the sale of stocks or real estate held for five years or longer. This would be most attractive to owners who acquired their property at very low cost, measured by today's prices. For others the existing capital gains tax would be less costly and would be used.

An examination of stock prices and other data indicate that for most owners whose initial stock cost is 64% or less than the current selling price of their stock, the proposed 10% sales tax would be better than the capital gains tax. But if their cost is 80%, then the 28% tax would be better.

The prime purpose of Renshaw's proposal is to encourage more holders of low-cost properties to sell them, thereby unlocking and using the capital gains. This would secure approximately $30 billion a year in new revenue for the Treasury that isn't being realized now because the high capital gains tax is a disincentive for these owners to sell. Another benefit is that, because this is a sales tax, the alternative eliminates the need to calculate the cost of assets, which can be difficult and expensive.

Since many low-cost property owners do not sell their property during their lifetime, the government does not realize any capital gains tax revenue until an owner's death, after which the property is revalued. Would this proposal be enough to unlock these capital gains? There is some interesting evidence:

- In 1972 the capital gains tax was 35%, and about $5.7 billion was paid in capital gains taxes. In 1981 the Reagan tax cut reduced capital gains taxes to 20%; subsequently, nearly $13 billion in capital gains was paid to the Treasury, proving the frequently made point that government gets more revenue when taxes are cut.
- During the heyday of leveraged buyouts (1984 to 1989), absurdly high prices were offered for stocks so the buyers could gain control of certain corporations. That proved to be a strong enough inducement for vastly increased sales and realized capital gains. Indeed, total realized gains increased from $122 billion in 1983 to $326 billion in 1986, with Treasury revenue increasing from $18.5 billion in 1983 to $49.7 billion in 1986.

Given these figures, it seems clear that with sufficient inducement longtime owners of low-cost property are willing to unlock and sell.

Renshaw's estimate of a yearly $30 billion in new revenue for the Treasury is based on data showing that there is about $5 trillion in accrued and unrealized capital gains from stocks and real estate. Of this huge sum, taxable individuals own about $800 billion in stocks and $1.6 trillion in real estate. If the alternative tax induced the sale and realized the gains of 50% of these locked-up stocks and 30% of the real estate, over a three-year period there would be $30 billion a year in new revenue for the Treasury. And because there wouldn't be an incentive to lock up assets, the benefits to the Treasury should be ongoing.

. Renshaw's proposal seems to be an alternative that Congress could accept, applying it to the long-held, low-cost assets. It is a simple, elegant and, I think, highly desirable plan that warrants careful study and rigorous analysis. ■

Citizens Commemorative Coin Advisory Committee
Established by Act of Congress, Public Law 102 390

July 26, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We are writing to request your support for a legislative initiative which will greatly benefit U.S. commemorative coin programs authorized by Congress and the collectors who purchase the coins. This initiative would allow a deduction for the purchase of commemorative coins, thus recognizing the charitable contribution made with the purchase of such coins and providing a boost to a significant profit-making venture of the Federal government.

As you know, each year Congress authorizes the U.S. Mint to produce special coins to commemorate persons, places, and events of cultural and historical significance to the United States. Each commemorative coin program carries a surcharge to benefit designated charitable organizations. This year's programs will provide millions of dollars in surcharges to the Atlanta Committee on the Organization of the 1996 Summer Olympic Games, the Special Olympics, and the Civil War Trust.

In recent years, commemorative coin sales have been in decline, resulting in corresponding decreases in profits for the Federal government and surcharges for beneficiary organizations. This decline can be traced to increasing frustration among coin collectors that Congress ignores their interests and regards commemorative programs largely as a way to raise funds for favored projects without raising taxes.

Although charitable organizations receive surcharges from coin sales, the tax code does not recognize commemorative coin purchases as deductible as charitable contributions. By allowing for a tax deduction for the purchase price of a commemorative coin minus its face value, Congress would clearly recognize the contributions that collectors make to charitable organizations when they purchase these coins. In addition, this change in the tax code would more than pay for itself by enhancing commemorative coin sales and thereby increasing profits deposited in the Federal Treasury.

You may be interested to know that since 1982, the U.S. Mint's commemorative coin programs have generated $650 million in net revenues for the Federal Treasury through program profits and the sale of stockpiled gold and silver, while raising $283 million in surcharges to support such American icons as the Statue of Liberty, the U.S. Capitol, Mount Rushmore, Monticello, the Vietnam Veterans Memorial, and the U.S. Olympic team.

We understand that Members of the Committee on Ways and Means have voiced their support to you for allowing such a deduction. We would like to join them in their support and request that you assist in moving this initiative at the earliest opportunity. If you have any questions concerning this matter, please do not hesitate to contact one of us or Eric Hallerberg at the United States Mint at (202) 874-7405.

We thank you for your consideration of this matter.

Sincerely,

Philip N. Diehl, Chairman	Elvira Clain-Stefanelli
Reed Hawn	David L. Ganz
Danny Hoffman	Elsie Sterling Howard
Thomas V. Shockley, II	Charles H. Atherton

TESTIMONY OF THE SPECIAL OLYMPICS INTERNATIONAL

Mr. Chairman and Members of the Committee, Special Olympics is pleased to present this written statement in support of an important tax reform measure, which if adopted, would benefit Congressionally-authorized commemorative coin programs and those collectors who purchase coins through these programs. The legislative proposal would allow a tax deduction for commemorative coins purchased directly from the United States Mint, thus acknowledging the charitable contribution that coin purchasers make when they buy commemorative coins.

Since 1982 Congress has authorized the United States Mint to issue commemorative coins to honor persons, places, and events of cultural and historical significance to the United States. Each commemorative coin authorization incudes a mandatory surcharge to benefit a statutorily-designated charitable organization. Last fall, Congress mandated that a $10.00 surcharge on the sale of Special Olympics commemorative silver dollars be contributed to the 1995 Special Olympics World Games Organizing Committee to provide a world-class sporting event for athletes with mental retardation and to demonstrate to a global audience the extraordinary talents, dedication, and courage of persons with mental retardation.

Special Olympics is deeply honored to have been designated by Congress to be the recipient of commemorative coin surcharges, especially since it is the first time a nation's legal tender celebrates the competency and abilities of persons with mental retardation. Other beneficiaries of commemorative coin surcharges in 1995 are the Civil War Trust and the Atlanta Committee on the Organization of the 1996 Olympic Games.

Although charitable organizations like ours receive surcharges from coin sales, coin purchases currently are not deductible as charitable contributions. By clarifying the tax code to allow for deductions for the purchase price of a commemorative coin minus its face value, Congress would clearly acknowledge the importance of numismatic support of charitable causes like Special Olympics.

We also believe such a clarification in the tax code would increase commemorative coin sales, which in recent years have been in decline. This decline is particularly distressing when one realizes that commemorative coin programs are a money-maker for the United States Treasury. Since 1982, the United States Mint's commemorative coin programs have generated almost $650 million in net revenue for the federal treasury in program profits and in proceeds from the sale of one million ounces of gold and 30 million ounces of excess silver from the nation's stockpiles. Additionally, $283 million in surcharges were raised to support American landmarks and charitable organizations like the Statue of Liberty, the United States Capitol, Mount Rushmore, Monticello, the Vietnam Veterans Memorial, the U.S.O., the United States Olympic team and athletes with mental retardation who participated in the recently-completed 1995 Special Olympics World Games. (See Exhibit I: Distribution of Commemorative Coin Surcharges).

With the decline in commemorative coin sales, there has been a corresponding decrease in profits for the federal government and in surcharges for beneficiary organizations. In the case of Special Olympics, coin sales to date have been about half of the original projections. As a result, the 1995 Special Olympics World Games has been left with a deficit which we are actively trying to erase though additional coin sales to our long-time corporate sponsors and supporters. A tax deduction for such purchases would be enormously helpful in this effort.

Moreover, we believe that this tax reform provision will help spark a renewed interest among coin collectors to purchase commemorative coins and ensure their profitability for the federal treasury. In addition, this change will more than pay for itself by enhancing commemorative coin sales and thereby increasing profits deposited at the federal treasury. (See Exhibit II: Cost and Profit Aspects of Proposed Legislation).

Mr. Chairman, I am happy to report that this tax reform proposal is endorsed by the Congressionally-established Citizens Commemorative Coin Advisory Committee and the American Numismatic Association. Sponsors of the following commemorative coin programs also support this proposal, including the Botanical Gardens Commemorative Coin Program; the West Point Military Academy Commemorative Coin Program; the 1995/1995 Atlanta Centennial Olympics Games Commemorative Coin Program; the National Community Service Commemorative Coin Program and the Robert F. Kennedy Memorial Commemorative Coin Program.

Thank you for allowing Special Olympics the opportunity to provides comments on this important tax reform proposal (See Exhibit III: Proposed Bill Language). Its enactment would greatly enhance our ability to provide year-round training and sports opportunities for persons with mental retardation in each of the 50 states and around the world.

SURCHARGE RECIPIENT ORGANIZATIONS
U.S. COMMEMORATIVE COIN PROGRAMS
1982 through 1995

Year	Program	Surcharges (in millions)	Recipient Organizations	Purpose
1982	George Washington	N/A*	Federal Treasury (General Fund)	To reduce the Federal budget deficit
1984	Olympic	$73.5	Los Angeles Olympic Organizing Committee	To support the United States Olympic Team and the staging of the 1984 Summer Olympic Games in Los Angeles
1986	Statue of Liberty	$83.2	Statue of Liberty - Ellis Island Foundation, Inc.	To support restoration of the Statue of Liberty and Ellis Island
1987	U.S. Constitution	$52.7	Federal Treasury (General Fund)	To reduce the Federal budget deficit
1988	Olympic	$22.9	U.S. Olympic Committee	To support the United States Olympic Team
1989	U.S. Congress	[illegible]	U.S. Capitol Preservation Commission	To support refurbishment of the U.S. Capitol
1990	Eisenhower Centennial	[illegible]	Federal Treasury (General Fund)	To reduce the Federal budget deficit
1991	Mt. Rushmore	$12.1	Mt. Rushmore National Memorial Society of Black Hills	To support Mt. Rushmore
1991	Korean War	[illegible]	Korean War Veterans Memorial Fund	To support the Korean War Veterans Memorial
1992	United Service Organizations	[illegible]	United Services Organization; Federal Treasury	[illegible] reduce the Federal budget deficit
1992	Olympic	[illegible]	U.S. Olympic Committee	To support the United States Olympic Team
1992	Christopher Columbus	$7.6	Christopher Columbus Fellowship Foundation	To [illegible] scholarships to encourage new discoveries [illegible] for the benefit of mankind
1992	White House	$5.0	White House Endowment Fund	To [illegible] refurbishment of the White House
1993	World War II	$7.8	Battle of Normandy Memorial, World War II Memorial	To support the Battle of Normandy Memorial and the World War II Memorial
1993	Madison - Bill of Rights	$9.2	James Madison Memorial Fellowship Trust Fund	To provide scholarships to encourage teaching and graduate study of the Constitution
1994	World Cup USA	$9.3	World Cup USA 1994 Inc.	To support the staging of the 1994 World Cup in the United States
1994	Thomas Jefferson	$6.0	Thomas Jefferson Memorial Foundation; Corporation for Jefferson's Poplar Forest	To support the restoration of Monticello and Poplar Forest
1994	Veterans	$8.2	Vietnam Veterans Memorial; POW Museum; Women in Military Service for America Memorial	To support the Vietnam Veterans Memorial, the POW Museum, and the Women in Military Service in America Memorial
1994	U.S. Capitol	$5.2	U.S. Capitol Preservation Commission	To support construction of a visitors center at the U.S. Capitol
1995	Olympic	$5.8	U.S. Olympic Committee; Atlanta Committee for the Olympic Games	To support the United States Olympic Team and the staging of the 1996 Summer Olympic Games in Atlanta
1995	Civil War	$4.8	Civil War Trust	To support preservation of historic Civil War battlefields
1995	Special Olympics	$1.5	Special Olympics International	To support the staging of the Special Olympics World Games

* The 1982 George Washington commemorative program did not include a surcharge; a portion of the net revenues, $14.4 million, was deposited to the General Fund.

SOURCE: U.S. Mint

COST AND PROFIT ANALYSIS OF PROPOSED AMENDMENT ALLOWING DEDUCTION FOR PURCHASES OF COMMEMORATIVE COINS
(per coin)

Costs as tax revenue foregone

Average price of a silver dollar commemorative coin	$29.72		
Face value of a silver dollar commemorative coin	$1.00		
Proposed deduction	$28.72		
Average tax rate for taxpayers taking deduction	31%		
Percentage of taxpayers who would claim deduction	29%		
AVERAGE TAX REVENUE FOREGONE PER COIN		$2.58	

Revenues from commemorative coin sales and sales of government stockpiled silver

COIN SALES			
Average price of a silver dollar commemorative coin	$29.72		
Average profit margin	0.12		
Average profit per coin	$3.57		
SILVER SALES			
Total proceeds on Treasury and DLA sales of silver to U.S. Mint (in millions)	$120.8		
Total sales of silver dollar commemorative coins (in millions)	25.9		
Average proceeds per coin	$4.66		
TOTAL AVERAGE REVENUE PER COIN TO GENERAL FUND		$8.23	
NET BENEFIT TO FEDERAL TREASURY			$5.65

SOURCE: U.S. Mint

Explanation of Cost and Profit Analysis for the Proposed Amendment Allowing a Deduction for Purchases of Commemorative Coins

The analysis presents on a per-coin basis projected costs of tax revenue foregone from the proposed deduction and revenues directly associated with the sale of United States silver dollar commemorative coins and the sale of silver in Federal government stockpiles.

The projected tax revenue foregone is derived by multiplying the proposed per-coin deduction (the 1994 average price of a silver one dollar commemorative coin minus its $1.00 face value) by an average tax rate for taxpayers taking the deduction and a 3-year IRS average of the percentage of taxpayers who claimed itemized deductions on their personal income tax returns.

Revenues from commemorative coin sales and sales of silver are derived separately and then combined. The average price of a 1994 silver one dollar commemorative coin is multiplied by the Mint's historical profit margin for all modern commemorative programs (1982-1994) to derive per-coin profit. Per-coin revenues from silver sales are calculated by dividing total revenue from the sale of stockpiled silver from the Treasury Department and the Defense Logistics Agency to the U.S. Mint by the number of silver one dollar commemorative coins sold as part of modern commemorative programs. The sum of these figures is the total average revenue per coin that is deposited to the Treasury's General Fund.

The net benefit to the Federal Treasury is average per-coin revenue deposited to the General Fund minus the average per-coin tax revenue foregone from the proposed deduction.

EXHIBIT III

A BILL

To amend the Numismatic Public Enterprise Fund to allow tax deductions for commemorative coin purchases from the U.S. Mint.

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

SECTION. 1. SHORT TITLE.

This Act may be cited as the "Numismatic Public Enterprise Fund Tax Amendment of 1995".

SEC. 2. TAX DEDUCTIONS AUTHORIZED.

Section 5134 of title 31, United States Code, is amended by adding subsection (e):

"(e) Tax Deductions. Any commemorative coin purchased directly from the U.S. Mint shall be considered a charitable deduction at an amount equal to the coin's purchase price minus its face value.".

Statement by
Sara E. Meléndez
President
INDEPENDENT SECTOR

Information about INDEPENDENT SECTOR

INDEPENDENT SECTOR (IS) is a nonprofit coalition of 800 corporate, foundation and voluntary organization Members with national interest and impact in philanthropy and voluntary action. The organization's mission is to create a national forum capable of encouraging the giving, volunteering, and not-for-profit initiative that help all of us better serve people, communities and causes. Attached is our Membership list.

The organizations of INDEPENDENT SECTOR and its mission derive from its Members' shared commitment to fundamental values relating to the creation and maintenance of a truly free society. Our Membership list is attached.

Background on H.R. 1493 and Charitable Tax Incentives

The Charitable Contributions Legislation was introduced by Congressmen Philip M. Crane, Charles Rangel, and Christopher Cox on April 7. The legislation will permit partial deduction for nonitemizers and will eliminate the 3% floor on charitable tax deductions for upper-income taxpayers.

Before providing detailed information regarding why this legislation should be enacted, I want to lay to rest any questions regarding the value of tax incentives to charitable giving.

Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the cost to them of giving.

A large body of research has shown that tax incentives can have a powerful effect on the amount individuals give. Tax laws can also have important effects on the types of gifts and on the types of groups that receive these gifts.

Assume that a person with a 25 percent marginal tax rate is giving $1,000 when the contribution is deductible (e.g. the price of giving is 0.75). If the contribution is made non-deductible, the price of giving increases to 1.0, a 33% increase. Thus, this person's giving would fall by 38% (33% x -1.13), or by $380. In this example, eliminating deductibility of the contribution reduces giving from $1,000 to $620.

It's a good investment by the federal government to allow the charitable tax deduction. The federal government, by "investing" $250 in revenue lost as a result of the charitable tax deduction, gains $380 or 52% in funds expended by the charity on public purposes such as feeding the homeless, comforting the sick, rehabilitating drug abusers, supporting community arts groups, preserving historic houses, protecting wetlands from pollution and neighborhoods from crime, and serving countless other local, regional, national and even international purposes.

If [the] deductibility [of charitable contributions] were eliminated, itemizers would reduce the amount they give. In 1992, approximately 32 million itemizers reported approximately $63 billion of charitable contributions. If the deductibility of contributions were eliminated, this level of giving would likely have been more than $20 billion lower. While charitable organizations may be able to offset some of this reduction by more aggressive fund raising techniques, a substantial short-fall is inevitable.

Clearly, charitable tax incentives play an important part in the decision regarding the amount that taxpayers will give. Following is information related both to the enormous value of these increased charitable tax incentives for nonprofit organizations and people they serve, as well as additional information regarding the incentive effect that charitable tax deductions have on giving.

A CHARITABLE TAX DEDUCTION FOR NONITEMIZERS SHOULD BE ENACTED BY CONGRESS

Since Congress permitted the charitable tax deduction for nonitemizers to sunset in 1986, seven of ten taxpayers, the nonitemizers, can no longer deduct their charitable contributions and the resulting loss in charitable giving has been substantial. This becomes obvious when a comparison is made of the amount contributed by itemizers and nonitemizers who are in the same income groups.

Income Group	Amount Contributed by Itemizers	Amount Contributed by Nonitemizers	% of Income Contributed by Itemizers	% of Income Contributed by Nonitemizers
0 - $10,000	$317	$244	1.3%	2.8%
$10,000 - $19,000	$795	$421	3.0%	2.1%
$20,000 - $29,000	$813	$505	2.2%	2.9%
$30,000 - $39,000	$726	$543	3.0%	1.1%
$40,000 - $49,000	$1,289	$692	1.9%	0.6%
$50,000 - $74,000	$1,341	$898	1.9%	1.3%
$75,000 - $99,000	$1,612	$1,899	2.2%	1.0%
$100,000 +	$2,491	$2,199	3.8%	2.0%

The average annual amount contributed by itemizers is $1,313; the average by nonitemizers is $509.

Eighty one million taxpayers are nonitemizers. It is clear that if all nonitemizers raised their contributions to the amount given by itemizers, giving would increase greatly. In fact, charitable contributions by nonitemizers increased by 40% or $4 billion from 1985 to 1986, according to Internal Revenue Service data. Nonitemizers were permitted to deduct only 50% of their charitable contributions and they gave $9.5 billion that year. In 1986, they could deduct a full 100% and, according to the IRS, they gave $13.4 billion - an increase of 40%. The message from that experience is apparent. Charitable tax deductions do stimulate substantially increased giving from middle income Americans.

Nonitemizers are low to middle income Americans (65 million have incomes under $30,000 a year) who support services such as the Red Cross and the American Cancer Society. They give to churches and synagogues, environmental organizations, schools, colleges, hospitals, food programs for the homeless, and the Boy Scouts and Girl Scouts. They give to advocacy organizations, health research, the arts, international development, and myriad activities in the public interest that enrich our society and protect its people. Congress should enact legislation that will permit these moderate income Americans to take a deduction for their contributions to charity.

CONGRESS SHOULD ELIMINATE THE CHARITABLE TAX DEDUCTION FROM THE THREE-PERCENT FLOOR ON ITEMIZED DEDUCTIONS

On August 10, 1993, President Bill Clinton signed into law the Omnibus Budget Reconciliation Act of 1993, making the 3% floor on charitable deductions permanent. Congress had included, in its 1990 budget agreement, a 3% floor on itemized tax deductions, including charitable deductions, for families with adjusted gross incomes over $100,000. Adjusted for inflation, the $100,000 amount has been indexed to $114,700 for 1995. Following are reasons why the charitable tax deduction should be dropped from the 3% floor.

- The exact affect that the 3% floor will have on charitable deductions has yet to be determined. However, studies conducted by the IS Research office now indicate that from 1989 through 1993 household giving decreased by 25%.

- Eliminating the charitable deduction from the 3% floor involves relatively little in federal revenue. Of the $2 4 billion in federal revenue raised annually by the 3% floor, only about 10% comes from the charitable deduction according to Price Waterhouse research conducted for INDEPENDENT SECTOR.

- The floor sets a terrible precedent. Once a floor is established on a tax deduction, Congress is almost always inclined to increase it. The floor on the medical deduction is a case in point. Over the years, the floor on the medical deduction increased so much that now taxpayers can deduct only half of what they could twenty years ago. Since 1990, on six different occasions, Congress tried to extend the 3% floor beyond its 1995 expiration date, or make it permanent. With the enactment of the Omnibus Budget Reconciliation Act of 1993, Congress, as we predicted, made permanent the 3% floor.

- The floor is inequitable. If a taxpayer has no mortgage and doesn't live in a jurisdiction with state or local income taxes, the three percent floor has to be subtracted entirely from the taxpayer's charitable contributions deduction.

- The 3% floor on itemized deductions is a complicated, anti-tax simplification provision which requires taxpayers to perform a ten step process to determine whether or not they are subject to the floor.

- Since 1990, 26 states modeling their tax law after the new federal law, have passed the 3% floor, or very similar provisions on itemized tax deductions.

- Individuals with incomes of $100,000 or more contribute substantially to a broad range of charities that provide services to low and middle income individuals. Their total contributions averaged $2,113* annually and of that amount $1,243 went for dinner programs for the homeless, drug abuse counseling, low income housing development, women and minority issues, libraries, adult education, day care centers, foster care services, family counseling, consumer protection, legal aid, crime and delinquency prevention, employment/jobs, public safety, hospices, Boy and Girls Scouts, Camp Fire groups, 4-H clubs, little leagues, civil rights, community and social action, advocacy, community improvement and similar programs.

- The floor on charitable deductions was the fourth major undercutting over the past decade of the very organizations to which government is transferring so much responsibility.

  -- Between 1982 and 1993, government's allocations to its nonprofit partners to fulfill such public services such as job training and maternal and child health, dropped by $47 billion, exclusive of Medicare and Medicaid.

  -- During that same period, Congress cut funding for all federal human service programs of concern to nonprofits by $77 billion, exclusive of Medicare and Medicaid, with the expectation that essential services would be picked up by charities.

  -- Under the Congressional FY 1996 Budget Resolution approved by the House and Senate, federal outlays for file years 1992-2002, nonprofits will lose a cumulative $263 billion in federal funds in the funding of social programs.

  -- The 1986 Tax Act hurt the voluntary sector more than others because of the elimination of the charitable deduction for those who do not itemize their tax returns and the direct correlation between lower tax rates and the size of many people's contributions. As we forewarned in the years immediately following 1986, there was a 50% decline in the prior rate of growth of charitable giving growth.

It makes no sense to tax contributions to groups whose service relates to protection of the environment, health, research, food programs for the homeless, schools and colleges, refugee crisis counseling, youth services, civil rights, hospitals, community and international development, the arts, housing for senior citizens, and the many other activities that enrich our society and protect its people. Congress should eliminate the charitable tax deduction from the 3% floor.

*Source information: From Belief to Commitment: The Activities and Finances of Religious Congregations in the United States, INDEPENDENT SECTOR, 1988.
*Giving and Volunteering, 1994, Findings from a National Survey, 1994 Edition, INDEPENDENT SECTOR.

THE IMPORTANCE OF CHARITABLE ORGANIZATIONS TO AMERICA

Nearly one million charitable, educational, religious, health, and social welfare organizations create, nurture, and sustain the values that frame American life. They promote altruism, in a society that reinforces self-interest; community, in a society that reward individual achievement; and pluralism, in a society sometimes threatened with divisiveness. They provoke, challenge, and question. They also teach, mediate, and heal.

Collectively, these organizations represent an increasingly important sector of our society: the independent sector. They function on a not-for-profit basis, entrusted with public purposes and barred by law from private gain. They are exempted from tax on their assets and on income from their public-purpose activities. Those who support them with gifts can deduct those gifts from their own taxable income. Volunteers provide their boards with essential leadership, stewardship and accountability, and play vital roles at all levels.

The independent sector has become a major force in the American economy. In 1990 alone, organizations in this sector received an estimated nearly $123 billion in financial contributions, and volunteer time and energy from nearly 100 million people, as well as income from endowments and revenue-generating activities. That same year, they spent an estimated $389 billion in providing vast and varied services.

Independent sector organizations have played important roles in almost all of American society's major advances -- in human rights, health, knowledge, ecology, creativity, and other fields. As with other institutions in our society -- government, business, the professions -- they are under especially critical scrutiny today. Questioned on what they contribute to the public good, they must be prepared to explain their roles to the public, and give full and frequent accounting of their activities.

At the same time, they must maintain a spirit of diversity and openness that gives them their special character. They must be free to express divergent, even unpopular ideas. And they must not be asked to assume tasks properly performed by government with its vastly greater resources. Only thus can the sector they represent meet the challenge of its independence.

As leaders from other countries are recognizing, organizations of the independent sector reflect and express much of what is best in the American character. They embody and sustain fundamental social, cultural, and spiritual values, including:

Altruism. Independent sector organizations affirm that all human beings have basic moral obligations to look beyond themselves, and to undertake activities for the betterment of other people and other species -- present and future. They further affirm that regard for others must balance the self-regard of the marketplace in a duality that engenders the dialogue and compromise essential to democracy.

Altruism is the most fundamental unifying principle among the diverse organizations of the independent sector. It is the root of their other values: compassion, humility, respect for others, concern for the community, and justice for all.

Pluralism. America's multitudes, with our countless heritages, cultures, political philosophies, and religious beliefs, reflect an unparalleled pluralism. This diversity cradles our society's creative energies, and represents a core value of its life.

For the organizations of the independent sector, encouraging and sustaining pluralism represents a second unifying principle. They affirm that our nation gains strength from respecting differences among its citizens and fostering the free and creative expression of ideas and opinions. Each organization owes its own creation to individuals who acted upon distinct ideas and values.

Some organizations work in areas barred to government: religion in particular. Some speak out in the forum of public discourse, and resist government intrusion lest it suppress dissent. Some spring up swiftly, responding in crises to special human needs. Others provide alternative responses to constant needs.

Community. The principle of community reaches beyond geographic or demographic entities. Communities are groups of individuals who share common values, interests, purposes, or goals. They are critical to our economic, political, social, intellectual, and cultural life. The independent sector itself is a vast community.

Organizations of the independent sector create, nourish, enlarge, and sustain communities. Education equips individuals with the scholarship, discipline, and creativity to contribute effectively to community life. Arts, culture, and the humanities stimulate community self-discovery, self-awareness, and self-definition. They preserve a community's heritage, challenge its assumptions, and refine its perceptions.

Human service, health, and religious groups bring commitment to the community's welfare. They instill compassion for community members in need, and provide the mechanisms to address particular community problems. Human rights, environmental, and public policy

groups teach leadership, consensus-building, and citizen participation skills that ensure community vitality. They empower individuals to lead, and offer them leadership opportunities.

In summary, business and government alone cannot sustain altruism, pluralism, and community - principles fundamental to American society - nor the underlying values of trust, compassion, justice, and moral behavior that bind us together.

The independent sector has become America's linchpin. Business, government, and in fact all Americans have a fundamental stake in preserving and strengthening it.

STATE OF CALIFORNIA

Franchise Tax Board
PO Box 115
Rancho Cordova, CA 95741-0115

Telephone: (916) 845-4543

July 19, 1995

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Attention: Phillip D. Moseley, Chief of Staff

Dear Committee Members:

I am writing to urge that you include in the next tax bill the provisions of H.R. 757, to establish a program to offset federal income tax refunds to satisfy legally enforceable, past due state tax debts.

Currently, 31 states, including California and the District of Columbia, offset state income tax refunds to satisfy federal income tax debts. The program generates in excess of $50 million a year for the federal treasury. California alone offset $22 million of state income tax refunds for federal tax collections in 1993-94.

Providing statutory authority for a comparable program to offset federal tax refunds to satisfy delinquent state tax debts would generate substantial revenues for the states. It is estimated that such authority could increase revenues for California by $85 million per year, according to estimates by the Franchise Tax Board Economic and Statistical Analysis staff. The program also should increase federal revenues by approximately $8 million over a five-year period, according to the Joint Committee on Taxation, because all income tax states would be expected to participate in the program for offsetting state refunds to meet federal tax obligations.

Offsetting federal revenues for state tax debts would be an effective method of collecting delinquent debts owed the state. I hope this measure is included in the next tax bill before your committee.

Sincerely,

Gerald H. Goldberg
Executive Officer

cc: Hon. Kathleen Connell, Chair
Hon. Johan Klehs, Member
Hon. Russell Gould, Member
Franchise Tax Board

Harley Duncan, Executive Director, Federation of Tax Administrators

Illinois Department of Revenue

Ken Zehnder, Director
101 West Jefferson Street
Springfield IL 62794

July 25, 1995

The Honorable Phillip D. Moseley, Esq.
Chief of Staff
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20215

Dear Mr. Moseley:

I appreciate this opportunity to write in support of H.R. 757 which the Committee is considering for inclusion as one element of the miscellaneous tax bill currently before the Committee. This particular provision would benefit the State of Illinois, as well as the federal government by amending sections 6103 and 6402 of the Internal Revenue Code to allow, inter alia, the Treasury Department to establish an offset program for legally enforceable, past due state tax obligations.

Currently the federal government may levy on state income tax refunds to satisfy delinquent federal tax debts. In 1993 alone, states returned approximately $61 million to the Treasury under their refund offset programs. Permitting federal refunds to be offset for Illinois income tax debts would further existing cooperative efforts in joint IRS/Illinois Department of Revenue tax administration. In addition, offsetting federal refunds for Illinois tax debts will be an effective method of collecting delinquent debts owed to Illinois. The Federation of Tax Administrators estimates that a federal offset program could increase state receipts by about $150 to $200 million annually in the early years and by less as the current inventory of receivables is reduced.

Finally, the Joint Committee has determined that a reciprocal program would increase federal receipts somewhat because the states with an income tax which do not currently do so, may begin to offset for the Treasury in order to participate in this proposed IRS offset.

I urge your staff to communicate our support of H.R. 757 to Chairman Archer and to the other members of the Committee. I will be sharing a copy of this statement with Committee members from Illinois. Thank you for soliciting comments on this important provision.

Very truly yours,

Ken Zehnder
Acting Director

STATE OF IOWA

DEPARTMENT OF REVENUE AND FINANCE
GERALD D. BAIR, DIRECTOR

July 18, 1995

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Mr. Moseley:

We are writing to urge adoption of provisions which would authorize the offset of federal tax overpayments to satisfy state tax debts introduced in H.R. 757 by Committee members Representative Jacobs and Representative McCrery.

It is our understanding that 31 states already offset state tax overpayments to satisfy delinquent federal tax debts through their own offset compliance programs. These programs generate in excess of $50 million annually to the federal treasury. The IRS lacks the authorizing legislation to include state tax delinquencies in its existing refund offset program. H.R. 757 provides that authorization and lays forth the necessary technical details.

This issue was the subject of a hearing before the Ways and Means Select Revenue Subcommittee in late 1994. At that hearing, the U. S. Treasury Department indicated its support for the concept of reciprocal refund offset. The Joint Committee on Taxation has estimated that the measure will raise federal revenues by $8 million over five years.

Equally notable is the issue of fairness and reciprocity. States for the most part voluntarily include the federal government in their refund offset programs; it is only proper that the federal government do the same for them. Some states have even expressed a willingness to pay for the cost of each offset, even though with minor exceptions they do not charge the federal government.

Most importantly, the state and federal tax authorities work closely together on a wide range of compliance and service activities. This is an efficient, modern approach to effective government and, as such, the refund offset provision is important as a symbol of reciprocity and of a continued good working relationship.

A two-page explanation and history of H.R. 757 is included with this letter for your convenience.

Sincerely,

G. D. Bair
Director

drj

Enclosure

cc: Harley Duncan, FTA
Phil Smith, Iowa Washington D.C. Office

Reciprocal Refund Offset Legislation
H.R. 757, 104th Congress

Current Law

The federal government may levy on – essentially, seize – state income tax refunds to satisfy delinquent federal tax debts. The IRS currently exercises its right to levy on state refunds in 31 states and the District of Columbia, working through those states' refund offset programs. This occurs under a cooperative arrangement between the state tax agency and the IRS district(s).[1] There is no reciprocal authority for the federal government to offset federal income tax refunds to satisfy delinquent state tax debts.

In 1993, states returned about $61 million to the federal government under their refund offset programs; the state offsets generated roughly $25 million to $35 million annually in previous years.[2] States are generally not compensated for these offsets.

The federal government has its own refund offset program. Under IRC § 6402, a specified agency that is owed a past-due, legally enforceable debt can collect it by having the IRS withhold or reduce the debtor's income tax refund if reasonable efforts have been made to collect the debt. Currently these offsets are available for delinquent federal tax debts, past-due child support that offsets public assistance, debts owed other federal agencies (such as student loans and VA housing), and child support owed a parent not receiving ADC, but who has asked for assistance in collecting support.

Federal agencies are charged for each offset, and IRS is permitted to disclose certain taxpayer information to the federal agency requesting the offset.

Reason for Change

Permitting federal refunds to be offset for state income tax debts would further cooperative efforts in joint federal/state tax administration. A number of cooperative efforts are currently underway. To a substantial degree, these efforts are reciprocal in that benefits accrue to both the federal and state governments. These cooperative efforts improve the efficiency of federal-state tax administration, increase compliance with the nation's tax laws, and reduce the burden on taxpayers. Examples of cooperative programs include two-way information exchanges, joint electronic filing of income tax returns, and joint taxpayer service and education programs. Permitting the offset of federal refunds would further this reciprocity and is consistent with the goals of the IRS Strategic Business Plan.

Offsetting federal refunds for state tax debts will be an effective method of collecting delinquent debts owed the states. The Federation of Tax Administrators (FTA) estimates that a federal offset program could increase state receipts by about $150 million to $200 million annually in the early years of a program and by somewhat lesser amounts as the current inventory of receivables is reduced.

---

1 There are 41 states, including the District of Columbia, with a broad-based individual income tax. Included in the 31 states with an offset program for federal tax debts is Alaska, which has no individual income tax. It does, however, have a unique state refund program that works in a similar manner.

2 Recent growth in federal collections appears attributable to technical advancements within the program that make it more efficient and to an increase in the number of states that participate.

A reciprocal program would also be expected to increase federal receipts somewhat because it is anticipated that the remaining income tax states would begin to offset for the federal government in order to participate in the IRS offset (except in any state where the Secretary of Treasury chooses to not have federal debts offset). **The Joint Committee on Taxation has estimated that reciprocal refund offset legislation would benefit the federal government by some $8 million.**

History of Proposal

Rep. Andrew Jacobs (D-Ind.) introduced H.R. 4138 in the 103rd Congress; the bipartisan bill had 20 cosponsors. The House Ways and Means Committee on Select Revenue Measures held a hearing on H.R. 4138 in October, 1994. Treasury formally voiced its support for the proposal and suggested four minor technical adjustments to the language, all of which are believed to have been incorporated into the bill now before the 104th Congress. **Neither during the hearing nor at any other time did the bill encounter opposition.**

Rep. Jacobs along with Rep. McCrery and Rep. Moran introduced the bipartisan H.R. 757 in February, 1995.

Description of Proposal

The proposed legislation would amend IRC § 6402 by adding a new subsection allowing the Secretary of the Treasury to establish an offset program for legally enforceable, past due state tax obligations. To be eligible for the offset, the delinquency must be one that is no longer subject to administrative or legal appeal at the state level. As with other federal agencies, states would be further required to notify taxpayers of the obligation and that such debt will be referred to the IRS for offset if not satisfied in 60 days.

State tax debts would not be satisfied from an offset until all federal tax debts, assigned child support, non-assigned child support and debts due other federal agencies were satisfied.

The Secretary could charge the states for the costs of the offset program in the same manner as other federal agencies are charged.

Once an offset is made, taxpayers could still protest the amount due. The legislation also contains provisions allowing a joint federal refund to be split among both spouses if only one spouse owes the state tax debt. The legislation would also amend IRC § 6103 to permit the disclosure of information regarding the offset to state tax agencies when necessary.

Federation of Tax Administrators
July, 1995

if you would convey my support to the Committee for granting authority to the IRS to offset federal tax refunds for state tax delinquencies in any tax bill which it reports out.

With kindest personal regards and best wishes for your continued good health, happiness and success, I remain,

Most cordially yours,

Louis L. Goldstein

LLG:cew
Enclosure
cc: Mr. Harley T. Duncan
Mr. Stephen M. Cordi
Mr. George H. Spriggs, Jr.

Louis L. Goldstein
Comptroller of the Treasury

Louis L. Goldstein Treasury Building, P. O. Box 466
Annapolis, Maryland 21404-0466

July 19, 1995

Mr. Phillip D. Moseley, Chief of Staff
Committee of Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: **H.R. 757**

Dear Mr. Moseley:

Harley T. Duncan, Executive Director of the Federation of Tax Administrators, has advised me that the Ways and Means Committee is considering incorporating the proposal of H.R. 757 to allow the Internal Revenue Service to offset federal tax refunds for state tax delinquencies in a list of "miscellaneous tax provisions" to be considered as part of a subsequent tax bill.

As Maryland's chief tax collector, I can assure you that this proposal is extremely important to the administration of Maryland's tax laws. The collection of state taxes through offset is an efficient method of tax collection which eliminates the need for expensive manual procedures. Just as importantly, a federal refund tax offset would permit Maryland and other states to collect taxes from individuals who have left the state, from whom recovery can be made at only at great expense, if at all. Effective collection tools are essential in assuring that the burden of taxation is fairly distributed.

Maryland is one of those states which voluntarily offsets state income tax refunds for the Internal Revenue Service. For your information, I am enclosing a copy of our most recent report of refund offsets. You will note that so far in the current year, we have intercepted 11,746 refunds for the IRS, resulting in a recovery of $3,694,875 for the federal treasury. We would expect comparable results if the IRS were permitted to offset for us. I would very much appreciate it

The Kentucky Revenue Cabinet respectfully submits the following written comments to the House Committee on Ways and Means to express support for the inclusion of H.R. 757 in the next tax bill enacted by Congress:

Currently, Kentucky and 30 other states and the District of Columbia offset state income tax refunds to satisfy federal income tax debts. The program generates roughly $61 million for the federal treasury. In Kentucky alone, the program resulted in $402,266 of federal tax collections in 1993. H.R. 757 represents bipartisan legislation to establish a program to offset federal income tax refunds to satisfy legally enforceable past due state tax debts. Enactment of H.R. 757 would be extremely beneficial to the Commonwealth of Kentucky and to states generally.

The federal government lacks the statutory authority to offset federal tax refunds to satisfy delinquent state debts. H.R. 757 would provide such authority. Such legislation could increase state revenues by $150-$200 million per year for the first few years, until the inventory of delinquent debts is reduced, and at a lesser amount in subsequent years, according to estimates by the Federation of State Administrators. Approximately $3 million of this amount would benefit Kentucky. The program should also increase federal revenues, according to the Joint Committee on Taxation, because all states with income taxes would be expected to participate in the program for offsetting state refunds to meet federal tax obligations.

The proposed legislation would allow the Secretary of the Treasury to establish an offset program for legally enforceable past due state tax obligations similar to that established for debts due other federal agencies. State tax debts would not be satisfied from an offset until all federal tax debts, both types of past due child support, and debts due other federal agencies were satisfied. As with other federal agencies, states would be required to notify taxpayers of the obligation and that such debt will be referred to the IRS for offset if not satisfied in 60 days. The Secretary would be authorized to charge the states for the offset. The proposed legislation would also amend IRC § 6103 to permit the disclosure of information regarding the offset to state agencies when necessary.

State of Maryland
Comptroller of the Treasury

Revenue Administration Division
Revenue Administration Center
Annapolis, Maryland 21411-0001

HUQ
Louis L. Goldstein
Comptroller

Stephen M. Cordi
Deputy Comptroller, Revenue Operations

George H. Spriggs, Jr.
Director

MEMORANDUM

Date: June 30, 1995

RECEIVED
JUL 5 1995
COMPTROLLER OF THE TREASURY
OFFICE OF THE COMPTROLLER

TO: The Honorable Louis L. Goldstein, Comptroller of the Treasury

FROM: George H. Spriggs, Jr., Director, Revenue Administration Division

SUBJECT: Refund Comparison # 22 - FINAL FY 1995 TO FY 1994

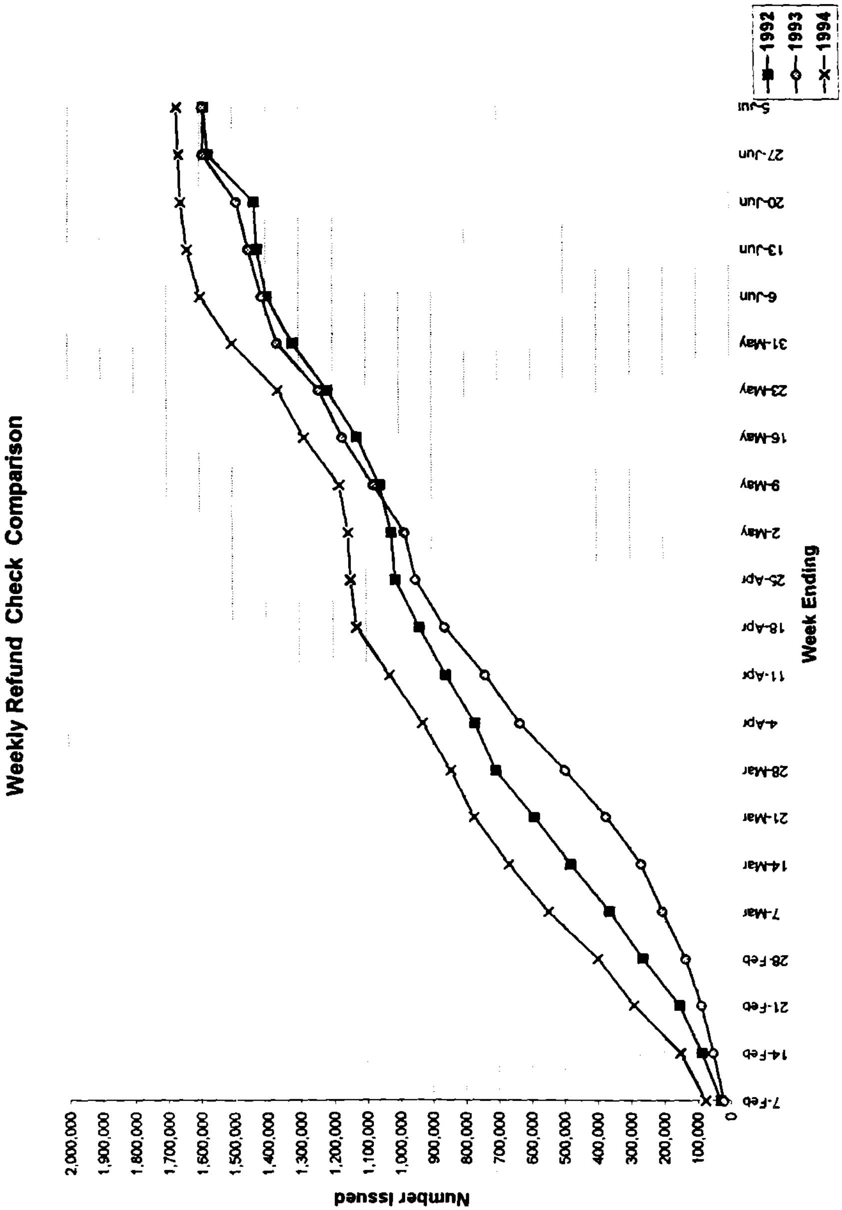
	06/30/94 1993	06/30/95 1994	94 Over 93 (Under)	% Increase (Decrease)
TOTAL REFUNDS ISSUED:				
Number	1,600,230	1,669,658	69,428	4.34%
Amount	$674,136,539	$723,323,099	$49,186,560	7.30%
DISTRIBUTION OF TOTAL REFUNDS ISSUED				
REFUND CHECKS MAILED:				
Number	1,465,977	1,506,645	40,668	2.77%
Amount	$623,204,617	$658,009,660	$34,805,043	5.58%
Average	$425.11	$438.74	$13.63	3.21%
REFUNDS APPLIED TO ESTIMATED TAX:				
Number	53,312	61,748	8,436	15.82%
Amount	$31,220,072	$41,006,312	$9,786,240	31.35%

Voice telephone:
For the hearing impaired: MRS 1-800-735-2258 • TDD (410) 974-3157 • EOE

	06/30/94 1993	06/30/95 1994	94 Over 93 (Under)	% Increase (Decrease)
REFUNDS INTERCEPTED:				
(1) Child Support				
Number	17,301	19,685	2,384	13.78%
Amount	$4,957,523	$5,903,938	$946,415	19.09%
(2) Central Collection				
Number	18,845	24,180	5,335	28.31%
Amount	$4,428,834	$5,091,815	$662,981	14.97%
(3) Internal Revenue Service				
Number	9,920	11,746	1,826	18.41%
Amount	$2,951,779	$3,694,875	$743,096	25.17%
(4) Sales & Use Tax Division				
Number	148	100	(48)	(32.43%)
Amount	$88,123	$54,584	($33,539)	(38.06%)
(5) Income Tax Division				
Number	34,727	45,554	10,827	31.18%
Amount	$7,285,591	$9,561,915	$2,276,324	31.24%

GHS:jyr

cc: Mr. Stephen M. Cordi
Mr. Robert L. Swann
Mr. Marvin A. Bond
Mrs. Ann O. Franklin



Weekly Refund Check Comparison
Number Issued
2,000,000
1,900,000
1,800,000
1,700,000
1,600,000
1,500,000
1,400,000
1,300,000
1,200,000
1,100,000
1,000,000
900,000
800,000
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
7-Feb
14-Feb
21-Feb
28-Feb
7-Mar
14-Mar
21-Mar
28-Mar
4-Apr
11-Apr
18-Apr
25-Apr
2-May
9-May
16-May
23-May
31-May
6-Jun
13-Jun
20-Jun
27-Jun
5-Jul
Week Ending
1992
1993
1994

The Commonwealth of Massachusetts
Department of Revenue
Leverett Saltonstall Building
100 Cambridge Street, Boston 02204

MITCHELL ADAMS
COMMISSIONER

July 26, 1995

Via Overnight Mail

Phillip D. Moseley,
Chief of Staff
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Proposed Amendment of Section 6402 -- State Tax Offsets

Dear Phillip:

We understand that the Ways & Means Committee is soliciting comments on the list of miscellaneous tax provisions which are currently pending before the Committee. By this letter we wish to indicate our support of one of those provisions -- H.R. 757 (copy enclosed). As you know, H.R. 757 would amend Section 6402 of the Internal Revenue Code ("Code") by adding "past due, legally enforceable state tax obligations" to the list of liabilities against which federal income tax refunds may be offset. The following discussion summarizes the "reciprocal" Massachusetts practice in this area and the reasons for our support of H.R. 757.

1. Massachusetts offset of state tax refunds by federal income tax liabilities. Since the late 1980's, Massachusetts has followed a systematic program of turning over to the Internal Revenue Service ("Service") refunds due to Massachusetts taxpayers if such taxpayers have outstanding federal income tax liabilities. As explained in Section 3 of the enclosed Administrative Procedure 606, the Service will levy the Massachusetts refund pursuant to Code Section 6331, whereupon the Commonwealth will intercept the refund and, except to the extent that it exceeds the federal liability, turn it over to the

Service. The Service then applies the refund "against the taxpayer's federal liability." Massachusetts pays to the taxpayer any amount remaining from the state refund.

We believe that the Massachusetts program and the similar programs of thirty sister states have played a salutary role in tax administration and enforcement. For example, during 1993 through 1995 Massachusetts alone has forwarded between $2M and $3.3M each year to satisfy outstanding federal tax liabilities. Our understanding is that when the efforts of all of the state programs are taken into account in excess of $50M is collected each year. More importantly, the operation of these programs makes clear to delinquent taxpayers that they cannot "beat the system" by receiving refunds at the state level while simultaneously failing to meet their federal tax obligations.

2 Support of H.R. 757. We fully support H.R. 757 because it will authorize the Service to reciprocate the refund offset programs of the states thereby enhancing administration and enforcement of the state tax laws. Such ongoing federal and state cooperation will become more important in the decades ahead as information system technologies allow the taxing agencies to more efficiently manage and process the massive amounts of documents and information they receive and generate. As the levy process becomes more and more computerized, the efficiency of the state and federal refund offset programs will increase. Again, the end result will be, if H.R. 757 is adopted, that taxpayers will be held accountable by both levels of government for their failure to meet obligations properly due at either level of government.

3. Scope of offset program. While, as stated, we fully support H.R. 757, we would suggest that the scope of the program be slightly modified. Under the present proposal, federal refunds will not be offset against outstanding state tax assessments which are due and owing until the taxpayer has exhausted all judicial review of the underlying liability. The judicial process can require a number of years to run its course; during that time, some taxpayers have refused to pay amounts properly assessed and due and have resisted all collection activities which are properly authorized under the Massachusetts General Laws. The goals of H.R. 757 (collection of outstanding liabilities and promotion of voluntary compliance) would be further enhanced if the language were revised to allow the federal offset once the state tax assessment is properly made and the tax is due and owing. As to Massachusetts, if the taxpayer were to ultimately prevail in the court challenge, any amounts collected via the federal offset would be returned to the taxpayer with interest (short term federal rate plus four percent, compounded daily) from the date of the offset. This approach would conform the federal offset program to the treatment of other amounts garnered by Massachusetts through the usual levy and collection rules. Under the current H.R. 757 language, in contrast, a taxpayer with a due and owing Massachusetts liability could receive federal refunds for a number of years, and ultimately lose the court challenge. The prospects that the federal refunds would still at that point be available to satisfy the state obligation are uncertain at best.

Please do not hesitate to contact our offices at (617)626-3280 if we can provide any further information concerning our view of H.R. 757.

Sincerely yours,

Mitchell Adams
Commissioner of Revenue

cc: Honorable Richard E. Neal
Honorable Peter Blute
William A. Hazel, Tax Counsel

ADMINISTRATIVE PROCEDURE 606: REFUND INTERCEPTS

Procedures

606.1. Refund Intercepts for Child Support Enforcement Division

If DOR's Child Support Enforcement (CSE) Division certifies that a taxpayer owes past-due child support, DOR will intercept the taxpayer's refund and apply that amount to the child support debt.

If the taxpayer wishes to contest the validity and/or the amount of the debt, he or she may apply for a hearing with CSE. The request must be made on the Request for Review form enclosed with the Notice of Income Tax Refund Transfer and must be received by CSE within 30 days of the date of the notice. The form should be sent to: Massachusetts Department of Revenue, Child Support Enforcement Division, Tax Refund Intercept Unit, P.O. Box 7063, Boston, MA 02204-7063. In order to appeal successfully, the taxpayer must document either that he or she does not owe past-due child support or that he or she owes less past due child support than was intercepted. This documentation often includes canceled checks or court orders. CSE reviews these documents and informs the taxpayer of the results within 45 days, or within 60 days if a refund on a joint return is at issue and a nondebtor spouse appeal has been filed.

Joint filers cannot avoid having their refund intercepted. However, where a spouse who is liable for past-due child support files jointly, the nondebtor spouse may receive his or her share of the state income tax refund by filing an appeal and substantiating the share of the refund attributable to his or her income. To file an appeal, the nondebtor spouse must submit, along with a completed appeal form, a signed copy of the joint state income tax return and the W-2 forms of both spouses. The appeal form must be received by CSE within 30 days of the date of the Notice of Intercept. Appeal forms are enclosed with the Notice of Intercept or may be obtained by calling (617) 727-4200, ext. 184, in the Boston metropolitan area or 1-800-332-2733 toll-free within Massachusetts.

REFERENCES IN VOLUME 2

G.L. c. 62D

606.2. Refund Intercepts for American Student Assistance

If American Student Assistance (ASA) certifies that a taxpayer is delinquent in the repayment of a student loan, DOR will intercept the taxpayer's refund. ASA will then apply the refund against the taxpayer's education loan delinquency.

If the taxpayer wishes to contest the validity and/or the amount of the debt, he or she may apply for a hearing with ASA. The request must be made in writing and must be received by ASA within 30 days of the mailing date of the Notice of State Income Tax Refund Transfer. Requests for hearings should be sent to: ASA, Attention: Recove. , Department, 330 Stuart St., Boston, MA 02116. Other information may be obtained by calling 1-800-648-6550.

If the refund being transferred is from a jointly filed return, and all or part of the refund is attributable to a spouse against whom no debt is claimed, it is possible that a portion of the refund may be returned. The spouse must request this in writing from ASA within 30 days of the date of the notice of refund transfer.

606.3. Refund Intercepts for Internal Revenue Service

If the Internal Revenue Service (IRS) determines that a taxpayer is delinquent in the payment of federal income taxes, it may, as part of its general levy powers under Section 6331 of the Internal Revenue Code, levy the taxpayer's Massachusetts refund. DOR will intercept the refund and the IRS will apply it in whole or in part against the taxpayer's federal liability.

If the taxpayer wishes to contest the validity and/or amount of the debt, the taxpayer should contact the Internal Revenue Service, P.O. Box 9093, JFK Post Office, Boston, MA 02203, (617) 565-1878. DOR should not be contacted for information about a federal tax liability.

606.4. Refund Intercepts for Massachusetts Department of Employment and Training

If the Massachusetts Department of Employment and Training (DET) certifies that a taxpayer has not repaid an overpayment of unemployment benefits, DOR will intercept the taxpayer's refund. The Massachusetts Department of Employment and Training will apply the refund against the amount of overpayment of benefits.

If the taxpayer wishes to contest the validity and/or the amount of the refund transferred to DET, the taxpayer may request a review in writing within 20 days of the mailing date of the Notice of State Income Tax Refund Transfer. If the taxpayer filed a joint Massachusetts income tax return and all or part of the refund that has been transferred to DET is attributable to the income of a spouse who has not received an overpayment, the spouse may request a review in writing within 20 days of the mailing date of the Notice of State Income Tax Refund Transfer.

Requests for review should be sent to: Department of Employment and Training, Benefit Payment Control, State Income Tax Intercept Unit, 4th Floor, Charles F. Hurley Building, 19 Staniford Street, Boston, MA 02114. Additional information may be obtained by calling DET at (617) 727-8262. DOR should not be contacted for information about a refund transferred to DET.

606.5. Refund Intercepts for Massachusetts Department of Revenue

Massachusetts law allows the Massachusetts Department of Revenue (DOR) to apply taxpayers' overpayments to any outstanding tax liabilities they may have.

If the overpayment being applied to a liability resulted from the filing of a joint Massachusetts Income Tax return and only one joint filer is legally responsible for the debt, the non-debtor spouse may request that DOR refund a portion of the overpayment by filing Form M-8379. Form M-8379 may be filed only if the non-debtor spouse had income, withholding and or estimated tax payments in the year of the overpayment.

Any questions concerning the application of a refund or requests for Form M-8379 should be addressed in writing to: Massachusetts Department of Revenue, P.O. Box 7100, Boston, MA 02204.

Written testimony for Miscellaneous tax provisions heard on July 11, 12, and 13, 1995
Committee on Ways and Means, U.S. House of Representatives

H. Compliance
1. Allow offset of State tax liability with overpayments of Federal tax

As the Committee reviews the numerous individual tax provisions "to clean up the code", we urge the adoption of provisions which would authorize the offset of federal tax overpayments to satisfy state tax debts, as was introduced in H.R. 757 by Representative Jacobs and Representative McCrery.

Minnesota is one of 31 states and the District of Columbia that offsets state income tax refunds to satisfy federal income tax debts. The program generates in excess of $50 million annually for the federal treasury. In our state alone, the program resulted in $3.9 million of federal tax collections in 1994. Our state as well as the other states voluntarily participate in this program and we do not charge any fee to the federal government for doing so. Unfortunately, this offsetting of delinquent tax debts is not reciprocated by the federal government. Currently, the federal government lacks the statutory authority to offset federal tax refunds to satisfy delinquent state tax debts. The adoption of these provisions would provide that statutory authority.

According to estimates by the Federation of Tax Administrators, the offset of federal tax refunds could increase state revenues by $150-$200 million per year at the outset. This increased state revenue would come from those noncomplying taxpayers who have not honored their state tax obligations. This would be a tremendous debt collection tool for the states as it is now for the federal government.

The Minnesota Department of Revenue has actively sought ways to become more efficient in providing quality services in order to achieve our mission of achieving compliance with the tax laws. We have focused on increasing cooperative working relationships among federal, state and local governments as one important way to achieve these goals. By partnering with other government entities we are able to provide a government that works better and costs less.

Some successful joint ventures undertaken by the our agency and the Internal Revenue Service have included:

- Coordinating community-based volunteer tax assistance program that each year prepares federal and state returns for some 60,000 Minnesotans who cannot afford professional tax help.

- Working with the Minnesota Alliance for Children, a network of grassroots organizations and social service agencies, to help eligible low- and moderate-income workers claim the federal Earned Income Credit and the Minnesota Working Family Credit.

- Publishing a free comprehensive guidebook for anyone starting a business in Minnesota, conducting an ongoing series of small business tax workshops, and cosponsoring educational seminars for professional tax preparers.

By adopting this provision, it would help continue the successful partnerships between our state and the Internal Revenue Service that has been developed in order to provide better taxpayer service and a reduction of costs.

We urge the adoption of this provision to allow the offset of state tax liabilities with the federal tax overpayments. This is an important collection tool against delinquent taxpayers as well as a symbol of reciprocity and of a continuing successful partnering between the states and the federal government.

Respectfully submitted by:

Matthew G. Smith

Matthew G. Smith
Commissioner
Minnesota Department of Revenue
10 River Park Plaza
St. Paul, Minnesota 55146-7100
(612)- 296-3403

MISSOURI DEPARTMENT OF REVENUE
POST OFFICE BOX 311
JEFFERSON CITY
65105-0311
(314) 751-4450
FAX: (314) 751-7150

MEL CARNAHAN
GOVERNOR

JANETTE M. LOHMAN
DIRECTOR

July 26, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

House Resolution 757, introduced by Representatives Andrew Jacobs, Jim McCrery and Jim Moran in February 1995 is an important piece of legislation for Missouri and deserves your support. This legislation, if passed, would permit the states to recover delinquent state taxes through the offset of federal tax refunds.

Currently, the Internal Revenue Service can "levy on" state income tax refunds to satisfy federal tax debts. Thirty-one states, including Missouri, and the District of Columbia voluntarily allow the IRS to participate in their refund offset programs. The states are generally not compensated for performing these offsets, and in 1993, approximately $61 million in state tax refunds were offset to satisfy federal tax debts. House Resolution 757 would provide reciprocal authority for the states to offset federal tax refund dollars to satisfy state tax debts.

House Resolution 757 would ensure that federal refunds first be applied to federal tax debts, to debts due other federal agencies and to child support obligations. Only the refund remaining after satisfaction of these debts could be applied to the state tax debt. In addition, states would be required to notify taxpayers in writing that their federal refunds could be offset to satisfy the state tax debt. These offsets could only occur after all administrative remedies had been exhausted.

We urge your support of House Resolution 757 as an effective method for collecting delinquent tax debts owed the states. The Federation of Tax Administrators estimates that the states would initially collect as much as $200 million from the federal offset program, and slightly less in succeeding years. The Joint Committee on Taxation also estimates that an additional $9 million in federal revenues would be collected from the offset of state tax refunds in the states that do not currently participate in the IRS offset program.

I strongly encourage your support of this significant legislation. The State of Missouri has for many years, voluntarily and without remuneration, provided debt offset services for the Internal Revenue Service. A reciprocal program would help the Missouri Department of Revenue collect delinquent taxes due the state. If you have any questions about House Resolution 757 or the federal debt offset program, please feel free to contact me.

Sincerely,

Janette M. Lohman

JML:cs

cc: Chris Sifford
Brad Douglas
Rick Moore

State of Wisconsin • DEPARTMENT OF REVENUE

Tommy G. Thompson
Governor

Mark D. Bugher
Secretary of Revenue

July 27, 1995

Phillip D. Moseley, Chief of Staff
Committee On Ways & Means
US House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Moseley:

I am writing to provide you some background on H.R. 757 which establishes a program to offset federal income tax refunds to satisfy legally enforceable, past due state tax debts. This legislation was introduced by Representative Andrew Jacobs and currently is co-sponsored by Rep. Jim McCrery of Louisiana and Rep. Jim Moran of Virginia. H.R. 757 would be extremely beneficial to the State of Wisconsin and to states generally.

Currently, 31 states and the District of Columbia offset state income tax refunds to satisfy federal income tax debts. The program generates roughly $61 million for the federal treasury. Wisconsin currently does not offset state refunds for the federal government. Among the reasons we do not do so is because the federal government has not offered a reciprocal program.

The federal government lacks the statutory authority to offset federal tax refunds to satisfy delinquent state tax debts. H.R. 757 would provide such authority. Such legislation could increase state revenues by $150-$200 million per year at the outset, according to estimates by the Federation of Tax Administrators, an association of state revenue agencies. The program should also increase federal revenues by approximately $8 million over a five-year period, according to the Joint Committee on Taxation, because all income tax states would be expected to participate in the program for offsetting state refunds to meet federal tax obligations.

The proposed legislation would allow the Secretary of the Treasury to establish an offset program for legally enforceable, past due state tax obligations similar to that established for debts due other federal agencies. State tax debts would not be satisfied from an offset until all federal tax debts, both types of past due child support and debts due other federal agencies were satisfied. As with other federal agencies, states would be required to notify taxpayers of the obligation and that such debt will be referred to the IRS for offset if not satisfied in 60 days. The Secretary would be authorized to charge the states for the offset. The legislation would also amend IRC § 1603 to permit the disclosure of information regarding the offset to state tax agencies when necessary.

Thank you for your kind consideration of this matter. Please feel free to call me if you would like to discuss it further or if I may be of assistance to you on any other matter.

Sincerely,

Mark D. Bugher
Secretary of Revenue

MDB:DLH:eem
CKSEEM2843

cc: Secretary Klauser
Harley Duncan

TESTIMONY OF THE AMERICAN LAND TITLE ASSOCIATION AND THE AMERICAN ESCROW ASSOCIATION

I. Present Law

The American Land Title Association* and the American Escrow Association** appreciate the opportunity to comment on the repeal of the information reporting requirement on real estate brokers or reporting persons. Information reporting on real estate transactions under I.R.C. Sec. 6045 (e) has been part of the federal tax law since 1986. In general, under the law, the person handling a real estate closing, such as a title or escrow closing/settlement agent, is required to collect, store, and report:

(a) selected financial information on the transaction including the gross proceeds and, effective in 1992, the real property tax proration amounts, and

(b) the Taxpayer's I.D. number (Taxpayer Identification Number or TIN), on which the income from the sale will be filed with the I.R.S.

Virtually all residential sales and exchanges of real estate are subject to the reporting requirement under current Treasury regulations on IRS prescribed Form 1099-S. The term "reporting" includes filing the information in a prescribed format and manner with the IRS and furnishing a copy of that information to the taxpayer.

As the reporting requirement reaches its ten year point, we believe the law has not shown a sufficient level of usefulness to the government compared to the burdens on individual persons required to report that information on Form 1099-S.

First, we contend that there has been no *in terrorem* effect from 1099-S reporting. Individual taxpayers are not Filing 2119s, on which they are required to report sales of principal residences, with any measurably greater frequency than before the 1099-S requirement was imposed on tax reporting persons. Second, IRS does not appear to use the information provided on Form 1099-S on a widespread basis, and in any case, can obtain the information provided on Form 1099-S by other means.

Limited IRS use should be balanced against industry burdens which include unique problems such as (1) an effective prohibition on cost recovery in some states where insurance rates are regulated, and (2) the burden involved in the cost of paying penalties for incorrect information provided by customers with whom the person filing the return has no continuing customer relationship.

Consequently, we hope the Committee would take positive action and consider repeal of the reporting requirement. The critical elements which support this position follow.

II. Rationale for Reporting Requirement

It is our understanding that a major reason for the justification of the 1099-S reporting requirement when proposed in 1986 was underreporting by individual taxpayers of the proceeds from residential sales of real estate, and therefore the taxable income from those sales. The IRS suspected that a significant number of taxpayers with taxable principal residence sales were not notifying the IRS that they had a taxable gain. Therefore, it was assumed that a significant amount of lost tax revenue was at stake. An additional information reporting provision requiring real estate reporting persons to report real property tax proration amounts to the IRS was added in 1992. These real property tax proration amounts are an adjustment made at the time of a real estate closing, to take into account a net payment made by the buyer to the seller of a property to compensate the seller for real property tax payments already made for the time when the buyer will be in possession of a property. It was originally contended that these amounts were

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* The American Land Title Association membership is composed of 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

** The American Escrow Association consists of over 5,000 individuals whose principal business activity is handling real estate transactions, in a limited agency role as escrow settlement agents.

not included in the seller's deduction for real property taxes.

It was originally projected that the imposition of all taxpayer compliance reporting in the 1986 Tax Act would total $3.4 billion over a five year period. The increased compliance associated with 1099-S was not included as a separate item in the Committee report, but is some subset of that increase. Real property tax proration revenue was even more minimal.

It is important to note that the primary assumptions made were that the 1099-S reporting requirements would result in an increase in individual taxpayer compliance. Consequently, one would expect that any revenue increase would be reflected in a corresponding increase in the number of Form 2119s filed. All individual taxpayers are supposed to file Form 2119, "Sale of Your Home," with the IRS under requirements pertaining to Sec. 1034 of the I.R.C. The IRS uses the information on Form 2119 to obtain sale information on all home sales not just those involving capital gains. Sec. 1034(j) of the IRC recognizes the IRS need for the information on this form with a special extended statute of limitations period for these sales. Normally, a taxpayer selling a principal residence has two years to "roll over" their sales proceeds tax-free into a new principal residence. Therefore, the IRS generally has a three year period to examine the transaction from the time the transaction is reported by the taxpayer This gives the IRS special protection from missing taxpayer information for these types of sales. Therefore, if the presence of the 1099-S produced a significant degree of increase in the number of Form 2119s filed, a distinct utility to the information return could be seen.

However, based on tax return data, the opposite seems to have occurred. As can be seen in the table below, the number of Forms 2119 filed by individual taxpayers relative to sales, appears to show an erratic pattern, and no measurable increase since enactment of the reporting requirement in 1986.

Historic Data on Form 2119 Filings
(Forms 2119 filed as a percent of actual existing home sales)

1993	1992	1991	1990	1989	1988	1987
41%	36%	40%	43%	n/a	53%	47%

1986	1985	1984	1983	1982	1981
45%	45%	41%	30%	65%	58%

Source: Existing Home Sales, National Association of Realtors

Therefore, we strongly suspect that the amount of revenue actually realized by 1099-S reporting is minimal. We also contend that the IRS has alternative sources for the information generated by the 1099-S. In fact, the IRS actually can obtain the information on gross proceeds provided in the 1099-S through many other means.

III. IRS Use of and Alternative Sources of Information

The IRS will almost always have obvious clues anyway that the sale has occurred before the two-year rollover period has expired. Second, the IRS will not have sufficient transactional information from the 1099-S alone to have any real picture of the overall transactional setting. Thus, the IRS case against the taxpayer will be labor-intensive regardless of the 1099-S filing. Perhaps as a result of these constraints, the IRS also does not appear to use the information provided on the 1099-S on a wide-spread basis.

First, certain obvious changes from one year's tax return to the next, such as change of filing address, can assist the IRS in determining that a real estate sale may have occurred whether or not a Form 1099-S is filed. Second, the IRS can use migration flow data information obtained and collated by the Census Bureau to assess possible sales. Third, although the 1099-S submission has not resulted in increased filing of Form 2119, the IRS can still obtain basic information provided from those forms that are filed.

The IRS may use the information provided on a 1099-S in an individual audit. However, IRS pursuit of cases (encouraging taxpayers to pay taxes on capital gains on home sales) are often labor-intensive for the Service even with the 1099-S information filed. This is because the

1099-S provides only gross proceeds and real property tax proration amount information. If a Form 2119 is not filed with the taxpayer's individual return, the IRS has to fill in a large amount of information to complete the tax picture, particularly to determine the proper tax basis to calculate any gain on the sale. For instance, the current tax basis may well depend on a series of prior home sales by the taxpayer, over a period of many, many years. Further, the taxpayer may have used the rollover treatment previously in many of these sales. Consequently, the IRS will need substantial additional information that must be provided by the taxpayer to effectively use the information provided on Form 1099-S.

In addition, the information reporting requirement provided on real property tax proration amounts on the 1099-S form is a number calculated only for the purpose of the real estate closing. It can not be matched to any number independently calculated or filed with any other public entity, including those that include real property payments. Therefore, it can not even be used by the IRS in any meaningful way.

As noted above, there is no information on the 1099-S providing more than a minimal starting point in determining the tax result. This is unlike the reporting of dividends and interest the reporting of which (e.g., on Forms 1099-INT and -DIV) can be tied directly to dollar amounts set forth (or omitted) on the taxpayer's individual returns. It is also unlike stock and bond sales, reported on Form 1099-B, which, even though no basis information is reported for them either, are likely to be much more numerous and in smaller dollar amounts than real estate sales for any particular year. Thus, the argument that a taxpayer may forget an occasional sale is a compelling point with sale of stocks and bonds, but not with real estate transactions.

IV. Industry Burden

The industry has incurred substantial cost in implementing 1099-S reporting. These costs include not only the cost of reporting, but also the substantial penalty costs that are imposed for incorrect filings.

A real estate reporting person filing Form 1099-S faces numerous regulatory requirements on the format of the information that must be reported to IRS and the manner in which it must be filed. These requirements obviously reflect a need to have information filed in a way compatible with IRS systems. Large companies have implemented separate individual systems to institute 1099-S reporting. Small companies, including practitioners who do only a few closings a year, must of necessity use a tax reporting service to send information to the IRS. Some services charge $35.00 a transaction.

The Technical and Miscellaneous Revenue Act of 1988 (P.L.- 100-647) included a provision (Sec. 1015(e)(2)(A), I.R.C. Sec. 6045(e)(3)), prohibiting a separate charge for the preparation of Form 1099-S in connection with a closing. That law became effective in November, 1988.

The 1988 change has presented significant problems in terms of the real estate closing industry's abilities to absorb these costs. Many states regulate title insurance rates and charges by requiring that they be filed with state insurance commissioners for review and\or approval. These regulations can be very far-reaching, extending not only to premium rates, but to specific fees such as settlement charges. If any fee is to be increased to reflect additional expense, insurers are often required to justify the increase by enumerating included cost factors.

Unfortunately, this rate and charge setting procedure, itself a device for consumer protection, can be readily misinterpreted to infer that the fee for a particular closing service, determined in accordance with applicable regulation, violates the prohibition of Sec. 6045(e)(3) because the cost of compliance with the reporting requirement was an enumerated component in the regulatory review process.

There is now a legal dispute about the precise meaning of Sec. 6045(e)(3). It is being argued that this provision can not be interpreted to allow the cost of real estate reporting to be recovered as one of the items under a combined charge for related services. In Pennsylvania, that inference has already been proffered in an enterprising lawsuit, Burns et al. v. Commonwealth Land Title Insurance Company, et al., D.C. (Eastern District of Pennsylvania), C.A. No 91-1812, where title insurers and agents have been named as defendants. While the existing statutory language of the I.R.C. appears clear on its face, regulated providers of real estate

closing services are facing substantial litigation costs in the absence of language clarifying the intention of Sec. 6045(e)(3).

Though clarification of I.R.C. Sec. 6045(e)(3) regarding the separate charge was agreed to by Congress as Sec. 7616 of the Conference Report on HR 11, the "Revenue Act of 1992," President Bush vetoed the bill. Therefore, the industry is still, to this day, facing litigation costs and is finding it necessary to establish that while 6045(e)(3) prohibits separate charges for 1099-S filings, it does not prohibit combined charges or other means of recovering compliance costs.

With the exception of Sec. 6045(e)(3), we are unaware of any additional instances where private parties believe they have authority to enforce the Internal Revenue Code. We hope that the Committee considers that the current litigation is obviously financially burdensome, and that proliferation of this type of action on a national level, covering the 5 to 7 million annual real estate transactions would present a financially devastating picture. For our industries, this litigation is one precedent-setting instance which supports the need for repeal.

Real estate reporting persons are subject to penalties under Secs. 6721-24 for inaccurate reporting of information to the IRS. As a result of the uniform statutory reforms to the civil penalty system in 1989, the IRS submits 1099-S filers to the same automated regimes for penalties applicable to other information return filers. This penalty regime is applicable even though the 1099-S filer usually has limited contact with the taxpayer in question. A taxpayer may well give a 1099-S filer a social security number that does not match to IRS files. The 1099-S filer thus faces two levels of cost at two separate times. First, the filer must complete and transmit the original 1099-S form. Second, several years later the filer must respond to IRS inquires and penalties for a mismatched taxpayer identification number. In the meantime, has the IRS actually used very many of even just the 1099-S forms filed that had no matching errors to determine whether those taxpayers properly reported the transactions? There is no evidence that such is the case.

These penalties are set at $50.00 per incorrect filing. The penalties imposed by the IRS can be substantial for companies who perform a significant number of closings in the United States, annually approaching several hundred thousand dollars. These companies also have to face the possibility that (1) some individuals may have provided them with incorrect TINS, and (2) there may be some margin of clerical error inherent in the volume of transactions filed.

This assumption that there may be some incorrect TINS, is compounded by the predicament that there is no continuing customer relationship between a closing agent and a seller of real estate. Consequently, our companies often face the dilemma that it may be cheaper to pay a fine to the IRS, as opposed to committing staff time to retrieve warehoused files and attempt to track down the seller of a property to check a TIN.

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We believe that the Congress should require substantial evidence to justify retaining tax information return requirements which, standing alone, contribute minimally to a tax determination. The major example of this is Form 1099-S. It would seem that some alternative means to the current statutory system could be found to alert taxpayers to the importance of reporting their own real estate transactions and removing the burdens on filers for information that is, at best, of marginal use to the government.

We would be pleased to work with the Committee to arrive at such a different system.

ARCTIC SLOPE REGIONAL CORPORATION

Arctic Slope Regional Corporation ("ASRC") appreciates the opportunity to present this statement for the record pertaining to hearings on miscellaneous tax proposals.

ASRC is the Native Corporation established by the Inupiat Eskimo people of Alaska's North Slope pursuant to the Alaska Native Claims Settlement Act of 1971 ("ANCSA"). ASRC, along with 12 other regional corporations and numerous village corporations created by ANCSA, received title to land and a monetary compensation as settlement for the taking of Native Lands. The corporations were given a mandate to use those lands and money to promote the economic and social betterment of over 7,000 shareholders.

Specifically, ASRC wishes to comment on, and indicate its strong support for, the proposal to provide for taxation of Alaska Natives when payments from Settlement Trusts are actually made to them and not when such Settlement Trusts are created.

ANCSA provided that the corporate vehicle would be the primary entity to implement the goal of settling land and other claims of Alaska Natives. Subsequently, it was determined that other Native-controlled entities might provide increased flexibility and protections to preserve and appropriately disburse the Native assets. Accordingly, the 1987 amendments to ANCSA provided for the establishment of Settlement Trusts "to promote the health, education and welfare of its beneficiaries and preserve the heritage and culture of Natives". By statute, the Settlement Trust cannot operate as a business. While the original transfer of land and cash to Alaska Native Corporations was specified as a non-taxable event under ANCSA, the Settlement Trust provision is silent on the tax treatment of the conveyance of assets to Settlement Trusts.

This opportunity, created by the U.S. Congress, has been effectively thwarted by adverse Internal Revenue Service ("IRS") rulings. The IRS has ruled that if a Native Corporation, which has earnings and profits, conveys assets to a Settlement Trust, its shareholder-beneficiaries will be taxed as if they received a dividend. The IRS rulings require payment of a tax by the shareholder-beneficiaries before (usually several years before) they have actually received a distribution from the Settlement Trust. Put simply, in our case, the IRS is requiring Alaska Natives, with very few resources, to put up money in the form of prepaid tax payments, in order to receive monthly amounts of $125 to help them live in retirement. In reality, Alaska Natives would have to put up several thousand dollars to qualify for the payments and, if they die prematurely, or do not survive through their life expectancy, will never recover even the tax payments they have made.

Attached are case studies compiled to demonstrate the patent unfairness of this position. These case studies are representative of the elders of ASRC. For example, in Case A, if a trust is created this year and a male 62 years of age is a beneficiary, using the assumptions set forth in the paper, he would have to prepay taxes, in 1995, in the amount of $5,094, even though he would not begin to receive benefits until 1998 (when he is 65). It would take him until the year 2001 to recover his prepaid taxes and actually receive a benefit from the fund. And, to indicate how punitive the application of this theory is, if he dies in 1997, he will not have received a cent, yet paid $5,094 in taxes.

We are not rich people. It is conceivable that many potential beneficiaries would have to waive such benefits because they cannot raise the funds necessary to prepay the taxes. This is certainly not the result Congress intended when it passed the Settlement Trust amendments.

Accordingly, we are suggest a simple legislative cure: provide for taxation of the Alaska Natives when trust payments are actually made to them and not when the Settlement Trust is created. There is no revenue loss since this is only a question of the timing of the taxation. Our proposed language is as follows:

> Section 39 of the Alaska Natives Claims Settlement Act (43 U.S.C. §1629(e)) is amended to add the following new paragraph:
>
>> (d) A holder of Settlement Common Stock who is a beneficiary of a Settlement Trust created under this section shall not be subject to taxation with respect to assets conveyed to a Settlement Trust or any income earned by a Settlement Trust until a distribution of assets or income is actually received by such beneficiary.

The above provision would clarify that a Native Corporation's shareholders are not subject to tax under any theory (such as that the shareholders received or constructively received a dividend or a taxable economic benefit) until they have actually received a distribution from the Settlement Trust. The provision's treatment of shareholder tax liability would not adversely affect IRS rulings holding that, with regard to the Native Corporation, the conveyance of assets to the trust is a non-taxable event except for the conveyance of appreciated property and that Settlement Trust grantors will not be treated as owners of Settlement Trusts under Section 675 of the Internal Revenue code if their powers are appropriately limited.

ASRC would like the opportunity to create an Elder's Trust under the protections that the 1987 amendments provide. The burden on our elder shareholders under the current law would be impossible to bear. The Inupiat culture emphasizes the importance of our elders to our future and their contributions to our past. We would like to provide to them a small measure of financial security which was not provided for in their subsistence lifestyle. In conclusion, we hope this committee will see fit to rectify this problem which impacts so negatively on our esteemed elders.

PRACTICAL APPLICATION OF THE INTERNAL REVENUE SERVICE'S SETTLEMENT TRUST RULINGS TO RETIREES

Listed below are four hypothetical illustrations of the tax effect of the Internal Revenue Service's ruling that beneficiaries of a non-grantor trust are immediately liable for taxes on the actuarial estimate of benefits they might receive. These illustrations are based on the following assumptions:

- A non-grantor version of an Elders Trust, receiving the full benefits and protections of the Settlement Trust provision of the Alaska Native Claims Settlement Act, is created in 1995 that provides the same benefits and eligibility criteria as a grantor trust (not having such benefits and protections) that was in fact created by an Alaska Native Corporation.

- The actuarial benefit is calculated using standard life expectancy tables, based on a 1986 DHHS study, which is the most widely accepted table in use in the insurance industry today.

- The marginal tax rate is 28%.

- The discount rate is 5.0%, a number within a reasonable range of the likely return available to a shareholder on a relatively safe, long-term investment.

The computer printouts supporting the four case studies are attached.

The four illustrations reflect the actuarial benefit of the Elders Trust to a male and female at ages 62 and 65 at the time the trust is funded. These case studies are representative of the beneficiaries of the trust at that age. In this Elders Trust, shareholders become eligible for benefits at age 65, but must reach age 65 by 1998. The benefits are $125 per month in the first year of eligibility and increase by 4% a year thereafter.

Case A. Case A concerns a hypothetical male who is age 62 when the trust is created in 1995. He would not become eligible for benefits until 1998. Nonetheless, he would receive an actuarially estimated benefit of $18,000 and pay taxes on that amount of $5,094 in 1995. It would take him until the year 2001 (or seven years) to receive a benefit (in present value terms) equal to the taxes he paid in 1995.

Case B. Case B is the same as Case A except the assumed beneficiary is female. Her life expectancy is longer and thus her actuarial benefit is larger. Her taxes would be $6,333 in 1995 and it would take her until 2002 to recover her taxes.

Case C. Case C is a male, age 65 at the time the program is created. His taxes would be $6,261 in 1995 and it would take him until 1999 to recover his taxes.

Case D. Case D is a female, age 65 at the time the program is created. Her taxes would be $7,682 in 1995 and it would take her until the year 2000 to recover her taxes.

Shareholders who outlive their projected life expectancy will ultimately receive more in the way of benefits than the amount on which they paid taxes. It will take many years, however, for the balance to shift in their favor. In the meantime, these shareholders, most of whom can ill-afford the required taxes, would be forced to advance thousands of dollars to the government in the hope of living long enough to recoup them.

Shareholders who fail to live as long as projected will never receive all of the benefits for which they paid taxes. In addition to being perpetually overtaxed, they will also be forced to pay their excessive taxes well in advance of getting whatever benefits they do receive.

A

ACTUARIAL VALUE OF ELDERS TRUST BENEFITS

Year	Age	Amt. Rec'd.	PV	Cum. PV
1995	62	0	0	0
1996	63	0	0	0
1997	64	0	0	0
1998	65	1,500	1,296	1,296
1999	66	1,560	1,283	2,579
2000	67	1,622	1,271	3,850
2001	68	1,687	1,259	5,109
2002	69	1,755	1,247	6,357
2003	70	1,825	1,235	7,592
2004	71	1,898	1,223	8,815
2005	72	1,974	1,212	10,027
2006	73	2,053	1,200	11,227
2007	74	2,135	1,189	12,416
2008	75	2,220	1,178	13,594
2009	76	2,309	1,166	14,760
2010	77	2,402	1,155	15,915
2011	78	2,498	1,144	17,059
2012	79	2,598	1,133	18,193
2013	80	0	0	18,193
2014	81	0	0	18,193
2015	82	0	0	18,193
2016	83	0	0	18,193
2017	84	0	0	18,193
2018	85	0	0	18,193

Discount Rate	5.00%	
Life Expectancy	79	Male

Total PV	$18,193
Marg. Tax Rate	28.00%
Federal Taxes	$5,094

B

ACTUARIAL VALUE OF ELDERS TRUST BENEFITS

Year	Age	Amt. Rec'd.	PV	Cum. PV
1995	62	0	0	0
1996	63	0	0	0
1997	64	0	0	0
1998	65	1,500	1,296	1,296
1999	66	1,560	1,283	2,579
2000	67	1,622	1,271	3,850
2001	68	1,687	1,259	5,109
2002	69	1,755	1,247	6,357
2003	70	1,825	1,235	7,592
2004	71	1,898	1,223	8,815
2005	72	1,974	1,212	10,027
2006	73	2,053	1,200	11,227
2007	74	2,135	1,189	12,416
2008	75	2,220	1,178	13,594
2009	76	2,309	1,166	14,760
2010	77	2,402	1,155	15,915
2011	78	2,498	1,144	17,059
2012	79	2,598	1,133	18,193
2013	80	2,701	1,122	19,315
2014	81	2,809	1,112	20,427
2015	82	2,922	1,101	21,528
2016	83	3,039	1,091	22,619
2017	84	0	0	22,619
2018	85	0	0	22,619

Discount Rate	5.00%	
Life Expectancy	83	Female
Total PV	$22,619	
Marg. Tax Rate	28.00%	
Federal Taxes	$6,333	

G

ACTUARIAL VALUE OF ELDERS TRUST BENEFITS

Year	Age	Amt. Rec'd.	PV	Cum. PV
1995	65	1,500	1,500	1500
1996	66	1,560	1,486	2,986
1997	67	1,622	1,472	4,457
1998	68	1,687	1,458	5,915
1999	69	1,755	1,444	7,358
2000	70	1,825	1,430	8,788
2001	71	1,898	1,416	10,205
2002	72	1,974	1,403	11,608
2003	73	2,053	1,389	12,997
2004	74	2,135	1,376	14,373
2005	75	2,220	1,363	15,736
2006	76	2,309	1,350	17,086
2007	77	2,402	1,337	18,424
2008	78	2,498	1,325	19,748
2009	79	2,598	1,312	21,060
2010	80	2,701	1,299	22,360
2011	81	0	0	22,360
2012	82	0	0	22,360
2013	83	0	0	22,360
2014	84	0	0	22,360
2015	85	0	0	22,360
2016	86	0	0	22,360
2017	87	0	0	22,360
2018	88	0	0	22,360

Discount Rate	5.00%	
Life Expectancy	80	Male

Total PV	$22,360
Marg. Tax Rate	28.00%
Federal Taxes	$6,261

D

ACTUARIAL VALUE OF ELDERS TRUST BENEFITS

Year	Age	Amt. Rec'd.	PV	Cum. PV
1995	65	1,500	1,500	1500
1996	66	1,560	1,486	2,986
1997	67	1,622	1,472	4,457
1998	68	1,687	1,458	5,915
1999	69	1,755	1,444	7,358
2000	70	1,825	1,430	8,788
2001	71	1,898	1,416	10,205
2002	72	1,974	1,403	11,608
2003	73	2,053	1,389	12,997
2004	74	2,135	1,376	14,373
2005	75	2,220	1,363	15,736
2006	76	2,309	1,350	17,086
2007	77	2,402	1,337	18,424
2008	78	2,498	1,325	19,748
2009	79	2,598	1,312	21,060
2010	80	2,701	1,299	22,360
2011	81	2,809	1,287	23,647
2012	82	2,922	1,275	24,921
2013	83	3,039	1,263	26,184
2014	84	3,160	1,251	27,435
2015	85	0	0	27,435
2016	86	0	0	27,435
2017	87	0	0	27,435
2018	88	0	0	27,435

Discount Rate	5.00%	
Life Expectancy	84	Female

Total PV	$27,435
Marg. Tax Rate	28.00%
Federal Taxes	$7,682

Joint Statement in Support of a Proposed Amendment
to
Section 39 of the Alaska Native Claims Settlement Act (ANSCA)
Submitted by
The Old Harbor Native Corporation and Akhiok-Kaguyak, Inc.
to the Ways & Means Committee of the U.S. House of Representatives
July 27, 1995

The Old Harbor Native Corporation (OHNC) and Akhiok-Kaguyak, Inc. (AKI), both, Native village corporations established under the authority of the Alaska Native Claims Settlement Act (ANCSA), submit these comments for the record and for consideration by the Committee on Ways and Means in support of the Settlement Trust amendment pending before the Committee.

This statement is in response to the request by the Ways and Means Committee of the U.S. House of Representatives for comments on the legislative provision pending before the Committee which would "provide for taxation of Alaska Natives when payments from a settlement Trust are actually made to them and not when the settlement trust is created." Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95) July 10, 1995, Page 45.

The purpose of a Settlement Trust under Section 39 of ANSCA which established a "Settlement Trust Option" for Shareholders of Native corporations incorporated pursuant to the authority of the (ANCSA) is "to promote the health, education and welfare of its beneficiaries and preserve the heritage and culture of Natives."

In a joint submission of an "Analysis and Explanation" by Chairman Morris K. Udall and ranking Republican Member Don Young during the House consideration of the ANSCA amendments legislation, which included the Settlement Trust provisions, the intended purposes of Settlement Trusts were further explained and delineated in the CONGRESSIONAL RECORD on December 2, 1987 (at H 11936-11937):

> "Settlement Trusts are expected to serve two principal functions. They are intended to be permanent, Native-oriented institutions which shall hold and manage, in perpetuity, any historic or culturally significant surface lands, sites, cemeteries, traditional use areas, or monuments, for the benefit of the beneficiary population. It shall manage any other surface lands conveyed or culturally significant assets in like fashion. The Trusts will require income generated from assets conveyed to it, or other sources, to carry out these responsibilities.
>
> "The other prime function relates to the health, education and economic welfare of its beneficiaries. Trusts may receive conveyances of securities, cash, or other assets which it must manage prudently, and passively, in the interests of its beneficiaries, and in conformance with the terms and conditions set forth in the trust instrument and this Act. At the discretion of the trustees, the income generated from these assets, and, if permitted, Trust assets themselves can be used to provide scholarships and other educational benefits. Assets can be used to improve health care delivery or facilities, pay for needed health care and otherwise be devoted to bettering the health of the beneficiary Native community. Finally, the Trust assets may be used to bolster the economic well-being of the beneficiaries. Trust distributions may be used to fight poverty, provide food, shelter and clothing, and serve comparable economic welfare purposes. Additionally, cash distributions of trust income may be made on an across-the-board basis to the beneficiary population as part of the economic welfare function."

Settlement Trusts are a means of carrying out the goals of ANSCA to provide for a just settlement with Alaska Natives and a means of continued economic support through the investment and management of the assets given to the Natives in settlement of their aboriginal

land claims. As contemplated in the provisions which enacted Settlement Trusts, their purpose was not to conduct an active trade or business, but was to provide a secure holding for lands and investments that can be protected for generations to come.

The proposed amendment recognizes the differences that arise in implementing the intent of ANSCA with the Internal Revenue Code (IRC). The amendment provides that the mere transfer of funds to the Settlement Trust will not give rise to any current taxation at the shareholder's last beneficiary level. Under current law, it is possible that distributions or monies set aside in a Settlement Trust could be currently taxable to the shareholders. This would create a situation in which a tax liability existed without any funds being provided to the individual liable for the tax. We believe this result was not intended when Congress enacted the Settlement Trust provisions in 1987. Currently, some Native corporations have the ability of transferring funds to Settlement Trusts without incurring any current tax liability. This is due to the fact that these companies have a deficit in their earnings and profits. Other companies, however, are prohibited from making such a transfer for the benefit of their shareholders because they have an accumulation of earnings and profits already. The enactment of the Settlement Trust provisions was not intended to discriminate against companies that have done what ANSCA envisioned that they should do and generate some economic benefit (earnings) from their lands and other assets for their Native shareholders.

There is a fundamental inequity and deficiency currently as the law is being carried out. As it is now, if Native land entitlement is monetized and the proceeds placed in a Settlement Trust and that corporation had earnings and profits, there would be an immediate tax liability created for each shareholder of the corporation. The effect of this is to severely devalue the lands (and its cash equivalent) which were used in settlement by the people of the United States of aboriginal Native claims. Aside from the patent unfairness of such a result, it was not the intent of the Congress in ANSCA nor in amendments to the Act. This issue has become more relevant and important as more Native corporations, including our own, have begun to look (or have seriously looked) at the Settlement Trust as an option for helping to provide some modest long-term economic benefit to Native Shareholders.

The intent of the amendment is to allow the transfer to a Settlement Trust not to be treated as emanating from the earnings and profits of the corporation. Without this provision, a substantial portion of the assets of a Native Village Corporation will be taxed twice before it has ever generated any income whatsoever for its shareholders: once when it is taxed on any gain realized while the asset was in the corporation and again when these assets are transferred to the Settlement Trust. In addition to the unfairness of such a result and its nature of undermining the goals of ANCSA, if not corrected, the problem addressed by the amendment will continue to frustrate the establishment of and reliance on settlement trusts. Many companies simply will not be able to afford the decrease in corporate/trust assets on a combined basis by creating a tax liability to their shareholders. Accordingly, many Settlement Trusts that could be established for the benefit of current and future generations will not materialize or will not be augmented unless there is some remedy to this flaw in the Settlement Trust is corrected.

It does not appear that there will be any adverse revenue impact from this provision since among other reasons, without the provision successful Native companies will be severely restricted from establishing Settlement Trusts and many will simply never be created. While if such Trusts are established there will be a tax revenue stream generated in perpetuity including the ancillary state and local tax benefit generated by such a permanent fund. In fact, our analysis indicates that with adoption of the amendment the tax revenues over time, will generate federal, state and local tax revenues in excess of those generated if the Settlement Trusts were not created and the funds simply distributed, which is a likely alternative to establishing a Settlement Trust.

In addition to the pending amendment, we urge that language be included which would recognize the reporting difficulties associated with the establishment of Settlement Trusts.

While simple in principle, the actual mechanics of providing the information and reporting in a timely manner to beneficiaries of the Settlement Trust become very complicated.

This complication is further aggravated by the fact that the majority of beneficiaries have had relatively low income levels. Accordingly, their tax returns and their filings have been relatively straightforward. The establishment of Settlement Trusts and the taxation of distributions to these individuals creates a need for timely information, reporting and direction. Additionally, many of the shareholders of Village Corporations in the coastal communities make a living from commercial fishing. As a result they have the ability of avoiding estimated tax payment penalties, providing they file their tax returns by March 1. This, again, creates a very short time frame to file a complete and accurate Trust tax return and distribute information Forms K-1 to a substantial base of beneficiaries. This base can exceed 500 or 1,000 and beyond beneficiaries, depending on the size of a village corporation and the number of such corporations who may establish Settlement Trusts under the law. A regional corporation could well be in excess of 5,000 shareholders/beneficiaries who would be receiving information Forms K-1.

Currently, Section 645 of the IRC provides that trusts must be on a calendar year. By allowing an earlier year-end, Settlement Trusts will be permitted to distribute important tax reporting information to the beneficiaries early and allow for additional time in order to ensure that the beneficiaries have adequate information and assistance in filing correct and complete income tax returns. In this way, the government is assisted by an attempt to avoid reporting discrepancies which can arise when the information is rushed due to year-end time constraints. The revenue impact of this provision should be a positive one since it will enhance the ability of the individual and the government to ensure that reporting is accurate and all taxes are reported and paid in a timely manner. Some income may remain in the Trust for inflation-proofing and to recognize an expanding base of beneficiaries. This net retainage would be subject to tax at the Trust level. A deferral on the recognition of this income of up to three months would provide for a benefit to the Trust only to the extent that the tax on the income in the stub period exceeded the estimated payment responsibilities of the Trust. Since the Trust will not conduct an active trade or business, its investment income is anticipated to be relatively even throughout the year. Accordingly, any deferral should not give rise to a major savings or difference between the taxes due on the income and the estimated taxes required.

Settlement Trusts provide a unique opportunity for Native corporations to help carry out the Congressional intent of ANSCA, by providing a firm and continuing economic base for shareholders/beneficiaries and avoiding one-time distributions to the shareholder community which would deplete the combined corporate/trust funds. Settlement Trusts have a potential of providing a much needed step in achieving continued economic independence for the Native community. The proposed amendment is necessary to encourage the establishment of these Trusts and to perform this function.

The language of the remedial provision submitted to the Committee by Chairman Don Young would cure most of the current deficiency in the settlement trust provision in ANCSA. As indicated earlier, OHNC and AKI urge that a reporting provision be added to enhance the ability of any Settlement Trust that is created to get information to beneficiaries of the Trust prior to the time tax returns are due. This provision, for many of the beneficiaries who live in remote locations in Alaska and many of whom live close to the poverty line, will greatly enhance the ability of the individuals to accurately report any dividend from such Trust, and thereby help ensure full accounting and reporting in a timely manner.

We understand that there are other Alaska Native corporations which are supportive of this Settlement Trust amendment pending before the Committee.

We believe that there may be a better or more appropriate way to correct the problem in the current law. Both OHNC and AKI would look forward to the opportunity to discuss with representatives of the Committee the amendment and ideas about how it might be improved.

Thank you for this opportunity to present comments to the Committee on the amendment to the Alaska Native Claims Settlement Act regarding Settlement Trusts.

Enclosure to Statement by Old Harbor Native Corporation and Akhiok Kaguyak, Inc. on Settlement Trusts to Ways and Means Committee, U.S. House of Representatives

Settlement Trust Amendment to the Alaska Native Claims Settlement Act

Section 39 of the Alaska Native Claims Settlement Act (43 U.S.C.§1629e) is amended to add the following new subsections:

(d) A holder of Settlement Common Stock who is a beneficiary of a Settlement Trust created under this section shall not be subject to taxation with respect to assets conveyed to a Settlement Trust or any income earned by a Settlement Trust until a distribution of assets or income is actually received by such beneficiary.[1]

(e) With regard to Settlement Trusts, the taxable year shall be a permitted year, which, for purposes of this section, shall mean a taxable year ending on September 30, October 31, November 30, or December 31.[2]

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[1] Language of legislative proposal referenced on page 45 of pamphlet entitled "Description of Miscellaneous Tax Proposals," Joint Committee on Taxation, (JCS-19-95), July 10, 1995.

[2] Supplemental reporting provision to facilitate accurate reporting of Settlement Trust beneficiary income.

'Pass to the Future'

SHAAN-SEET INC.

July 18, 1995

Via Telecopier

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth Office Building
Washington, D.C. 20515 - 6348

Dear Mr. Chairman:

We are writing to provide you testimony upon two of the miscellaneous tax proposals for which public hearings were held on July 11-13, 1995[1]. Although we understand that at the present time oral testimony on these proposals has not been scheduled, we would welcome the chance to testify in person should that opportunity become available. In making this submission, it is our intent that this material be included in the written record of the hearing.

Shaan-Seet, Incorporated is the corporation organized under the Alaska Native Claims Settlement Act[2] for the Alaska natives residing in the Craig, Alaska area. Craig is located on the west side of Prince of Wales Island, which in turn is approximately 100 miles west of Ketchikan, Alaska. There were originally 317 enrollees to Shaan-Seet; in 1993 Congress directed that two more persons be enrolled to Shaan-Seet for a total of 319 enrollees. In view of various transfers of its stock over the years, Shaan-Seet now has approximately 400 shareholders.

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[1] These proposals were described in the pamphlet issued by the Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995. For simplicity, we refer to this in the text simply as the "*Description of Miscellaneous Tax Proposals*".

[2] Pub. L. No. 92-203, 85 Stat. 688 (December 18, 1971), codified at 43 U.S.C. § 1601 *et seq.*

P. O. Box 90 • Craig, Alaska 99921-0090 • 907-826-3251 • Fax 907-826-3980

Shaan-Seet is keenly interested in the both of the Alaska Native proposals set forth at pages 44-46 of the *Description of Miscellaneous Tax Proposals*. It is for this reason that we today submit this testimony. The remaining portions of this letter refer to the proposal on regular ANCSA distributions as "Taxation of ANCSA Distributions" and the proposal relative to Settlement Trusts as "Taxation on Contributions to Settlement Trusts".

Taxation of ANCSA Distributions. One of the principle purposes of the ANCSA legislation was to provide for "the real economic and social needs of Natives"[3] through the establishment of profit-making corporations. Like most Native corporations, Shaan-Seet makes every effort to provide significant economic assistance to its shareholders through regular distributions. The source for these distributions is the cash Shaan-Seet derives from its timber harvest operations. At present, taxation of these distributions is determined by the rules contained in § 301 of the Internal Revenue Code. That is, the distributions are taxable to the extent of current and accumulated earnings and profits; thereafter, further distributions are treated as a return of capital (and hence tax free) to the extent of a given shareholder's basis. Once the shareholder's basis is exceeded, any remaining distributions would be taxable as a capital gain item.

Although we can state these rules relatively simply, their actual application can be extraordinarily complex. This is particularly so given the fact that most ANCSA corporations (including Shaan-Seet) have received their ANCSA lands at various times, and may have a variety of different tax bases in their timber. This in turn may lead to considerably different tax impacts on our shareholders depending on which timber is cut at what times. Also, it is not unusual for Native corporations to eliminate their own taxable income (through carry over NOLs) but nonetheless to be paying taxable distributions (because NOLs do not enter into the calculation of current year earnings and profits).

As you can imagine, many of our shareholders are elderly or unemployed, and the tax impact on them can be substantial even in the lower marginal rate brackets. There is a very real concern, therefore, to minimize the tax impact on our distributions. The result,

[3] Section 2(b) of ANCSA, codified at 43 U.S.C. § 1601(b).

however, is that Shaan-Seet again like most Native corporations, must devote substantial resources each year in attempting to minimize its earnings and profits and in order to reduce taxation on our shareholders. This is expensive, time consuming, and distracts Shaan-Seet from what should be its real focus, developing profitable businesses.

ANCSA was (and is) Indian settlement legislation. The Alaska Natives received land and cash through their corporations in exchange for the settlement of their land claims against the United States. Most other modern day Indian settlement acts[4] have provisions which significantly reduce or eliminate the tax impact from the settlement. The drafters of ANCSA recognized this, and provisions were included which would reduce and/or eliminate taxation relative to the ANCSA settlement[5].

However, ANCSA as drafted did not go far enough ANCSA required Alaska Natives to incorporate to receive the ANCSA settlement, and Alaska Natives had no choice in the matter. As you know, Mr. Chairman, the corporate form carries with it a high potential tax cost in terms of double taxation (once to the corporation, once to the shareholders) and the possibility that distributions will nonetheless be taxable even though the corporation might have no profit. Had the corporate form not been employed, these anomalies would not be present. Shaan-Seet believes that it is a matter of fundamental fairness to reduce, to the greatest extent possible, these anomalies so that the original ANCSA settlement is not indirectly made taxable through a tax on distributions.

With this in mind, Mr. Chairman, Shaan-Seet declares its support for a provision such as that outlined in the *Description of Miscellaneous Tax Proposals* so that ANCSA distributions would not be taxable until such time as a certain minimum amount has been distributed.

Taxation on Contributions to Settlement Trusts. The ANCSA Amendments of 1987[6], amended ANCSA to permit Native Corporations to establish "Settlement Trusts" as an

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[4] See, e.g., Maine Indian Claims Settlement Act of 1980, codified at 25 U.S.C. § 1729; the Rhode Island Indian Claims Settlement Act, codified at 25 U.S.C. § 1716; and the Connecticut Indian Claims Settlement Act, codified at 25 U.S.C. § 1754.

[5] Section 21 of ANCSA, codified at 43 U.S.C. § 1620.

[6] Pub. L. No. 100-241, 101 Stat. 1788 (1988).

alternate vehicle to provide benefits for that Native Corporation's shareholders. As envisioned by the ANCSA Amendments, the Native Corporation would transfer assets directly to the Settlement Trust, and the Settlement Trust would thereafter provide benefits to the shareholders. One of the important driving forces behind the Settlement Trust provisions was that it would permit the shareholders to receive benefits[7] through the trust that they might not have been legally able to receive through the corporate form. Importantly, the enabling legislation[8] permits Settlement Trusts to last for a very long period of time, without regard to the rule against perpetuities, thereby enabling a Native corporation to use a Settlement Trust to provide for future generations of shareholders.

Unfortunately in a series of rulings[9] the IRS has repeatedly taken the position that transfers by a Native corporation into a settlement provide an indirect current benefit to the Native corporation's shareholders even though no cash is currently distributed. The result is the worst of all tax nightmares: possible "phantom" income. Put differently, the IRS ruling posture means that a distribution to the shareholders is being made at the time of the contribution to the trust. Leaving aside the horrendous effect of a phantom distribution of this sort, this problem is even more complex in that the IRS takes the position that the amount of the phantom income is to be determined based on all the events and circumstances which surround the beneficial interests in the trust. Thus, not only is the phantom income a problem, but it is not possible to say with any certain what the current economic value is for a given transfer into a settlement trust.

The result has been to leave transfers into settlement trusts in a somewhat uncertain area, especially for those corporations which have been highly successful and

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[7] E.g., educational benefits. This is because educational benefits would not necessarily be actually provided to all corporate shareholders on a pro rata basis, thereby potentially violating the rule that all corporate shareholders must be treated equally.

[8] Section 39(b)(4), codified at 43 U.S.C. § 1629e(b)(4).

[9] Private Letter Ruling (PLR) 9516023 (January 17, 1995); PLR 9516022 (January 17, 1995); PLR 9502011 (September 29, 1994); PLR 943302 (May 19, 1994); PLR 9329026 (April 28, 1993); and PLR 9326019 (March 31, 1993). The IRS has also issued three other PLRs involving the same settlement trust, but these PLRs did not reach the deemed distribution issue: PLR 8947054 (November 24, 1989), as modified by PLR 9119037 (February 8, 1991) and PLR 9452019 (September 28, 1994).

therefore may have significant earnings and profits.[10] For all these reasons, Mr. Chairman, Shaan-Seet believes it is critical that Congress pass legislation which clarifies Congressional intent that contributions to a settlement trust do not produce disguised income to the shareholders/beneficiaries.

Summary

Thank you, Mr. Chairman, for the opportunity to provide you this testimony. Again, Shaan-Seet would very much appreciate the opportunity to present oral testimony upon these important tax issues for the Alaska Native community. Shaan-Seet's designated contact persons upon this legislation are Paul A. Lingley, Jr., and Thomas Abel. Their address and telephone number are Main Street, PO Box 690, Craig, Alaska, 99921 and (907)826-3251.

Please do not hesitate to contact us if we can provide further information.

Sincerely,

SHAAN-SEET, INCORPORATED

Thomas H. Abel

Thomas Abel
Chairman of the Board

Paul Lingley, Jr.
President

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[10] The presence of either current or accumulated earnings and profits will mean that the "deemed distribution" occurring upon contributions to a settlement trust will be taxable to the shareholder/beneficiary.

SHEE ATIKÁ
INCORPORATED

P.O. Box 1949
Sitka, Alaska 99835
Tel (907) 747-3534
Fax (907) 747-5727

July 21, 1995

Via Telecopier

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth Office Building
Washington, D.C. 20515 - 6348

Re: **Miscellaneous Tax Proposals**
July 11 - 13, 1995 Public Hearings

Dear Mr. Chairman:

We are writing to provide you testimony upon one of the miscellaneous tax proposals for which public hearings were held on July 11-13, 1995[1]. Although we understand that at the present time oral testimony on these proposals has not been scheduled, we would welcome the chance to testify in person should that opportunity become available. In making this submission, it is our intent that this material be included in the written record of the hearing.

ABOUT SHEE ATIKA

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[1] These proposals were described in the pamphlet issued by the Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995. For simplicity, we refer to this in the text simply as the "*Description of Miscellaneous Tax Proposals*".

Shee Atika, Incorporated is the corporation organized under the Alaska Native Claims Settlement Act[2] for the Alaska natives residing in the Sitka, Alaska area. Sitka is located on the west side of Baranof Island, which in turn is approximately 100 miles southwest of Juneau, Alaska. There were originally approximately 1850 enrollees to Shee Atika. In view of various transfers of its stock over the years, Shee Atika now has approximately 2300 shareholders.

THE PROPOSED LEGISLATION

Shee Atika understands that the Congress is considering a proposal under which neither contributions to nor earnings of "settlement trusts" established under ANCSA will be taxable to the trust's beneficiaries until actual distributions are made to those beneficiaries. Specifically, our comments are directed at language which we understand to have been proposed by Congressman Don Young of Alaska in his letter to you dated March 10, 1995. Congressman Young's proposal would amend section 39 of ANCSA (which authorizes Native corporations to create settlement trusts) to add a new subsection (d), as follows:

> *"(d) A holder of Settlement Common Stock who is a beneficiary of a Settlement Trust created under this section shall not be subject to taxation with respect to assets conveyed to a Settlement Trust or any income earned by a Settlement Trust until a distribution of assets or income is actually received by such beneficiary."*

Shee Atika is keenly interested in seeing this provision adopted, and it is for this reason that we today submit this testimony. We note further that the *Description of Miscellaneous Tax Proposals*, supra, at page 46, contains language regarding this same topic, i.e., not taxing settlement trust beneficiaries until amounts are actually distributed to them. Our testimony today assumes that the proposal set forth in the *Description of*

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[2] Pub. L. No. 92-203, 85 Stat. 688 (December 18, 1971), codified at 43 U.S.C. § 1601 *et seq*. We refer in this letter to this Act as "ANSCA".

Miscellaneous Tax Proposals is the same as the proposal put forth by Congressman Young. If it is not, we wish there to be no mistake that Shee Atika wishes to see Congressman Young's proposal adopted rather than some other proposal[3].

OVERVIEW

One of the principle purposes of the ANCSA legislation was to provide for "the real economic and social needs of Natives"[4] through the establishment of profit-making corporations. Like most Native corporations, Shee Atika makes every effort to provide significant economic assistance to its shareholders through regular distributions.

The ANCSA Amendments of 1987[5], amended ANCSA to permit Native Corporations to establish "Settlement Trusts" as an alternate vehicle to provide benefits for that Native Corporation's shareholders. As envisioned by the ANCSA Amendments, the Native Corporation would transfer assets directly to the Settlement Trust, and the Settlement Trust would thereafter provide benefits to the shareholders. Importantly, the enabling legislation[6] permits Settlement Trusts to provide benefits for a very long period of time, without regard to the usual rule against perpetuities.[7] This enables a Native

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[3] It is unclear to us in reading the proposal set forth in the *Description of Miscellaneous Tax Proposals* whether the solution therein described for the settlement trust tax problem is simply that a minimum amount can be distributed by an ANCSA corporation to its shareholders free of tax. We do not today comment upon this later proposal other than to indicate that we do not think it adequately addresses the problem we outline in our testimony relative to the taxation of the beneficiaries of settlement trusts. For this reason, we have focused on the specific language proposed by Congressman Young in his March 10 letter to you which we have quoted above

[4] Section 2(b) of ANCSA, codified at 43 U.S.C. § 1601(b).

[5] Pub. L. No. 100-241, 101 Stat. 1788 (1988).

[6] Section 39(b)(4), codified at 43 U.S.C. § 1629e(b)(4).

[7] The rule against perpetuities is a doctrine for English common also present in the law of most U.S. States that a trust cannot last longer than a certain period. This period is usually expressed in terms of a "life in being at the creation of trust, plus twenty-one years." But for the

corporation to use a Settlement Trust to provide for future generations of shareholders. Moreover, Settlement Trusts are especially desirable in that the assets of the Settlement Trust are insulated from the creditors of both the shareholder/beneficiaries and the corporation itself[8]. The enabling legislation also expressly prohibits a Settlement Trust from operating a business[9]. The assets which may be placed in a Settlement Trust include land received as a part of the ANCSA settlement.[10] This is especially significant given the intense regard the Native people have for their land.

The combination of all these provisions makes the Settlement Trust a particularly viable method to hold long term assets (such as ANCSA land) and to provide a safe, secure source of distributions for Native shareholders into the indefinite future.

ABOUT SHEE ATIKA'S SETTLEMENT TRUST

In 1993, Shee Atika's shareholders voted to establish a Settlement Trust which would distribute at least 75% of its annual net cash income pro rata to Shee Atika's shareholders[11]. In May, 1993, after the Internal Revenue Service issued a private ruling

ANCSA provision cited above, the rule would be a significant impediment to multi-generational trusts.

[8] Section 39(c)(5), codified at 43 U.S.C. § 1629e(c)(5).

[9] Section 39(b)(1)(A), codified at 43 U.S.C. § 1629e(b)(1)(A).

[10] Section 39(b)(1)(B), codified at 43 U.S.C. § 1629e(b)(1)(B). See also House Explanatory Statement, 133 Cong. Rec. H. 11933, reprinted in 1988-5 U.S. Code Cong. & Admin. News 3269, 3307 (1988). However, neither the "subsurface estate in land" nor "timber resources subject to [ANCSA] section 7(i)" may be conveyed to a settlement trust. See Section 39(a)(2), codified at 43 U.S.C. § 1629e(a)(2) (no subsurface estate) and Section 39(c)(2), codified at 43 U.S.C. § 1629e(c)(2) (no 7(i) timber). We refer generally to the land which was conveyed under ANCSA to the Native corporations as "ANCSA land".

[11] Prior to the year 2000, the 25% of annual net cash income which is not distributed is added to principal to grow the Settlement Trust. Beginning in the year 2000, the Trustees

to Shee Atika[12], Shee Atika placed approximately $24 million in the Settlement Trust. Later in 1993, Shee Atika placed a further $6 million in the Settlement Trust. Thus the initial contributions totaled $30 million, or about $15,000 per original Shee Atika shareholder. Semi-annual distributions of the net income began in 1994. The source for these distributions is the cash income Shee Atika derives from passive investment in stocks, bonds and other securities. None of Shee Atika's ANCSA land has to date been placed in the Settlement Trust.

IRS RULING POSITION

Although the private letter ruling Shee Atika received (see note 12 above) was generally favorable, it held that any contributions by Shee Atika into the Settlement Trust were deemed distributions to Shee Atika's shareholders. The stated rationale was that the shareholders were receiving an economic benefit from the transfer, even though the shareholders were not receiving cash directly and had no election to receive cash.[13] The ruling also indicated that because a distribution was deemed to occur to Shee Atika's shareholders, § 311(b) of the Tax Code would require gain recognition to the extent the property being contributed was appreciated at the time of transfer.

Although Shee Atika did not (and does not) agree with this ruling position by the IRS, Shee Atika had anticipated the negative ruling on this point and timed the contributions into the Settlement Trust to occur in a year (1993) in which Shee Atika did not anticipate much in the way of earnings and profits.[14] The result is that for Shee Atika,

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of the Settlement Trust may choose, on a year by year basis, to also distribute some or this 25% of annual net cash income. Income not distributed in such years would be compounded.

[12] Private Letter Ruling ("PLR") 9329026 (April 28, 1993);

[13] See Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 67-203, 1967-1 C.B. 105.

[14] At present, taxation of distributions to Native corporation shareholders is determined by the rules contained in § 301 of the Internal Revenue Code. That is, the distributions are taxable to the extent of current and accumulated earnings and profits; thereafter, further distributions are treated as a return of capital (and hence tax free) to the

the initial contributions into the Settlement Trust did not produce taxable income to the shareholders.

However, because the Service's ruling position required Shee Atika to treat the contributions as a deemed distribution to our shareholders, albeit a non taxable one, Shee Atika had to provide Form 1099s to each of its shareholders reporting a "distribution" of approximately $15,000 in 1993 due solely to the contribution to the Settlement Trust. To say that this confused our shareholders is a massive understatement. We received numerous calls from our shareholders wanting to know what had happened to the $15,000 they never received.

The ruling to Shee Atika that contributions into a Settlement Trust are deemed distributions to Shee Atika's shareholders and potential § 311(b) gain recognition events is not unique, since the IRS has taken these positions in a series of rulings[15]. The result is the worst of all tax nightmares: possible "phantom" income to both the Native corporation and its shareholders. Leaving aside the disastrous effect of income without actual realized cash to pay the tax, this problem is made even more complex in that the amount of phantom income is to be determined based on all the events and circumstances which surround the beneficial interests in the trust. Thus, not only is the existence phantom income a problem, but also the amount of that phantom income, since it is not possible to say with any certainty what the current economic value is for a given transfer into a settlement trust.

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extent of a given shareholder's basis. Once the shareholder's basis is exceeded, any remaining distributions would be taxable as a capital gain item.

[15] Private Letter Ruling (PLR) 9516023 (January 17, 1995); PLR 9516022 (January 17, 1995); PLR 9502011 (September 29, 1994); PLR 943302 (May 19, 1994); PLR 9329026 (April 28, 1993); and PLR 9326019 (March 31, 1993). The IRS has also issued three other PLRs involving the same settlement trust, but these PLRs did not reach the deemed distribution issue: PLR 8947054 (November 24, 1989), as modified by PLR 9119037 (February 8, 1991) and PLR 9452019 (September 28, 1994).

To say the least, the IRS ruling position that contributions into Settlement Trusts are deemed distributions to the Native corporations shareholders casts a chilling effect on any future decision by Shee Atika to make future contributions into the Settlement Trust.[16]. In all likelihood, Shee Atika will now have positive earnings and profits which would cause such a future deemed distribution to become taxable to our shareholders. As you can imagine, many of our shareholders are elderly or unemployed, and the tax impact on them can be substantial even in the lower marginal rate brackets. There is a very real concern, therefore, to minimize the tax impact on our real cash distributions, let alone "deemed distributions" when the shareholders receive nothing. The result is that although Shee Atika has available cash and ANCSA land which it would at least consider placing into the Settlement Trust, it is unlikely Shee Atika would do so now given the difficulties which follow from the Service's deemed distribution ruling posture.

Not only does the Service's ruling position cast a chilling effect on potential contributions by Shee Atika of cash into its Settlement Trust, but also, upon contributions of land into the Settlement Trust. The valuation of land is potentially subject to a major disagreement between the taxpayer and the IRS, and this factor alone makes an in kind contribution of ANCSA land an uncertain proposition at best given the need to report a value for the contribution as a deemed distribution upon the annual Forms 1099 sent to shareholders. Moreover, if the ANCSA land is appreciated at the time of the contribution to the Settlement Trust, the application of § 311(b) of the Tax Code will require the contributing Native corporation to recognize gain on the appreciated ANCSA land deemed distributed. This gain, in turn, adds to any existing corporate earnings and profits, thereby severely compounding the overall tax problem. The end result, of course, is that few if any ANCSA corporations (including Shee Atika) can afford to place their ANCSA land in a Settlement Trust despite the clear Congressional intent that they be able to do so.

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[16] Shee Atika understands that the ruling posture has also served as a deterrent to other Native corporations which would like to establish a Settlement Trust, but have substantial earnings and profits which would render the "deemed distribution" taxable to their shareholders, producing phantom income unless those corporations wish to risk a fight with the IRS.

THE PROPOSAL GIVES EFFECT TO ANCSA

On the other hand, if the law were amended to permit contributions into a Settlement Trust without those contributions constituting deemed distributions to Shee Atika's shareholders, further contributions of cash and ANCSA land would be an option Shee Atika would consider seriously. We have to believe that when Congress enacted legislation providing for Settlement Trusts that Congress wished to encourage rather than discourage their use. Yet the present ruling posture of the Service effectively discourages use of Settlement Trusts by imposing the potential for a very high tax cost on its establishment.

ANCSA was (and is) Indian settlement legislation. The Alaska Natives received land and cash through their corporations in exchange for the settlement of their land claims against the United States. Most other modern day Indian settlement acts[17] have provisions which significantly reduce or eliminate the tax impact from the settlement. The drafters of ANCSA recognized this, and provisions were included which would reduce and/or eliminate taxation relative to the ANCSA settlement[18]. At a bottom line, placing former corporate assets into a Settlement Trust to provide for ongoing pro rata distributions is functionally akin to a restructuring of the Native corporation. If the initial ANCSA settlement was to be accomplished tax free, does not it follow that a restructuring of that same Native corporation should also be tax free if it leaves no new cash in the pockets of the Native shareholders?

It is worth remembering, too, Mr. Chairman, that ANCSA required Alaska Natives to incorporate to receive the ANCSA settlement, and Alaska Natives had no choice in the matter. As you know, Mr. Chairman, the corporate form carries with it a high potential

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[17] See, e.g., Maine Indian Claims Settlement Act of 1980, codified at 25 U.S.C. § 1729; the Rhode Island Indian Claims Settlement Act, codified at 25 U.S.C. § 1716; and the Connecticut Indian Claims Settlement Act, codified at 25 U.S.C. § 1754.

[18] Section 21 of ANCSA, codified at 43 U.S.C. § 1620.

tax cost in terms of double taxation (once to the corporation, once to the shareholders) and the possibility that distributions will nonetheless be taxable even though the corporation might have no profit. Had the corporate form not been employed, these anomalies would not be present. Shee Atika believes that it is a matter of fundamental fairness to reduce, to the greatest extent possible, these anomalies so that the original ANCSA settlement is not indirectly made taxable through a tax on phantom distributions.

For all these reasons, Mr. Chairman, Shee Atika believes it is critical that Congress pass legislation which clarifies Congressional intent that contributions to a settlement trust (whether or cash, ANCSA land, or other assets) do not produce disguised income to the shareholder/beneficiaries. Instead, taxation would be deferred until such time as distributions are actually made to the shareholder/beneficiaries.

Summary

Thank you, Mr. Chairman, for the opportunity to provide you this testimony. Again, Shee Atika would very much appreciate the opportunity to present oral testimony upon these important tax issues for the Alaska Native community. Shee Atika's designated contact person upon this legislation is James P. Senna. His address and telephone number are Suite 201, 200 Katlian Street, Sitka, Alaska, 99835 and (907)747-3534.

Please do not hesitate to contact us if we can provide further information.

Sincerely,

SHEE ATIKA, INCORPORATED

James P. Senna
President/CEO

STATEMENT BY HONORABLE DON YOUNG
REGARDING
SETTLEMENT TRUSTS
before the
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
JULY 11, 12, 13, 1995

Mr. Chairman and Members of the Committee, thank you for the opportunity to record my strong support for a proposal which would provide for appropriate and equitable taxation of Alaska Settlement Trusts.

In 1987 amendments to the Alaska Native Claims Settlement Act of 1971 ("ANCSA"), the Congress created Settlement Trusts, non-business entities intended "to promote the health, education and welfare of its beneficiaries and preserve the heritage and culture of natives". Subsequently, several Alaska Native Corporations, created under ANCSA, established Settlement Trusts to provide for minimum retirement assistance payments to their elders and other such trusts to promote the general welfare of the Native community.

What started out as a rather simple proposition, promoted by the Congress in its legislation -- to provide a protected source separate from the corporate entity, to assist Alaska Natives -- has now become a complex and bewildering situation. This stems from a rather bizarre Internal Revenue Service ("IRS") interpretation calling for the immediate taxation to potential beneficiaries when these trusts are established, as opposed to when funds are actually received by the beneficiaries.

In one case, the IRS is requiring Alaska Natives, with very few resources, to put up money in the form of prepaid tax payments, in order to receive monthly amounts of $125 to help them live in retirement. If they die prematurely, they may never recover the amount of the taxes paid. In other cases, Alaska Native Corporations are reluctant to follow the Congressional mandate "to promote the health, education and welfare...and preserve the heritage and culture of Natives", because of the threat of confiscatory taxation by the IRS.

It is my understanding that even the IRS administrators are uncomfortable with this situation and do not feel they can resolve the problem themselves. **Therefore, I suggest that legislation be enacted to clarify that the beneficiaries of such trusts should be taxed when they actually receive payments and not when the trusts are created.** The taxes will still be collected, but on a normal, regularized basis.

I hope you will hear the pleas of the Alaska Native community and help us apply some common sense to the taxation of these benefits -- exact a tax when the benefits are received. Thank you for your consideration.

Suggested language to correct this problem is attached.

PROVISION

Section 39 of Alaska Native Claims Settlement Act (43 U.S.C. §1629(e)) is amended to add the following new paragraph:

(d) A holder of Settlement Common Stock who is a beneficiary of a Settlement Trust created under this section shall not be subject to taxation with respect to assets conveyed to a Settlement Trust or any income earned by a Settlement Trust until a distribution of assets or income is actually received by such beneficiary.

EXPLANATION

The Alaska Native Claims Settlement Act of 1971 ("ANCSA") provided that the corporate vehicle would be the primary entity to implement the goal of settling land and other claims of Alaska Natives. Subsequently, it was determined that other Native-controlled entities might provide increased flexibility and protections to preserve and appropriately disburse the Native assets. Accordingly, the 1987 amendments to ANCSA provided for the establishment of Settlement Trusts "to promote the health, education and welfare of its beneficiaries and preserve the heritage and culture of Natives".

This opportunity has been effectively thwarted by adverse Internal Revenue Service ("IRS") rulings. The IRS has ruled that if a Native Corporation conveys assets to a Settlement Trust, its shareholder-beneficiaries will be taxed as if they received a dividend. The IRS rulings require payment of a tax by the shareholder-beneficiaries before (usually several years before) they have actually received a distribution from the Settlement Trust.

The above provision would clarify that a Native Corporation's shareholders are not subject to tax under any theory (such as that the shareholders received or constructively received a dividend or a taxable economic benefit) until they have actually received a distribution from the Settlement Trust. The provision's treatment of shareholder tax liability would not adversely affect IRS rulings holding that, with regard to the Native Corporation, the conveyance of assets to the trust is a non-taxable event except for the conveyance of appreciated property and that Settlement Trust grantors will not be treated as owners of Settlement Trusts under IRC section 675 if their powers are appropriately limited.

STATEMENT BY HONORABLE DON YOUNG
REGARDING
TAX TREATMENT OF CERTAIN DISTRIBUTIONS
OF ALASKA NATIVE CORPORATIONS
before the
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
JULY 11, 12, 13, 1995

GENERALLY

Mr. Chairman and members of the Committee, I am seeking the Committee's approval of an amendment to the Internal Revenue Code that will allow shareholders of Alaska Native Corporations to have distributions of cash proceeds from the sale of Alaska Native Claim Settlement Act (ANCSA) assets treated as a return of capital and not a taxable dividend. Proceeds eligible for this treatment will not exceed the basis of the asset. In 1992, Congress included such an amendment in H.R. 11 which was vetoed by President Bush.

PURPOSE OF AMENDMENT

The purpose of this amendment is to allow Alaska Natives to receive the value of their ANCSA settlement prior to realizing any tax consequences due to the existence of current and accumulated earnings and profits. This will not exempt the Alaska Natives from taxation of profit and gain but simply defer taxation until their rightful ANCSA settlement has been received.

BACKGROUND

In ANCSA, Congress provided that the federal government would provide the Alaska Natives with 44 million acres of land and approximately $1 billion in cash in exchange for the extinguishment of the Natives' aboriginal claims. While each Native was entitled to an equal share of the settlement, individual cash and land allocations was impractical. Therefore, the Natives were directed under the Act to form Native corporations in order to facilitate the transfer of the land and cash from the federal government. Section 21 of the Act explicitly states that the transfers are not taxable to the Native corporations.

The Act also explicitly states that distributions by the Native corporations of the cash portion of the settlement are not taxable to the Native shareholders. It does not, however, address the tax consequences of distributions of the proceeds from the sale of the resources on the land portion of the settlement. This statutory silence has caused, and continues to cause, considerable problems for Alaska Native corporation shareholders and needs to be resolved.

REASON FOR ACTION

In order to fulfill the intent of ANCSA that Alaska Natives should receive the full value of the settlement amount agreed to in exchange for the extinguishment of their aboriginal rights, clarification is needed to allow for the distribution of the proceeds from ANCSA resource sales without the Natives being subject to dividend treatment.

This would not affect the taxability of profits or gain. It would only defer such a taxable event until sale proceeds have been distributed up to an amount not to exceed the basis of the assets. Subjecting the proceed distributions to normal dividend treatment delays the Alaska Natives receipt of their ANCSA settlement.

This proposal is in no way related to the sales of net operating losses by Alaska Native corporations. As evidence of this, the proposal eliminates from the proposed tax treatment amounts directly or indirectly attributable to net operating loss sale transactions.

ANCSA was enacted in 1971. The massive bureaucratic undertaking of making land selections and transfers has taken years and in some cases remains incomplete. The Alaska Natives have endured the bureaucratic delays involved with ANCSA and should not have this delay compounded by the application of dividend treatment to certain distributions.

HISTORY OF CONGRESSIONAL ACTION

Alaska Natives have been seeking tax clarification to this shareholder distribution issue since 1988.

In 1992, the Ways and Means Committee and the House approved an amendment (H.R. 5658, 102nd Congress) to H.R. 11, sponsored by Messrs. Young and McDermott, that provided the necessary clarification. This amendment was accepted by the Senate in conference and would have become law had President Bush not vetoed the bill.

Alaska Natives believe the action of the 102nd Congress validated their claim despite the legislative vehicle being vetoed. They hope to bring this matter to its rightful conclusion in the 104th Congress as the Ways and Means Committee considers miscellaneous tax reform proposals.

DETAILED EXPLANATION OF PROPOSAL

The proposal would treat an amount of distributions by an Alaska Native corporation to its shareholders or their descendants as distributions that are not out of earning and profits, in cases where such distributions would otherwise, under Section 316 of the Internal Revenue Code of 1986, be treated as dividends.

The amount of distributions granted this treatment would be limited to an amount equal to the lesser of (1) the amount of cash received by the corporation (or its wholly owned subsidiary) on or before

December 31, 1994 from the sale by the corporation (or by such subsidiary) of any natural deposits or timber received by the corporation pursuant to ANCSA, or (2) the aggregate bases (as determined pursuant to section 21(c) of ANCSA) of such natural deposits or timber sold on or before December 31, 1994; in each case adjusted as described below.

For purposes of these computations, basis and cash attributable to natural deposits or timber that were sold in a "special purpose sale" are excluded. Such a sale is one in which a loss was recognized and which was made under an agreement entered into (1) after October 22, 1986 and on or before April 26, 1988, or (2) after April 26, 1988, if the loss incurred thereon was used in a contract referred to in section 5021(b) of the Technical and Miscellaneous Revenue Act of 1988. Also, any amount realized directly or indirectly for the use of losses or credits of the Native corporation is excluded.

The proposal would apply to any distributions after the date of enactment of ANCSA. However, the proposal does not include any special rules that would reopen any closed tax year or extend the statute of limitations for any taxpayer to permit claims for credit or refund. Nevertheless, all distributions made by Native corporations since the enactment of ANCSA are counted toward the maximum amount of distributions treated under this provision.

A draft copy of the proposed amendment is attached.

DRAFT: NOT YET INTRODUCED

104th CONGRESS
1st SESSION H.R. _____

To provide for the tax treatment of certain distributions made by Alaska Native corporations and for other purposes.

IN THE HOUSE OF REPRESENTATIVES OF THE UNITED STATES

_________, 1995

Mr. Young of Alaska introduced the following bill; which was read twice and referred to the Committee on Ways and Means.

A BILL

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

SECTION. 1. TAX TREATMENT OF CERTAIN DISTRIBUTIONS MADE BY ALASKA NATIVE CORPORATIONS.

(a) IN GENERAL. --- For purposes of the Internal Revenue Code of 1986, any qualified distribution made by a Native Corporation shall be treated as a distribution not made out of earnings and profits.

(b) QUALIFIED DISTRIBUTION.--- For purposes of this section---

(1) IN GENERAL.--- Except as otherwise provided in this subsection, the term 'qualified distribution' means any distribution to a Native (as defined in section 3 of the Alaska Native Claims Settlement Act) or descendant of a Native (as so defined)--

(A) which is made after the date of the enactment of the Alaska Native

Claims Settlement Act, and

(B) which, but for this section, would have been treated as a dividend under chapter 1 of such Code.

(2) LIMITATION.--- The aggregate amount of distributions made by any Native Corporation which may be treated as qualified distributions shall not exceed the lesser of ---

(A) the aggregate amount received in cash by such Corporation on or before December 31, 1994, from the sale of any depletable property received by such Corporation pursuant to the Alaska Native Claims Settlement Act, or

(B) the aggregate bases (as determined pursuant to section 21(c) of such Act) of depletable property received by such Corporation pursuant to such Act and sold on or before December 31, 1994, reduced by the aggregate bases of any depletable property sold in a sale referred to in subsection (c)(2)(B).

(c) ADJUSTMENTS TO AMOUNT REALIZED.--- For purposes of subsection (b)(2)(A)---

(1) there shall be taken into account any amount of cash received by the Corporation indirectly through another corporation all the stock of which is owned directly by such Corporation, but

(2) the following amounts shall be disregarded:

(A) Any amount realized directly or indirectly by the Corporation for the use of losses or credits of such Corporation or of a corporation all of the stock of which is owned directly by such Corporation where such use would not have been allowable without regard to section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986, and repealed by section 5021 of the Technical and Miscellaneous Revenue Act of 1988).

(B) Any amount realized directly or indirectly by the Corporation from a special purpose sale of any depletable property where the loss incurred on such sale was used in a manner which would not have been allowable, but for such section 60(b)(5), and such Corporation realized directly or indirectly any consideration for such use.

(d) SPECIAL PURPOSE SALE.--- For purposes of subsection (c), the term "special purpose sale" means a sale in which a loss was recognized and which was made under an agreement which was entered into either (1) after October 22, 1986, and on or before April 26, 1988, or (2) after April 26, 1988, if the loss incurred thereon was used in a contract referred to in section 5021 (b) of the Technical and Miscellaneous Revenue Act of 1988.

(e) NATIVE CORPORATION.--- For purposes of this section, the term "Native Corporation" has the meaning given such term by section 3 of the Alaska Native Claims Settlement Act as amended.

(f) DEPLETABLE PROPERTY.--- For purposes of this section, the term "depletable property" means any property of a character subject to the allowance for depletion under section 611 of the Internal Revenue Code of 1986.

(g) CLOSED TAX YEARS.--- This provision does not reopen any taxpayer's closed tax year or extend the statute of limitations for any taxpayer to permit claims for credit or refund.

DONALD C. ALEXANDER
AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

Statement on Capital Loss Carryforward Extension
Before the
Committee on Ways and Means
July 11, 1995

Mr. Chairman and Members of the Committee, I am Donald Alexander. I am a partner in the law firm of Akin, Gump, Strauss, Hauer & Feld, LLP. I am testifying on behalf of the a group of over 50 corporations supporting Congressional action to extend the capital loss carryforward period from the current five years to fifteen years. A list of these companies accompanies my statement. We would propose that the legislative change apply to losses expiring in taxable years ending after December 31, 1995. Thus, the proposal would not operate retroactively to resurrect losses which have expired in prior years.

This change would merely conform the period over which a corporation may deduct the capital losses which it has incurred to the period over which a corporation may deduct net operating losses. It is supportable on the basis of fairness, simplicity, and economic policy.

Present Law

Corporations may deduct capital losses only against capital gains. If a corporation's capital losses exceed its capital gains in any year, it may carry the excess back against capital gains incurred in the previous three years, or forward against capital gains it may incur in the following five years. If capital losses cannot be deducted within this period, the deduction is lost forever.

Taxpayers other than corporations have an unlimited number of years to deduct their capital losses against any gains they may realize in the future.

The Internal Revenue Code currently provides a much more generous rule for ordinary ("net operating") losses. Both corporate and other taxpayers may carry ordinary losses back for three years and forward for fifteen years.

Historical Background

The Internal Revenue Code has not always provided this discrepancy in treatment. Prior to 1976, the carryforward period for both net operating and capital losses was set at five years. In 1976, the carryforward period for net operating losses was extended to seven years, and, in 1981, to fifteen years. The carryforward period for capital losses has remained unchanged at five years.

The reason for the changes in the net operating loss carryforward period enacted in 1976 and 1981 is simply that corporations, as a result of economic conditions existing at the time, had net operating losses that would have expired absent extension of the carryforward period. Anyone who can recall the economic conditions of that era will certainly understand the desire of Congress to ameliorate the harshness of the short carryforward period for net operating losses. The legislative history does not indicate that expiring capital losses were causing a similar problem at the time.

It should also be noted that there is nothing in the legislative history to indicate that, in extending the carryforward period for net operating losses, Congress was making a decision that there was a policy justification for distinguishing between ordinary and capital losses. Indeed, in 1969, the issue of whether a difference in carryback rules was justifiable was explicitly addressed. The Senate Finance Committee report accompanying the Tax Reform Act of 1969 explicitly noted:

The committee sees no reason why capital losses should be treated any differently in this respect in the case of corporations than net operating losses.[1]

Present Law Overstates Income

It is very important to focus on the purpose served by the capital and net operating loss carryforward periods. Unlike certain provisions in the Internal Revenue Code, the carryforward provisions were not enacted to provide an incentive or to encourage a particular activity.

The carryforward periods exist simply to ameliorate the hardship created by an artificial tax accounting principle that the Government has applied for its own convenience: the annual income tax return. Certainly, any number of economists would agree that business and economic cycles do not always coincide with a twelve-month period. The extension of the net operating loss carryforward period from five to fifteen years was simply a recognition that businesses needed a longer period to deduct ordinary losses if the income tax was to tax true economic income.

The same issue arises today with an inappropriately short capital loss carryforward period. When corporations restructure to meet changing business conditions, they often will sell their under-performing assets and keep assets in the businesses in which they have had more success. They are, therefore, more likely to generate capital losses than gains. If the Internal Revenue Code does not allow a corporation to deduct capital losses--actual reductions in wealth--simply because a corporation does not have sufficient capital gain to offset those losses,[the Government has overstated that corporation's income. The Government is taxing income that does not exist.

The limitation in present law that allows a deduction of corporate capital losses only against capital gain emphasizes the nature of the problem. Most corporations are in the business of generating ordinary income, not capital gain. It stands to reason that it will take a corporation a longer period to generate sufficient capital gain to offset a major loss from, for example, a failed business venture, than to generate sufficient ordinary income to offset a large operating loss. Yet, the carryforward period for corporate capital losses is merely one-third the period provided for net operating losses. This makes no sense from a policy perspective.

The Supreme Court's *Arkansas Best* decision in 1988 exacerbated this problem by substantially broadening the scope of capital losses in corporate business transactions. This decision has made it even more essential that the disparity between the treatment of capital loss carryforwards and ordinary loss carryforwards be removed.

Disincentive Effect

The short carryforward period in present law creates an unnecessary disincentive for corporations to risk capital investments which create new jobs. We might hope that every investment will ultimately be successful. Unfortunately, reality teaches us that this is simply not the case. The fact that economic losses incurred as a result of a capital investment may be offset only against capital gain and must be offset within five years inevitably is taken into consideration before a corporation makes an investment and serves as a deterrent to investments that otherwise would occur.

The Five-Year Limitation Provides an Incentive to Uneconomic Behavior

Even if a corporation has appreciated assets that may be sold to offset capital losses, the short capital loss carryforward period creates an uneconomic incentive for a corporation to sell assets which they otherwise would retain, merely to avoid losing a tax deduction for real economic losses

[1] S. Rep. No. 91-552, 91st Cong., 1st Sess. 197-98.

they have incurred. It is not in the national interest to force corporations to sell capital assets, such as subsidiaries they are managing profitably and well, merely to assure that they can deduct real economic losses within an artificially limited time period.

The Limitation Places Some Corporations at a Competitive Disadvantage

It may also be of interest to the Committee that the short capital loss carryforward period operates to disadvantage U.S. corporations vis a vis their multinational competitors. For example, Canada taxes only 75 percent of capital gains and allows and provides for carryforward of 75 percent of capital losses over an unlimited period of years. The U.K. and Germany also allow an unlimited carryforward period for capital losses.

Conclusion

The *Tax Relief Act of 1995* which this committee considered and approved earlier this year provides a capital gains rate cut as part of a package to lower taxes on investment that creates jobs. We applaud your focus on the importance of encouraging capital investment.

However, we hope you will now take the opportunity to correct an additional limitation on capital investment--the limitation on the carryforward of corporate capital losses.

In many cases, this limitation effectively disallows the deduction of corporate capital losses, while leaving subject to tax future corporate capital gains which may arise. This treatment has no basis in sound public policy. Lengthening the corporate capital loss carryforward period from five years to fifteen years is an appropriate and responsible way to remedy this problem in a way that is consistent with the treatment accorded corporate net operating losses.

SUPPORTERS OF FIFTEEN YEAR CAPITAL LOSS CARRYFORWARD

American Financial Group, Inc.
Cincinnati, OH
Apogee Enterprises, Inc.
Minneapolis, MN
Arch Mineral Corporation
St. Louis, MO
Arizona Public Service Co.
Phoenix, AZ
Armco Inc.
Pittsburgh, PA
Avon Products, Inc.
New York, NY
Baker & Hughes, Inc.
Houston, TX
Black & Decker Corp.
Towson, MD
Campbell Soup Co.
Camden, NJ
Citbank
New York, NY
Continental Medical Systems Inc.
Mechanicsburg, PA
Cooper Industries
Houston, TX
CP Hall Co.
Chicago, IL
Crystal Oil Co.
Shreveport, LA
Curtice Burns Foods
Rochester, NY
Curtiss Wright Corp.
Lyndhurst, NJ
Durakon Industries
Lapeer, MI
Ecolab Inc.
Minneapolis, MN
Elmira Savings Bank
Elmira, NY
Encore Computer Corp.
Ft. Lauderdale, FL
FPL Group, Inc.
North Palm Beach, FL
Franklin Bank
Northern Michigan
Gilbert Associates, Inc.
Reading, PA
Grand Metropolitan PCL
The Pillsbury Company
Minneapolis, MN
Haliburton Co.
Dallas, TX
Herman Miller, Inc.
Western Michigan
Hershey Foods Corporation
Hershey, PA
Insilco Corporation
Dublin, OH
Rolodex
KinderCare Learning Centers, Inc.
Montgomery, Al
Komag, Incorporated
Milpitas, CA
LADD Furniture
High Point, NC
MCI Communications Corp.
Washington, DC
Mobil Corporation
Fairfax, VA
Moorman Manufacturing Company
Quincy, IL
Morton International
Chicago, IL
Mutual Savings Bank
Northern MI
National Beverage Corp.
Ft. Lauderdale, FL
Faygo Beverages, Inc.
Shasta Beverages, Inc.
Nike, Inc.
Portland, OR
Playboy Enterprises
Chicago, IL
Portland General Electric Corp.
Portland, OR
RP Scherer Corp.
Troy, MI
Salomon Inc.
New York, NY
SBC Communications Corporation
San Antonio, TX
Sequa Corporation
NY & NJ
Sierra Health Services
Las Vegas, NV
Tenneco Inc.
Houston, TX
Terra Industries
Sioux City, IA
Texas Instruments
Dallas, TX
The TJX Companies, Inc.
Framingham, MA
Tosco Corp.
Concord, CA
Tucson Electric Power Co.
Tucson, AZ
U.S. Energy Corporation
Riverton, WY
Western Financial Savings FSB
Irvine, CA

July 27, 1995

Hearing before the
Committee on Ways and Means
U.S. House of Representatives

on

Miscellaneous Tax Reform Proposals
July 11-12, 1995

Written Statement
of
Price Waterhouse LLP

Relating to a Proposal to Clarify the "Hot Interest" Corporate Underpayment Rules

Price Waterhouse LLP (Price Waterhouse) appreciates the opportunity to submit this written statement concerning a proposal to rationalize the large corporate underpayment rules of Section 6621(c) in carryover situations. Price Waterhouse strongly supports this proposal, and urges its enactment as early as possible. Many taxpayers feel the current application of the large corporate underpayment rules is arbitrary, particularly where the events creating the additional liability are unrelated to the events triggering the additional interest charges. Adoption of the proposal would address the concern in cases where the adjustment creating additional interest and the event triggering the additional interest charge are not even in the same taxable year.

Current Law

Generally, the interest rate on corporate underpayments is the Federal short-term interest rate plus 3 percentage points (sec. 6621(a)(2)). The interest rate on "large corporate underpayments" (those over $100,000) is increased to the Federal short-term rate plus 5 percentage points (the "hot interest rate") for the period beginning 30 days after a letter of proposed deficiency (a/k/a a "30-day letter") or a statutory notice of deficiency has been sent. If the proposed deficiency is paid within 30 days, hot interest does not apply. However, if the notice is not paid until the 31st day or later, the year is permanently established as a hot interest year. All current and future underpayments in excess of $100,000 for that taxable year will then be subject to the higher, hot interest rate, whether or not the underpayment is related to the event triggering hot interest charges.

A similar rule applies to underpayments of tax that are not subject to the deficiency procedures, e.g., amounts attributable to mathematical or clerical errors appearing on a return, and employment taxes. If such an underpayment is not paid within 30 days from the date of any letter or notice notifying the taxpayer of the assessment or proposed assessment of the tax, the year is permanently established as a hot interest year and all current and future underpayments in excess of $100,000 for that taxable year will be subject to the higher, hot interest rate.

Problems with Current Law

Under current law, any failure to pay any deficiency in full results in the year to which the deficiency applies becoming a "hot interest" year. Once this occurs, any future deficiency in excess of $100,000 is subject to the higher, hot interest rate, even if paid in full within 30 days from the date it is first proposed by the IRS. This applies without regard to whether such deficiency is related to the original deficiency that established the "hot interest" trigger. The result is a rule which is arbitrary in its application.

The hot interest rules provide a significant incentive to the prompt payment of deficiencies. Unfortunately, this incentive is reduced once a year is established as a "hot interest year" since that status will continue whether or not the next deficiency is timely paid.

These problems are particularly acute in cases where the tax deficiency for one taxable year arises as the result of the reduction by the IRS of a net operating loss or other carryback arising in a different taxable year. In these cases, hot interest could apply from the date that an unrelated deficiency notice was issued for the carryback year.

Example of Carryback Problem Under Section 6621(c)
This problem is illustrated in the following example.

The first deficiency: A calendar-year corporation timely files its 1992 tax return on March 15, 1993. On October 1, 1993, a 30-day notice is received for the 1992 return. The taxpayer pays the proposed deficiency on November 15, 1993. As the proposed deficiency was not paid in full within 30 days, the 31st day after the issuance of the notice is the "applicable date" for the 1992 tax year. Any underpayment in excess of $100,000 after that date is subject to hot interest. The normal rate of interest applies to the additional tax liability from the due date of the 1992 return -- March 15, 1993 -- through October 30, 1993, and hot interest runs from October 31, 1993 until it is paid on November 15, 1993.

The claim for refund on an NOL: The tax return for 1995 shows an NOL that is carried back against the 1992 year. The taxpayer files a tentative carryback adjustment on March 1, 1996, and the refund is received on April 1, 1996.

The second deficiency: In 1998, an IRS exam of the 1995 tax return determines that the 1995 loss was excessive and should be reduced by half. The IRS issues a 30-day notice proposing a deficiency in the carryback year -- 1992 -- thus reducing the amount of the refund to which the taxpayer is entitled. The notice is dated February 1, 1998, and the taxpayer pays the deficiency within 30 days of receipt.

Interest runs on the proposed deficiency created by the carryback adjustment from the original due date for the tax return of the year the NOL arose -- March 15, 1996 -- until the date the proposed deficiency is paid. The key issue is the date upon which hot interest begins to apply. Since March 15, 1996 falls after the applicable date already established for any deficiencies stemming from the 1992 tax return, the entire amount of interest on the latest deficiency is hot interest. This higher rate of interest applies retroactively to March 15, 1996, despite the fact that the original 30-day letter had been paid in 1993, the second 30-day letter was not dated until February 1, 1998, and the second 30-day letter is paid in full within 30 days of receipt.

Proposed Change

The proposal provides an exception to the large corporate underpayment rules that prevents changes to the return for one tax year from automatically triggering the higher interest rate in other tax years for which an applicable or trigger date has otherwise been established. The exception would provide that, with regard to such deficiencies, the applicable date would be the date of the letter or notice of the deficiency created by the change to the return. As with other letters or notices, this letter or notice could be disregarded if an amount equal to the amount shown as due on the letter or notice is paid within 30 days.

Changes to a return for this purpose would include amendments to returns, adjustments on examination, as well as other changes. The exception would be available wherever changes to a return result in a deficiency in another taxable period. This would include the carryover of losses and credits, as well as correlative adjustments to any item of income, expense, credit or tax.

Application of Proposed Change Relating to Carrybacks

Utilizing the example above, adoption of the proposed change would yield the following:

The first deficiency: A calendar-year corporation timely files its 1992 tax return on March 15, 1993. On October 1, 1993, a 30-day notice is received for the 1992 return. The taxpayer pays the proposed deficiency on November 15, 1993. As the proposed deficiency was not paid in full within 30 days, the 31st day after the issuance of the notice is the "applicable

date" for the 1992 tax year. The normal rate of interest applies to the additional tax liability from the due date of the 1992 return -- March 15, 1993 -- through October 30, 1993, and hot interest runs from October 31, 1993 until it is paid on November 15, 1993.

The claim for refund on an NOL: The tax return for 1995 shows an NOL that is carried back against the 1992 year. The taxpayer files a tentative carryback adjustment on March 1, 1996, and the refund is received on April 1, 1996.

The second deficiency: In 1998, an IRS exam of the 1995 tax return determines that the 1995 loss was excessive and should be reduced by half. The IRS issues a 30-day notice proposing a deficiency in the carryback year -- 1992 -- thus reducing the amount of the refund to which the taxpayer is entitled. The notice is dated February 1, 1998, and the taxpayer pays the deficiency within 30 days of receipt.

Interest runs on the proposed deficiency created by the carryback adjustment from the original due date for the tax return of the year the NOL arose -- March 15, 1996 -- until the date the proposed deficiency is paid. However, since the proposed deficiency is satisfied within the required 30 day period, none of the interest is hot interest.

Conclusion

Under current law, there is no causal connection between the subsequently determined deficiency and the triggering of hot interest with respect to the deficiency in certain instances. We believe this result is inconsistent with the legislative history of the hot interest rules and extremely unfair to taxpayers who are acting in good faith to resolve disputes with the IRS on a timely basis. Price Waterhouse, therefore, urges that the committee favorably consider the proposed change to the hot interest rules at the earliest possible date.

STATEMENT OF THE UNITED STATES TELEPHONE ASSOCIATION

SUBMITTED TO THE HOUSE COMMITTEE ON WAYS AND MEANS

JULY 27, 1995

The normalization provisions of the Tax Code have protected capital formation incentives for investors in public utility property for a quarter of a century. This protection is necessary because of the interplay between income tax provisions and utility rate-making practices.

In the 1980's, the IRS repeatedly ruled that consolidated tax adjustments violated the normalization requirements. The utility industry relied on those rulings. With the rulings withdrawn and the Treasury regulation project on this issue closed, the prognosis for consolidated tax adjustments in regulatory proceedings is uncertain. This is an important issue for the members of the USTA The consolidated tax adjustment has been raised in our regulatory jurisdictions in the past but was not adopted, partly because of the interpretations offered by the IRS rulings. The current state of the law leaves telephone companies exposed to regulatory actions that could damage business investment decisions. This situation undermines the tax policy underlying the normalization provisions - that of offering equal access to capital formation incentives for regulated and non-regulated businesses alike.

To understand how consolidated tax adjustments arise and why they are inconsistent with the fundamental policy reasons for normalization, it may be helpful to discuss the elements of rate-of-return ratemaking.

In traditional ratemaking, regulators attempt to design rates so that consumers receive affordable services while utilities receive a return of their costs, including a reasonable return on invested capital.

The ratemaking process is not an exact science, nor is it automatic. Before a rate case arises, a filing must be made by either the utility commission or an affected utility. Once the rate case begins, all elements are the subject of intense scrutiny.

The first step in a rate case is developing a test period. The test period may be historical, future, or a blend of both. The utility's authorized revenues (which ultimately translate into customer rates) are based on financial data for the test period.

The authorized revenues are based on a "ratemaking formula." This formula adds an "earnings requirement" to other costs of providing utility services. The earnings requirement is the product of the investment in the utility plant and an authorized rate of return. Thus, the ratemaking formula permits the utility an opportunity to recover its costs, including a reasonable rate of return on invested capital.

As mentioned above, however, rates are also designed to ensure that customers receive affordable services. Traditional ratemaking protects customers by making sure no element of the ratemaking formula results in excess charges. In determining the earnings requirement, a utility commission will examine the plant investment. No investment related to non-regulated business is to be included. Further, investments viewed as imprudent will be excluded. In determining a proper rate of return to apply, a utility commission will review a utility's capital structure and will impute a different structure if the ratio of debt to equity is considered unreasonable. Further, the permitted return on equity is the subject of significant controversy. The permitted return is generally viewed as the yield that would attract capital from equity investors. However, commissions generally authorize only that return deemed appropriate for a low-risk equity investment - often discounting the overall corporate cost of equity to ensure that utility customers are not burdened with a risk premium related to non-utility operations.

In assessing the utility's costs, a commission carefully reviews all items to ensure that they are directly related to the provision of utility services and are reasonable in amount. Amounts related to non-utility businesses are simply disallowed, as are costs considered unreasonable, imprudent, or excessive.

Among the costs a utility may recover are income taxes assessed on utility operations. Thus, taxes are an important factor in determining utility rates. This is where normalization

comes into play. Because Congress wished to preserve the tax benefits of accelerated depreciation for the equity investor, normalization denied those benefits to any utility if the benefit was used to reduce authorized revenues and passed directly through to customers. Instead, the benefit is provided to customers as they are charged the related depreciation expense.

Any excess tax benefit is appropriately treated as a reduction in the cost of utility plant and equipment in computing the utility's authorized earnings.

Like adjustments for the tax benefit of accelerated depreciation on utility plant, the consolidated tax adjustment compromises tax attributes intended for equity investors. This adjustment results when a utility commission determines the income tax element of the ratemaking formula by taking into account the effects of the utility's ability to join in consolidated filings with other companies. If tax loss affiliates join in the consolidated filing, a consolidated tax adjustment could be used to reduce utility rates by the tax effects related to affiliate losses.

As discussed above, all aspects of non-regulated operations are treated as distinct and separate from regulated operations in the ratemaking process. Any investment in non-utility businesses is transparent to the utility customer, as is any capital cost associated with increased risk from non-utility businesses and any costs incurred in that business. The rate-making process protects the utility customer from bearing any burdens associated with non-utility investments. It is the utility shareholder that bears the risk of those investments. To the extent tax incentives accrue from the acceptance of that risk, those incentives require as much protection as is afforded to the utility investment. The normalization provision of the Code should provide that protection by attaching penalties to ratemaking activities that impinge upon the intended economic effects of tax law.

In assessing the applicability of normalization provisions to consolidated tax adjustments, we must consider the end result of this adjustment. A consolidated tax adjustment results in a windfall to utility customers for the tax attributes of businesses for which they bear no risk. The utility shareholder alone bears this risk and, thus, earns the right to any related tax benefits. Further, if a regulator incorporates a consolidated tax adjustment, the result is decreased revenues for the utility business at the same time as affiliated non-regulated entities are reporting tax losses. This will magnify the negative impacts on federal tax revenues, with no attendant economic stimulus.

The bottom line is that regulators could reduce a utility's rates when its non-utility affiliates report tax losses, but utilities would have to request rate increases when their affiliates became profitable. Without increased rates, the utility would have to accept ever-decreasing yields on utility investments. Further, if a utility cannot obtain increased rates the ratepayer's windfall is perpetuated. The utility investor would need to report continued tax losses to maintain a fair return on its utility investment. Yet that return is maintained only by the sacrifice of tax benefits specifically ordained by Congress - exactly the result proscribed by the concept of normalization.

By reducing the effective return a utility investor can earn, a consolidated tax adjustment discourages both non-regulated investments and investments in utility property. This is contrary to the intent of normalization provisions and is particularly critical to the telecommunications industry today as it invests heavily in the development of an advanced information infrastructure. This investment activity is aimed at the deployment of sophisticated communication networks that will have a dramatic impact on American lives. An advanced communications network can promote national goals in the areas of health care, education, and the environment while furthering a healthy economy at home and U.S. competitiveness abroad. The communications network has become a critical tool around which new business opportunities will develop. Studies indicate that between 50% and 60% of all U.S. jobs involve information processing, goods or services. In fact, 90% of jobs created during the last decade were information related. Educational opportunities are unlocked for students at all economic and social levels as the network places untold resources at the fingertips of students and teachers. The economically disadvantaged, the small business, and the entrepreneur are connected to resources that were previously available only to the wealthy and large enterprises. Telecommuting is expanding, reducing the load on American highways and the pollutants in the air. Increasing informational needs put pressure on an aging telecommuting network. Meeting these needs will require significant investment in equipment and network capabilities. Tax incentives can encourage this investment by reducing its cost. Normalization is a tax policy means of protecting these

incentives and should be available to discourage consolidated tax adjustments as well as to protect capital formation incentives with respect to utility property.

For a tax incentive to be effective it must motivate an investor to accept an economic risk. It does this by providing an economic benefit. Thus, to achieve the desired response, a tax incentive should appeal to a taxpaying entity. Utility holding companies are taxpaying entities and they respond to the incentives provided by Congress in the appropriate manner: by investing funds into productive sectors of the economy. In each business decision, these companies accept the risks of their investments. Acceptance of these risks is required, as a matter of tax policy, to obtain the tax benefits provided by law. When those risks involve capital investment, normalization has preserved tax benefits for the utility investor. It is inconceivable that there would be no comparable protection for similar tax benefits incurred by non-regulated affiliates of utility companies.

Normalization was enacted to preserve capital formation incentives of the Code, to promote equity in the tax treatment of regulated and non-regulated businesses, and to avoid depletion of federal tax revenues because of ratemaking practices that flow through tax benefits. If consolidated tax savings are generated by accelerated depreciation deductions of non-utility property and those savings are passed to ratepayers in the form of rate reductions, capital formation incentives for non-regulated businesses are compromised. Other tax incentives are also compromised, as is the ability of the investor to recognize a tax reduction to mitigate the effects of a true economic loss. Companies not affiliated with public utilities face no such danger. Further, consolidated tax adjustments depress federal tax revenues and provide no compensating economic benefit. Thus, the consolidated tax adjustment violates the purposes for which normalization was incorporated into tax law.

Finally, consolidated tax adjustment impinges upon the purposes for a consolidated filing privilege in an area where this privilege is totally consistent with the intent of the normalization provisions. The consolidated return regulations were developed to promote equity between similarly situated business operations, differentiated only by the choice of legal structures. Permitting a consolidated tax adjustment in any form limits the effectiveness of the consolidation privilege for the utility investor.

These tax policy matters should be addressed by federal tax policy makers. They will not be addressed by state regulatory bodies. These bodies are motivated by many factors: universal service, low rates, political and social pressures, and ethical considerations. However, state regulators are <u>not</u> concerned with assuring that the policies underlying federal tax laws are achieved. That simply is not part of their agenda. For this reason, we urge you to consider this issue very seriously.

**WRITTEN STATEMENT OF EDWARD L. WINN, III
GENERAL COUNSEL TO THE ASSOCIATION OF
PROGRESSIVE RENTAL ORGANIZATIONS
BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES**

Submitted July 21, 1995

Mr. Chairman and distinguished members of the Committee:

My name is Edward L. Winn, III. I am General Counsel for the Association of Progressive Rental Organizations (APRO) the national trade association which represents the rental-purchase industry. I am submitting this testimony on behalf of the association in support of Item 50 of the Joint Committee on Taxation Staff Description (JCS-19-95) of Miscellaneous Tax Proposals issued July 10, 1995, which would establish a 3-year recovery period for property subject to certain rental-purchase agreements. Members of the association could be affected by this change in the law, and support the change as a fairer, more equitable method of depreciating rental property than current IRS interpretations of the law.

Mr. Wayne Chambers, a rental-purchase merchant and former president of the association, in both written and oral testimony before this Committee on January 26, 1995, outlined some of the difficulties the industry has been having with IRS interpretations of the law. In many respects, my written testimony today will complement the testimony of Mr. Chambers, a copy of which I am attaching to this testimony.

Briefly, the rental-purchase industry, made up of some 7,500 outlets nationwide in all 50 states, engages in the business of renting household durable goods to consumers, in the following categories: TVs, 16%; VCRs, 9%; stereos, 8%; appliances, 22%; furniture, 31%; miscellaneous, 14%.[1] Consumers rent these items a week at a time or a month at a time. At the end of the initial rental period, usually a week or a month, the consumer has a choice -- rent for another week or month by making another rental payment or return the merchandise with no further obligation whatsoever. Other choices include purchasing the merchandise at a discounted price, or trading up or down for different merchandise by negotiating a new deal with the merchant.

The consumer is never obligated to make another payment and there is no debt associated with the transaction. The consumer can terminate the transaction at any time. If, however, the consumer renews the agreement for a prescribed number of weeks or months in a row, ownership typically transfers to the consumer automatically without payment of any additional consideration. Rental-purchase merchants do not conduct credit checks on potential customers, nor do they require a deposit. A rental-purchase merchant is willing to allow a piece of merchandise whose wholesale cost is $300 to $500 to go out into a consumer's home for a single rental payment of perhaps $15 to $20.

The maximum number of renewal periods specified in a rental-purchase agreement is generally 12 to 24 months depending upon the type, age and condition of the property. Most new property will be rented for 18 to 24 months. As the units age, the rental ownership term will be shortened for subsequent rental customers, down to 12 months or even shorter periods. Industry statistics consistently have shown that only 25-30% of rental-purchase transactions result in title transferring to the consumer. Most consumers rent property for a while, 3-4 months, and then return it. When the property is returned, rental-purchase merchants repair and refurbish the merchandise and rent it out again to another consumer on a new rental-purchase agreement, again on a weekly or a monthly basis.

An item of rental property will typically generate revenue for a rental-purchase merchant on and off for 21 to 24 months. During some of that time it will sit in idle

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[1] Association of Progressive Rental Organizations Statistical Survey, 1994.

inventory. Most often, within two years of life in the rental-purchase merchants store, the unit will leave inventory. The consumer who is renting it will rent long enough to obtain ownership or, the merchant will sell the property off the floor, or less often, the unit will be stolen. After an item has been rented to 2, 3 or 4 different consumers, obsolescence and wear and tear make disposal of the property necessary. A certain percentage of the rental merchandise will become unrentable and must be scrapped. Accordingly, because of consumers' obtaining ownership of these used units, the destruction or theft of rental-purchase property and the abandonment of unrentable property, in most rental companies, the income stream rarely exceeds two (2) years.

For internal financial reporting purposes, nearly all rental-purchase merchants, 90% or more, use either income forecasting, 24 month straight-line, 21 month straight-line or 18 month straight-line to depreciate their rental merchandise. Recent association surveys demonstrate that as many as 80% of the companies in the industry are currently using income forecasting or some straight-line variation of income forecasting to depreciate rental merchandise for tax purposes. Of the choices available, income forecasting has been viewed by rental-purchase merchants as the most accurate means of matching revenues to expenses. Under true income forecasting, rental merchandise is only depreciated when it is generating income. In periods of time when it is idle and not generating income, no depreciation is taken.

The issue of whether income forecasting is an appropriate method of depreciation for the industry was challenged by the IRS and decided last December in a tax court case, ABC Rentals of San Antonio, Inc. v. Commn'r., TC Memo 1994-601 (December 7, 1994). In that case the tax court ruled that income forecasting was not an appropriate method of depreciation for the rental-purchase industry. The tax court ruled that revenues were predictable with some precision by the rental purchase entity and, accordingly, there was no need for the taxpayer to use income forecasting. The ABC case is currently on appeal in the Fifth Circuit.

The taxpayer in the ABC case was using the "fixed denominator" method of calculating depreciation under income forecasting. The tax years in question were 1987 and 1988. Since then, the industry has developed more accurate methods of calculating depreciation using income forecasting, namely the "floating denominator" method of depreciation which recalculates the predicted revenue remaining on a unit for each time it is returned to the store. Many rental-purchase merchants are persuaded that the facts in the ABC case are distinguishable from how they are currently depreciating their rental merchandise and, therefore, many dealers have elected not to follow the tax court ruling and, instead, are continuing to use income forecasting. Therefore, the industry feels that if the Congress allows 3 year MACRS depreciation for the rental-purchase industry, given how most of the industry is currently calculating depreciation, there will be some revenue increase in taxes paid by rental-purchase companies which will move from depreciating rental merchandise over roughly a two-year period under income forecasting to a three-year period under the new law. Nonetheless, the industry, in order not to have to continue to litigate the issue of the appropriate depreciation method of rental merchandise, supports the 3 years MACRS category as fair given the choices that currently exist in the Code.

It is clear to rental-purchase merchants that requiring them to use 5-year MACRS depreciation is simply unfair. It causes a significant mismatch between income generated by an item of rental property and the cost of producing that income. The result is an unfair acceleration of income due to the postponement of depreciation until the unit leaves inventory. The increased tax works a special hardship on small companies which are the mainstay of the association (80% of association members own 5 or fewer stores).

Mr. Chambers' previous testimony provided an illustration comparing income forecasting to 5 year MACRS. The illustration below compares 3 year MACRS, 5 year MACRS and income forecasting. The chart assumes that rental income remains the same, two-thirds being received in year one and the balance in year two. Three year MACRS is a

closer match of revenues to expenses than 5 year MACRS and has wide-spread industry support.

	Percentage of Income Received	Percentage of Cost Recovered Using Income Forecasting	Percentage of Cost Recovered Under 5-Year MACRS	Percentage of Cost Recovered Under 3-Year MACRS
Year One	66 2/3%	66 2/3%	20%	33 1/3%
Year Two	33 1/3%	33 1/3%	80%	66 2/3%

The proposal to allow the rental-purchase industry to depreciate its rental merchandise over a three year class life would result in fair taxation to the industry. It would reduce the economic costs to the industry of the unjustified deferral of cost recovery deductions until the end of the rental dealers' income stream if the industry were forced to use 5-year MACRS on property that only lasts for 2 years. In addition, this recognization of depreciation method applicable specifically to rental-purchase transactions by the Congress would be consistent with 42 states which have recognized rental-purchase agreements as leases.

Thank you for the opportunity to submit this testimony on this most important issue to the rental-purchase industry.

apro\testimony.elw

STATEMENT OF WAYNE E. CHAMBERS
of the
ASSOCIATION OF PROGRESSIVE RENTAL ORGANIZATIONS
before the
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

January 26, 1995

Mr. Chairman and distinguished Members of the Committee:

My name is Wayne Chambers. I own and operate a rental-purchase business. I am also a director of the Association of Progressive Rental Organizations ("A•PRO"), which is a nonprofit national trade association representing the rental-purchase industry. The rental-purchase industry is comprised of hundreds of businesses that rent household durable goods to consumers on a short term basis. A•PRO represents nearly 500 of the businesses in the industry, most of which are small companies.

I am pleased to present to this Committee A•PRO's and my views regarding the principles of neutral cost recovery set forth in H.R. 9, the *"Job Creation and Wage Enhancement Act."* In particular, I want to discuss a cost recovery problem currently faced by the rental-purchase industry that should be addressed in connection with the proposed legislation.

By indexing depreciation against inflation, the proposed legislation promises to reduce the economic costs of the deferral of depreciation deductions. The economic costs to the rental-purchase industry of the deferral of depreciation deductions may well eliminate jobs and could even put some companies out of business. Inflation, however, is only one factor contributing to such economic costs. For the rental-purchase industry, unjustified economic costs of much greater magnitude are created by an IRS interpretation of tax rules (upheld in one case by the Tax Court) that would mandate cost recovery of rented property over five years (or longer). Under the IRS interpretation, rental-purchase property would be depreciable over a five year class life, even though the income stream generated by that property rarely exceeds two years. This postponement of cost recovery deductions cannot be justified on any theory of matching income with related deductions.

Description of Rental-purchase Industry

The rental-purchase industry is a young industry comprised of more than 7,500 stores throughout the 50 states that currently employ approximately 50,000 persons and are estimated to generate more than $4.5 billion of revenue per year. The typical rental-purchase dealer is a small company or sole proprietorship that has very limited capacity to

finance its inventory with borrowed funds. Most of them have virtually no capacity to finance the additional tax liability attributable to the postponement of cost recovery deductions.

Rental-purchase businesses rent household durable goods -- such as furniture, TVs, stereos, VCRs, refrigerators, washers and dryers -- to consumers on a short term basis. Virtually all of the industry's customers are individuals who obtain the property for personal household use. While customers enter rental-purchase transactions for a broad variety of reasons, many customers enter the transactions becaue (i) they have only a temporary need for the property, (ii) they want no continuing payment obligations, or (iii) for a variety of reasons, they are not sufficiently creditworthy to purchase the item on a credit sale basis. Thus, the rental-purchase industry occupies an important niche among suppliers of household goods.

Rental-purchase transactions are designed to provide flexibility to customers by permitting them to obtain immediate use of the property on a week-to-week or month-to-month basis without incurring financial obligations beyond the one-week or one-month term of the agreement. Because the customer has no obligation to continue making rental payments, rental-purchase dealers do not conduct credit checks or require a deposit. The customer makes one rental payment on the date he enters a rental-purchase agreement and has no obligation to make any additional payments. The typical rental-purchase agreement has an initial term of one week or one month. Although a customer has the option to renew the agreement for an additional term of one week or one month, the customer has no obligation to renew the agreement. The customer can elect at any time to return the property (or have the dealer pick up the property) without any further obligation.

If the customer elects to renew a rental agreement for an item of property for the maximum number of rental periods stated in the agreement, title to the property is transferred to the customer. The maximum number of renewal periods stated in the agreement usually covers a period of 12 to 24 months, depending on the type, age and condition of the property. The customer also can purchase the property before the end of the maximum number of rental periods by paying an amount stated in the agreement. The purchase option price generally equals a stated percentage (usually ranging from 50% to 80%) of the payments that would be made during the remainder of all possible renewal periods stated in the agreement.

Industry experience shows that only 25 to 30 percent of all rental-purchase agreements result in the customer ultimately obtaining title to the property. On average, a customer will make rental payments and maintain possession of an item of rental property for approximately 12 to 14 weeks after which the customer returns the property to the dealer. An item of property typically is rented to three or four different customers before a customer obtains title or the dealer abandons the property. Moreover, rental-purchase dealers often experience theft of 10 percent or more of their inventory per year.

Rental Income Stream

The average stream of income from an item of rental property is approximately 21 to 24 months. After an item of property has been rented to two or three different customers and subsequently returned to the store, obsolescence and wear and tear force the rental-purchase dealer to reduce the rental amount and/or the maximum possible number of renewal periods. As a result, the third or fourth customer is more likely to renew the rental-purchase agreement enough times to acquire ownership of the used property. Moreover, because renters tend to treat property with less care than owners, the used property often becomes unrentable and must be abandoned by the rental-purchase dealer. Thus, because of customer payouts and the destruction or theft of rental-purchase property, on the average a dealer's income stream from an item of property does not exceed two years.

Cost Recovery

Income Forecast. Members of the industry generally have depreciated rental-purchase property using the income forecast method.[1] Under this method, a rental-purchase dealer's depreciation deductions are closely matched with the income stream generated by the rental property. Using the income forecast method, the annual depreciation deduction is determined by multiplying (i) the adjusted basis of an item of property by (ii) a fraction, the numerator of which equals the amount of rent received during the year under all agreements relating to such property, and the denominator of which equals the total estimated rent that will be received over the remaining life of the property. For example, if rent in the amount of $50 is received during the year from an item of property, and the item of property had been expected to generate a total of $150 over its remaining life, then the depreciation deduction for the year using the income forecast method equals one-third (50/150) of the adjusted basis of the property.

Five-Year MACRS. Late last year, the U.S. Tax Court held that a particular rental-purchase dealer could not use the income forecast method. ABC Rentals of San Antonio Inc. v. Commissioner, T.C. Memo 1994-601 (December 7, 1994). Despite its finding that the rental property on average remained in the taxpayer's inventory only 21.6 months, the Tax Court indicated that the rental-purchase dealer was required to depreciate its rental property under Section 168 of the Code using a MACRS class life of five years.[2] The Tax

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[1] Section 168(f)(1) of the Internal Revenue Code allows a taxpayer to elect out of the Modified Accelerated Cost Recovery System ("MACRS") depreciation rules and properly use a method not expressed in terms of years. The income forecast method is such a method.

[2] For purposes of computing the alternative minimum tax, such rent-to-own property generally would be depreciable using a MACRS class life of nine years.

Court held that the income-forecast method could be used only for property that is "similar in character" to motion picture and television films and sound recordings.

Economic Harm from Deferral of Depreciation

If rental-purchase property is required to be depreciated using a five-year class life there will be a significant mismatch between the income stream generated by an item of rental property and the costs of producing that income. Such a mismatch will result in income from that property being taxed more quickly than it should be, to the economic disadvantage of the dealer. While the income stream from an item of rental property in general is spread over a 21 to 24 month period, the use of a five-year recovery period under MACRS defers most of a dealer's cost recovery until the last year the dealer uses the item of property in its rental inventory. The postponement of the rental-purchase dealer's cost recovery deduction is a significant economic loss based on the time value of money. The loss reduces the dollar amount available to a rental-purchase dealer to reinvest in new rental inventory items. The economic harm is particularly acute because most rental-purchase dealers are small companies or sole proprietorships that have very limited capacity to finance their inventory with borrowed funds. Thus, the postponement of cost recovery deductions will effectively reduce the volume of their business.

As an illustration, assume that a dealer acquires an item of rental property and places it in service on January 1 of Year One and depreciates the property using five-year MACRS (using the applicable half-year convention and the double declining balance method). Assume that a customer ultimately obtains title to the property as of June 30 of Year Two. In this example, 66⅔% of the dealer's rental income from the property is recognized in Year One, and 33⅓% of the rental income is recognized in Year Two. Using five-year MACRS, the dealer recovers only 20% of the costs of the property in Year One as a depreciation deduction, and recovers 80% of the costs in Year Two.[3]

	Percentage of Income [illegible]	Percentage of Cost Recovered Using Income Forecast	Percentage of Cost Recovered Under 5-Year MACRS	% of cost recovered under 3-year MACRS
Year One	66 2/3%	66 2/3%	20%	
Year Two	33 1/3%	33 1/3%	80%	

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[3] To the extent the dealer places property in service later in Year One, the mismatch is less dramatic, but nonetheless significant.

This mismatch between the timing of a dealer's income and cost recovery deductions causes an economic distortion. The dealer's taxable income and tax liability during the first year of the life of an item of rental property are unfairly overstated. Although the dealer's taxable income and tax liability during subsequent years is understated, the dealer bears the economic burden of the time value of the front-loaded tax liability.

Recommendation

A•PRO urges Congress to enact legislation expressly authorizing the application of the income forecast method for depreciating rental-purchase property. The tax law should reflect the actual business conditions in, and practices of, the industry. To require the MACRS depreciation period of five years results in a mismatching of revenue and costs in the rental-purchase industry. By reflecting depreciation for the periods that the property is actually leased, the income forecast method properly matches costs and revenue and more clearly reflects income.

Alternative Recommendation

In the alternative, A•PRO urges Congress to enact legislation authorizing the depreciation of rental-purchase property over a three-year class life under MACRS. Although three-year MACRS would not match a rental dealer's income with its depreciation costs as closely as the income forecast method, a three-year class life would provide a closer match (and a clearer reflection of income) than a five-year class life under MACRS.

* * *

Legislation expressly providing for depreciation of rental-purchase property under the income forecast method (or over a three-year class life) would reduce the economic costs to the rental-purchase industry of the unjustified deferral of cost recovery deductions until the end of a rental dealer's income stream. Moreover, consistent with statues in 38 states recognizing rental-purchase agreements as valid leases, such legislation would expressly confirm that rental-purchase agreements are true leases for tax purposes. Without such legislation, the economic costs to the rental-purchase industry of the unjustified postponement of cost recovery deductions will unnecessarily paralyze these small businesses, causing some to close.

Thank you for the opportunity to present my statement on this important issue.

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July 26, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Miscellaneous Tax Reforms

Dear Mr. Moseley:

This letter is submitted on behalf of the National Association of Music Merchants (NAMM) for inclusion in the printed record of public hearings held July 11-12, 1995 dealing with miscellaneous tax reforms.

By way of background, NAMM is an international organization which represents more than 4,500 retailers and manufacturers of musical instruments and related equipment. In addition to selling musical instruments, many of NAMM's retailer members rent instruments and equipment, typically to the parents of school-age children. These parents want their children to experience the positive effects of music education, but may be reluctant to make a financial commitment for the purchase of an instrument until they are satisfied that their child will, in fact, like the instrument chosen.

Thus, many of NAMM's members engage in the rental of instruments with a purchase option. The initial rental period is usually of short duration, generally between 3-6 months (coinciding with a school semester); the customer is given the opportunity to either return the instrument at the end of the initial period, or continue the rental until sufficient payments have been made to acquire ownership.

One of the proposals considered at the Committee's hearings on miscellaneous tax reforms would provide a three-year recovery period for property subject to a "qualified rental-purchase agreement." As described, a "qualified rental-purchase agreement" is an agreement that provides (1) for the rental of tangible personal property for an initial period of four months or less, (2) for the renewal of the agreement at the option of the renter for a

period of four months or less, (3) that the renter is not obligated to renew the agreement and may terminate at the end of the rental period, and (4) that the renter may at its option acquire ownership of the property either (a) at a stated amount based on the agreement (if required by law) at the end of the rental term, or (b) at a specific price or formula if acquired during such term. Under present law, such property generally has a five-year recovery period.

NAMM strongly endorses adoption of this proposal, with one amendment.

NAMM believes that reducing the period for cost recovery from five years to three years is a positive step, since the shorter period more closely approximates the maximum period during which rental payments must be made before ownership is acquired.

However, NAMM believes that, should the Committee include this provision in any tax reform legislation it reports, the definition of "qualified rental-purchase agreement" should be changed to include those agreements which have initial periods of six months or less, as contrasted with four months or less.

Our reasoning is based on the existence of two approaches toward the regulation of these agreements. The federal Consumer Leasing Act (15 U.S.C. §1667) provides a series of disclosures applicable to rentals with an initial period of more than four months, regardless of whether a purchase option is offered. Since the Act was passed in 1976, some 42 states have adopted specific statutes regulating disclosures which must be made in rental-purchase agreements with an initial period of four months or less, where a purchase option is present. Thus, NAMM members and others who wish to rental tangible personal property may freely choose which disclosure scheme they wish to follow.

Because the contemplated definition of a "qualified rental-purchase agreement" appears to comply with the definition used in the 42 state laws, its adoption at the federal level as part of the Internal Revenue Code would have the effect of forcing NAMM members and others to opt for the state regulatory scheme, which in some states is unduly burdensome for rental dealers.

Changing the rental period to six months or less in the Committee's proposed definition of "qualified rental-purchase agreement" would preserve the dealer's option to select one of two regulatory scheme, while at the same time assuring that the intent of the proposed tax reform is met, i.e., to limit its application to short-term rental transactions which have a purchase option.

We would be happy to meet with you or a designated Committee staff member to discuss this issue should you desire.

Sincerely,

James M. Goldberg

WRITTEN STATEMENT

OF

THE NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PROPERTIES

ON THE DEPRECIATION OF LEASEHOLD IMPROVEMENTS

BEFORE THE HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

JULY 12, 1995

The National Association of Industrial and Office Properties, (NAIOP), welcomes the opportunity to submit views of the commercial real estate industry regarding the cost recovery period associated with leasehold improvements. NAIOP is a professional Association comprised of over 5000 members engaged in owning, managing and developing industrial, office and other commercial related properties in the United States and internationally. Our members include not only the nation's leading developers, but also architects, brokers, engineers, financial planners, insurance companies, master planners and many other related real estate trades.

The 39-Year Depreciation Period of Nonresidential Structures and Tenant Improvements

Leasehold improvements typically include the interior elements that office, retail and other real estate lessees require in order to operate their businesses. While the exterior of a building may only require periodic upgrades, the interior components of most rental properties are reconfigured on a regular basis to meet the needs of new and existing tenants.

Current law forbids tenants and landlords form amortizing leasehold improvement costs over their useful life—the expected term of the lease (five-to-ten years). Instead, they must be recovered over the Tax Code's determined depreciable life of the structure--39 years.

The economic results of these depreciation rules can be absolutely absurd when applied to a landlord that must manage a large mix of tenants. This is because most improvements have no value beyond a specific tenant and the term of their lease. Simply stated, improvements are made to meet a tenant's business specifications. When a tenant leaves, the space must be built-out all over again to satisfy the new lessee.

The origin of this problem can be traced back to 1981. Prior to this time, real property was depreciated using a component method. Different depreciation schedules were used to write-off the basic building structure, electrical wiring, HVAC, and so forth. Leasehold improvements were generally written off over the life of the lease on the space.

In 1981, however, component depreciation was repealed and replaced by a simplified system where the entire building and all improvements were written off over a single recovery period. Because that recovery period was 15 years, this did not pose a real problem for leasehold improvements.

But beginning in 1982 and continuing for the next 11 years, the recovery period for commercial property was gradually extended to 18 years, then to 19 years, then to 20, 31-1/2, and finally to the current 39 year depreciation period. There was no return, however, to a shorten write-off period for leasehold improvements. Essentially, we now have pre-1981 treatment for building, but post-1981 treatment of build-out expenses.

Quite frankly, the 39-year depreciable life of non-residential structures is a non-economic injunction on the real estate industry and does not reflect the realistic, useful life of a structure or, particularly, its components. The Tax Code's long-standing principle of deriving true net income by matching expenses on an investment over the same period of time the investment earns income is arbitrarily denied to property owners.

Furthermore, this current policy hinders urban renewal and construction job opportunities as improvements are delayed or simply not undertaken. Where they are taken, the costs are passed on

to the tenant which artificially inflates market rental-rates and impedes the ability of small businesses to penetrate many business districts.

Additionally, the policy inhibits the infusion and use of technological advancements being made towards more energy efficient and environmentally friendly building elements. Its seems a shame that the very communities that the government is trying to assist, by attempting to eliminate burdensome federal laws and regulations, are subject to taxation that has no alignment whatsoever with economic reality. That reality is, tenant improvements are made for a tenant, not the building, and when the tenant vacates the building, that space will need to be reconfigured. The expenses that property owners repeatedly incur on behalf of maintaining their businesses should be matched with the useful life of their investment.

Shaw/Rangel Legislation

Because of the incredible timetable of the first 100 days of the 104th Congress, the tax provisions of the House-passed legislation had to be limited to items contained in the original "Contract With America." This, unfortunately, did not allow the House-passed bill to include legislation introduced by representatives Shaw and Rangel (H.R. 1171) that would correct the flaw in the tax treatment of leasehold improvement expenses. While a provision was included in the House-passed tax bill that clarifies that building owners can "close-out" these accounts once improvements are discarded, legislation is still needed to correct the underlying problem.

Simply stated, H.R. 1171 would enable building owners to match more closely the expenses incurred to construct leasehold improvements with the income these improvements generate under their leases. The would reduce the time period for writing off these expenses to 10 years to roughly approximate the average commercial lease.

Summary

As a result of today's flawed depreciation rules, the after-tax cost of reconfiguring, or building out, office retail or other commercial space to accommodate new tenants or modernizing work places is artificially high. This is because building owners are unable to fully deduct the economic costs expended on leasehold improvements over the period in which the improvements actually generate income.

The current policy also hinders urban reinvestment and construction job opportunities as improvements are delayed or not undertaken at all. Especially given the absence of new building construction in many markets, opportunities for the Nation's seven million construction and building trade workers for the remainder of the decade will largely be tied to the renovation and rehabilitation of existing commercial space.

Moreover, a widespread shift to more energy-efficient, environmentally sound building elements is discouraged by the current tax system because of their typically higher expenses.

Fortunately, the House Ways and Means Committee was able to include in the House passed tax bill a provision easing the absurd depreciation section of our tax laws. Accordingly, if leasehold improvements find their way to the dumpster at the end of a lease term, a building owner could write off or "close out" the remaining balance in this depreciation account the same year. This simple change makes sense, and it is necessary to prevent an even greater penalty on building owners.

The greater goal, however, is to reduce the write-off period for these expenses to match economic reality. Enactment H.R. 1171 will lead to a healthier and more efficient real estate economy.

The National Association of Industrial and Office Properties is encouraged by the tax proposals making headway in both Houses of Congress and are pleased to provide any input that will continue your endeavor to establish a more judicious, and economically oriented tax system.

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TESTIMONY OF BERNARD J. VAUGHAN
FLEXI-VAN LEASING, INC.

Mr. Chairman, thank you very much for the opportunity to testify before the Ways and Means Committee regarding needed legislative clarification of the tax treatment of intermodal containers.

Mr. Chairman, twice in the past this Committee has endorsed the proposed clarification concerning the tax treatment of intermodal containers which is the subject of this testimony. Moreover, both times this Committee acted on a bipartisan basis. First, in 1990, this Committee favorably reported out H.R. 5017, "The Intermodal Container Tax Clarification Act of 1990", of which Mr. Matsui was a lead sponsor. Congress adjourned before final action could be taken on that bill. As a consequence, once again, in 1992, the Ways and Means Committee favorably reported the clarification (H.R. 5674), which then became part of H.R. 11 (The Revenue Act of 1992). Unfortunately, because President Bush vetoed H.R. 11, this Committee, for the third time, is faced with the task of drafting legislation to provide needed clarification to the tax treatment of intermodal containers.

The proposal now before the Committee, like those which it previously approved, seeks to prevent a substantial retroactive change in the ability of U.S. companies to claim the investment tax credit and accelerated depreciation on the intermodal cargo containers which they lease to shipping companies and businesses. The proposal specifically is intended to overrule Revenue Ruling 90-9 with respect to containers placed in service by U.S. container lessors prior to January 1, 1990.

From its original enactment in 1962 until its general repeal in 1986, the investment tax credit generally was not allowed for property used predominantly outside of the United States. However, exceptions to this rule were provided for certain categories of assets used to transport people or property to and from this country. These exceptions sanctioned the predominant foreign use of transportation-related property as part of the credit's general purpose to improve our competitive position in the world economy. One of these exceptions applied to containers used in the transportation of property to and from the United States.

Prior to 1990, there were no Treasury regulations or rulings interpreting the exception for containers, even though that provision had been law for more than 25 years. Consequently, container owners relied on a common sense reading of the statute and the apparent Congressional intent regarding the container provision when determining both how the credit applied to their containers and whether containers qualified for the related accelerated depreciation. Significantly, for more than 20 years, the audit practice of the Internal Revenue Service ("I.R.S.")was to confirm the general availability of credits and deductions claimed by two groups of container owners, U.S. shipping companies and U.S. container leasing companies. Moreover, for lessors, the container credit was by far the largest item on each tax return and was reviewed by I.R.S. audit agents in numerous audits. Over the years, the I.R.S. also issued liberal interpretations of other transportation-related exceptions which further confirmed the lessors' understanding of the container exception.

Beginning in 1984, I.R.S agents chose to ignore some 20 years of administrative practice and radically altered their audit practices with respect to container lessors by disallowing the credit for containers because the lessors could not prove that each container touched the United States each year. In 1990, this approach was formally published in Revenue Ruling 90-9, which required all container owners who claimed an investment tax credit and related accelerated depreciation to demonstrate on a container-by-container basis that a "substantial" portion of a particular container's activity during the taxable year is in the "direct" transportation of property to or from the United States. "Substantial" is not defined or described in the ruling, so taxpayers have no basis on which to argue that they have met the ruling's requirement. The ruling defines "direct" transportation as involving only those trips that begin and end in the United States; trips between foreign ports are not taken into account, even if the property inside

the container may eventually come to the United States. The conceptual framework of Revenue Ruling 90-9 had no foundation in the law it sought to apply: neither of the terms "substantial" and "direct" was used in the statute or regulations, and neither had any support in the legislative history. Moreover, the ruling was applied retroactively.

Whatever the merits of the approach adopted by the Revenue Ruling, it constituted a dramatic change from established practices. That shift is objectionable--and unjustifiable--for numerous reasons.

First, it is fundamentally unfair for the I.R.S. to retroactively interpret--and modify--the statutory container exception in this manner: in the 20-year period following enactment of the credit, container lessors never had any indication that their records were inadequate to support their claiming the credit and related deductions, despite numerous audits. The I.R.S. had opportunities to issue regulations or rulings on the container exception, but did not provide these or any other form of public notice of new administrative requirements. Indeed, in 1981, the I.R.S. undertook a project to provide guidance on the container exception, yet a year later, after meetings with container leasing industry representatives, ended the project without any apparent revisions to existing practices. That decision by the I.R.S. should not be overlooked: in short, the I.R.S. specifically scrutinized industry practices with respect to claiming the credit and related accelerated depreciation and with respect to record keeping and chose not to require any changes.

Second, the I.R.S. interpretation is inconsistent with judicial precedents which have liberally interpreted the investment tax credit provisions and rejected administrative attempts to narrow its application. This interpretive approach of the courts, which is also reflected in I.R.S. interpretations of other transportation-related exceptions which accompany the container provision, reflects the courts' reading of Congressional intent.

Third, as Treasury and the I.R.S. apparently have recognized in this case, such a major change in interpretive policy is a tax policy decision that requires careful review by the I.R.S. and Treasury, followed by publication in a national policy statement which permits appropriate public comment, such as through proposed regulations. Only through such a national pronouncement can all affected taxpayers be fairly put on notice that such a change has occurred. Any such major change of policy should be prospective only and should include complete relief under section 7805(b) of the Internal Revenue Code.

Fourth, any change in interpretive policy by the I.R.S. with respect to the container exception should balance the I.R.S.'s strict, and in our view incorrect, reading of the statute against the need for a practical and reasonable resolution of the controversy. It is clear that Congress did not contemplate that the I.R.S. would interpret the container exception in a manner which would make it virtually impossible, as a practical matter, to utilize the benefits of the provision. The Revenue Ruling would require lessors to document retroactively the daily movements of individual containers. Providing such documents prospectively will be difficult enough, given that container lessors now typically manage fleets in excess of 200,000 containers that are used in carrying goods for lessees who are not under the control of the lessors. But retroactively providing such documents simply is impossible. Lessors keep detailed records about their containers, but they cannot maintain records regarding container movements when they are not in control of the containers. Lessee documents, to the extent they have not already been disposed of for prior years, focus on shipments of cargo, not on the specific containers, and often are not in computerized form or otherwise accessible and retrievable. Indeed, the cost of attempting to obtain detailed records from lessees to reconstruct the itinerary of a particular container in all likelihood would exceed the value of the credit or other tax benefits.

The Revenue Ruling applied to open taxable years, which generally included all of the 1980s for the leasing companies. That is a long period, but the lessors' exposure is

even greater because the ruling also applied to containers placed in service in closed taxable years but which generated credit carryovers to open years. This extended the Ruling's effect back as far as 1974.

If container lessors were on notice of the I.R.S. position through the issuance of a ruling or regulation on this issue 25 years ago, they could have taken appropriate steps to qualify for the credit or to challenge the I.R.S. interpretation in a timely manner. In any event, they could have set leasing rates and information requirements based on the costs of complying with the interpretation. Particularly in light of prior administrative practices over more than two decades, the retroactive imposition of a restrictive interpretation is unreasonable and unjustified.

As an alternative to the substantive and record keeping requirements of the Revenue Ruling, a safe harbor was provided in Revenue Procedure 90-10, published at the same time as the Revenue Ruling. It is interesting to read the portion of the Revenue Procedure which confirms that the Revenue Ruling's record keeping requirements are unfair, noting that a safe harbor is necessary because separate tracing of containers is too costly and difficult given the numbers of containers and the fact that lessees have physical control over the containers or the records relating to the containers.

Moreover, the safe harbor effectively allows only a portion of the credits at issue for prior years. For 1981 and later years, the allowance is only 50 percent. This is neither an adequate nor a fair solution to the retroactive problem posed by the Revenue Ruling. Industry statistics made available to the I.R.S. prior to the issuance of the ruling showed that, during every relevant year, the United States was the leading country for containerized exports and imports. Given those statistics, it should have been presumed that containers traveled in due course to or from the United States simply because of the prominence of the United States in world trade in general and container traffic in particular. Instead, the practical effect of the IRS position is that, if a taxpayer believes it is entitled to more than a 50 percent allowance, the taxpayer is required to document retroactively every container trip taken during every year in the recapture period, in order to meet an undefined "substantial" use test in the ruling. I believe that this position is clearly inconsistent with the language and the intent of the statute relating to containers.

For several years prior to the issuance of Revenue Ruling 90-9, taxpayers engaged in discussions with the I.R.S. about this issue in an effort to achieve an administrative result which would fairly resolve the controversy. More recently, the issues presented by Revenue Ruling 90-9 have led to considerable litigation. Unfortunately, neither negotiation nor litigation has proven constructive in the absence of Congressional clarification of its intent. A legislative resolution is now essential to prevent the unfair retroactive impact of the I.R.S. revenue ruling. Therefore, I respectfully urge the Ways and Means Committee to support the prompt enactment of the proposal now before the Committee.

Mr. Chairman, for your reference, set forth below is a more technical analysis of current law, the proposed clarification, and the issues they present.

Current Law

Prior to its repeal by the Tax Reform Act of 1986, the regular investment tax credit generally was not available for property which was used predominantly outside the United States. An exception to the predominant foreign use rule was provided in former Code section 48(a)(2)(B)(v) for "any container of a United States person which is used in the transportation of property to and from the United States." (Similar transportation-related exceptions also were provided for aircraft, railroad rolling stock, vessels, and motor vehicles.) Property of the type described in the container exception also was eligible for the most favorable accelerated depreciation. To better reflect the continued application of the container exception under the depreciation rules, the container

exception (and the other transportation-related exception to the predominant foreign use rule) were move to Code section 168(g)(4) by deadwood provisions of the Revenue Reconciliation Act of 1990.

For more than 25 years following the enactment of the investment tax credit in 1962, there were no regulations or rulings interpreting the container exception. Taxpayers and audit agents applied the container provision with minimal controversy.

In 1990, the I.R.S. published the first formal interpretation of the container exception in Revenue Ruling 90-9, which allows the credit and accelerated depreciation deductions only if a taxpayer can document on a container-by-container basis that a substantial portion of a particular container's activity during the taxable year is in the direct transportation of property to or from the United States. In the absence of such documentation, a taxpayer would be required to use a less favorable depreciation method applicable to tangible personal property used predominantly outside the United States. Revenue Ruling 90-9 states that "direct transportation" consists of the transportation of property by the container with the United States as the origin or terminus of the trip for the container and the property. Revenue Ruling 90-9 applies retroactively.

Revenue Procedure 90-10, which was published contemporaneously with Revenue Ruling 90-9, provided a "safe harbor" option for those who could not comply with the new record keeping requirements imposed by the ruling. Specifically, Revenue Procedure 90-10 allowed a taxpayer to make an irrevocable election to use certain specified percentages to determine the aggregate basis of intermodal cargo containers placed in service in 1974 and all subsequent years that would be deemed used in the direct transportation of property to or from the United States, and thus would be eligible for the investment tax credit and related accelerated depreciation. The election was available regardless of whether the taxpayer maintained sufficient records to trace the usage of cargo containers.

Several cases relating to the application of section 48(a)(2)(B)(v) are pending in the United States Tax Court as a result of the issuance of Revenue Ruling 90-9. On January 11, 1995 the Tax Court issued an opinion in Norfolk Southern Corp. et al. v. Commissioner, 104 T.C. No. 1, in which the court stated that the meaning of the phrase "used in the transportation of property" was an issue "of first impression" and that "[i]t appears that Congress did not explicitly consider the extent of contact with the United States a container must have to satisfy the container exception."

In the absence of express guidance from Congress, the Tax Court in Norfolk adopted an "actual use" test that requires "one contact with the United States" during the year a container is placed in service (regardless of when or where the container is placed in service during the year), plus proof of actual transportation of property to or from the United States at least once each year thereafter during the recapture period. That test is not set forth in the legislative history of section 48(a)(2)(B)(v) or in the Treasury regulations adopted under that section. Moreover, it differs from the respective tests urged upon the Tax Court by the taxpayer and the Commissioner in Norfolk.

The decision in Norfolk is likely to be appealed, possibly by both the taxpayer and the Commissioner. Other cases pending in the Tax Court, once decided, are appealable to various different Courts of Appeals, raising the possibility of years of litigation and inconsistent opinions from various courts in order to resolve this issue. It is thus particularly appropriate for this issue to be resolved by the Congress at this time.

Reasons For Change

Revenue Ruling 90-9 imposes a highly restrictive interpretation of the container provision which is not set forth in the regulations or legislative history of the provision

and necessitates detailed record-keeping requirements on a retroactive basis. In addition, it represents a substantial change from more than 20 years of I.R.S. audit practice. Retroactive application of the revenue ruling would be substantially unfair given the probable impossibility of developing the required records from prior years. The revenue procedure's alternative "safe harbor" allowing 50 percent of claimed credits for prior years is unfair and has not provided an adequate basis for an industry-wide settlement of this controversy.

To prevent a significant retroactive change in policy and the continued expense of protracted litigation, a statutory standard is necessary for application of the container provision in prior years.

Proposed Change

The proposal now before the Committee would provide a statutory standard for determining the eligibility of leased intermodal cargo containers for the investment tax credit and accelerated depreciation deductions. This standard would apply retroactively to leased containers placed in service before January 1, 1990, thereby overruling the I.R.S.'sinterpretation in Revenue Ruling 90-9.

The proposal would describe a particular category of leased containers which qualifies for the credit and deductions under the container exception. (Containers that would be treated under the proposed legislation as being described in the container exception also must satisfy any other applicable requirements for eligibility under the credit and depreciation rules.) The proposed legislation would explicitly provide that it is not intended to create any inference regarding how the container exception applies to other categories of containers that are not described in the proposed legislation, such as containers owned by shipping companies or shippers, or containers placed in service after 1989. The container exception would continue to apply to those other categories of containers without regard to the proposed change.

Under the proposal, an intermodal cargo container owned by a United States company and placed in service before January 1, 1990 would qualify for the credit and related deductions if it is subject to a "qualifying lease", is being repaired for subsequent lease, is being moved for purposes of leasing or being available for lease, or is otherwise being held for lease.

Statutory Standard

In general, a "qualifying lease" is any lease or sublease to a "container user" that has "one or more trade routes that contact the United States." For this purpose, a "container user" is a person in the business of using containers to ship or transport cargo for other persons (such as a steamship company) or a person that uses a container to ship or transport its own cargo (such as a manufacturer which packs goods for export or import in containers).

A container user is considered to have "one or more trade routes that contact the United States" if at any time during the taxable year the person either own, operates, or charters any vessel that receives or delivers any container in the United States, or uses any container to ship cargo to or from the United States. Proof of U.S. trade routes may be established by published schedules, *The Container Yearbook*, U.S. port and customs records, records of vessel owners or operators, or any other public documents or private records.

A qualifying lease also includes any "short-term" lease to a container user. This includes a lease, or any sublease, for a stated term of which does not exceed 50 percent of the depreciation "class life" of the container. It also includes any lease agreement (such as daily or "per diem" leases or, master lease agreements) that does not require the lessee or sublessee to use or hold a particular container for a specified term. This

definition of a short-term lease or sublease denies the benefit of the proposed change to any container leased on a long-term basis to a container user that does not have a U.S. trade route.

Effective Date

In general, the proposed change would apply the statutory standard to containers that were placed in service before January 1, 1990. Such containers must have been placed in service either in a taxable year for which the audit adjustment or refund period has not closed or in a closed taxable year from which an investment credit was carried forward to an open year. This is intended to assure that the statutory standard will govern all controversies concerning pre-1990 containers, in lieu of the Revenue Ruling, except where the relevant statue of limitations has expired. Thus, for example, where the statute of limitations otherwise precludes a refund claim, the proposal cannot be used as a basis for making such claim. Similarly, the proposed legislative change may not be used as the basis for a refund claim with respect to matters that are the subject of closing agreements entered into pursuant to Code section 7121.

In closing, Mr. Chairman, I believe it is useful to recall just what this Committee sought to achieve when it years ago provided for the tax treatment of intermodal containers. Above all else, it sought to promote international trade and foster the growth of foreign markets for American products. To a lesser degree, this Committee sought to foster the growth of a strong domestic intermodal container industry. On both counts, this Committee's policies have been extraordinarily successful: over the past generation, international trade and American exports have grown exponentially, and the American container industry is preeminent in global shipping, a distinction, unfortunately, that no other American shipping-related industry likely may claim. The proposal now before this Committee seeks merely to affirm that the intent of this Committee be honored, and that the gains this Committee's policies have engendered not be jeopardized.

Mr. Chairman, this concludes my testimony. Again, thank you very much for the opportunity to testify. I very much look forward to working with the Committee to resolve the issues relating to the tax treatment of intermodal containers.

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Statement of

Harris N. Miller
President
The Information Technology Association of America

Comments for the Record
In Connection with Hearings on Miscellaneous Tax Reforms
on
Exempting the Acquisition of Software and Software Services Businesses
From 15-Year Intangibles Amortization

July 11 and July 12, 1995

On behalf of the Information Technology Association of America ("ITAA"), I would like to compliment Chairman Archer and the Committee on Ways and Means for addressing many ways to simplify and improve the current tax laws at the same time the Committee continues to pursue alternatives for fundamental reform of the nation's tax system.

The Information Technology Association of America is the leading trade association for our nation's computer software and services industry. ITAA's more than 6,700 direct and affiliated member companies provide business application and systems software for mainframe, midrange, and personal computers; custom and contract software programming services; information systems integration services; and information processing services.

We support enactment of a proposal to exempt acquisition of software and software services businesses from 15-year intangibles amortization. Such a change will clearly improve the current tax laws regarding amortization of intangibles. Under this proposal, a portion of the intangibles acquired from certain computer software businesses would be exempt from 15-year amortization currently required by Code section 197. While this change would not protect all software services acquisitions from 15-year amortization, it is a step in the right direction. It does not interfere with the objectives of the original intangibles legislation to simplify the rules regarding the amortization of intangibles and eliminate controversies arising under prior law with respect to the useful life of an intangible and the allocation of purchase price among acquired intangibles.

A 15-year amortization period for computer software bears no reasonable relationship to its useful life. Since 1969, the Internal Revenue Service has recognized that computer software has a life expectancy of five years or less. In addition, with the passage of Code section 167(f)(1) in the Omnibus Budget Reconciliation Act of 1993, Congress recognized the limited useful life of computer software by mandating a 36-month amortization period for software acquired outside of the acquisition of a trade or business (or a substantial portion thereof) and for software that is publicly available, has not been substantially modified, and is subject to a nonexclusive license.

It is clear that software technology is evolving rapidly. The evolution is primarily in response to advances in technology, customer demands, and changes in law and regulation. For example, the popular spreadsheet program "1-2-3" from Lotus Development Corporation was introduced in 1983. Since then, there have been eight new versions of the program, with the latest being released in 1994. Likewise, Microsoft Corporation's word processing program, "Word," was introduced in 1983 and has since seen nine new versions. Even the complex mainframe software used to power sophisticated banking or airline reservation systems is upgraded and enhanced frequently due to advances in both software and hardware technology. At a typical software services company, the computers at the large information processing centers may be upgraded as often as every 18 months, meaning that the software must also be changed and upgraded. Thus, a 15-year amortization period for the purchase of such software bears no relationship whatsoever to the economic useful life of the acquired software.

The acquisition of computer software by one computer software or computer services company from another company that has developed or produced such software is often the most cost-effective and timely means of acquiring software technology. By definition, the primary asset of a software company is computer software. These companies typically have few other intangible assets to be acquired that may warrant a 15-year amortization period, such as goodwill. In situations where the primary asset(s) acquired are computer software, it is unreasonable for software to be assigned the arbitrary 15-year amortization period just because it is acquired in a transaction or series of transactions constituting the acquisition of a trade or business or a substantial portion thereof. The 15-year amortization period mandated by current Code section 197 effectively increases the cost of such software by more than 10 and by as much as 17 percent. This increase in business acquisition costs reduces the demand for companies that develop innovative software products and makes it more expensive for U.S. companies to acquire, integrate, and market U.S. software products and services. The proposal recognizes the limited useful life of software acquired in a business acquisition, while eliminating the need to allocate purchase price among acquired intangibles.

Finally, even though the U.S. is the recognized world leader in software technology, virtually all of our major trading partners, including Canada, France, Germany, Japan, and the United Kingdom, have acknowledged the limited useful life of computer software by allowing the amortization of software acquisition costs over five years or less. If the U.S. continues to impose a 15-year amortization period on business acquisitions of software by U.S. firms, foreign competitors bidding for U.S. software companies will have a significant advantage over U.S. bidders. This could lead to the export of the ownership of U.S. software technology and may even encourage U.S. firms to acquire software through foreign subsidiaries in order to reduce the competitive advantage of foreign firms.

Passage of the current proposal to exempt software and software services businesses from 15-year intangibles amortization will not completely resolve the problem with respect to acquisition of software services companies. However, it will constitute significant progress toward the removal of an undue burden on the acquisition of computer software companies and will in many instances allow acquired computer software to be amortized over a period that bears a reasonable relationship to its economic useful life.

Hearing before the
Committee on Ways and Means
U.S. House of Representatives

on

Miscellaneous Tax Reforms

July 11-12, 1995

Written Statement
of
The Section 197 Software Coalition

Introduction

The "Section 197 Software Coalition," a group of microcomputer software development companies, appreciates the opportunity to submit this written statement concerning a proposal that would exempt the acquisition of certain software and software services businesses from the 15-year amortization rules under section 197.

The Coalition's members -- Borland International, Inc., Microsoft Corporation, Novell, Inc., and Oracle Corporation -- support this proposal as a complement to the exclusion under section 197(e)(3)(A)(ii) for computer software not acquired in connection with the acquisition of a trade or business. Coalition members strongly advocated this exclusion for "stand-alone" software acquisitions when Congress drafted section 197 as part of the Omnibus Budget Reconciliation Act of 1993. Both the section 197(e)(3)(A)(ii) exclusion and the proposed exclusion now before the committee recognize that the actual economic life of computer software is significantly shorter than the 15-year amortization period generally required under section 197.

The Coalition is awaiting guidance from the IRS and Treasury interpreting the section 197 statute and the exclusions from 15-year amortization. It is imperative that these regulations maintain -- and not narrow -- the scope of the exclusion for stand-alone software acquisitions as envisioned under section 197(e)(3)(A)(ii). The Coalition also wishes to observe that legislative consideration of additional exclusions from section 197 in no way should bear on the development of these regulations.

The "50/50" proposal

The proposal before the committee as part of these hearings addresses situations where a taxpayer purchases a "qualified software business." For such acquisitions, 50 percent of the intangibles value would be amortized over a 15-year period and 50 percent would be treated as computer software that is not a section 197 intangible and amortized over a 3-year period.

The proposal, like the general approach of section 197, aims for "rough justice." For example, it would not attempt to provide more favorable treatment where the ratio of software value to total intangibles value in a qualified acquisition may be higher than 50

percent. Nevertheless, the proposal clearly would provide a more equitable result than current law.

The proposal defines a "qualified software business" (as described in a pamphlet prepared by the staff of the Joint Committee on Taxation) as follows:

> A qualified software business would be any entity that is engaged in the active conduct of the trade or business of developing, manufacturing, or producing computer software and that meets certain other tests. At least 50 percent of the ordinary gross income of the entity, if any, for the taxable year immediately preceding the acquisition must be income allocable to such trade or business. In addition, either (i) the sum of the deductions allowable under section 172 [sic][1], 174 and 195 for the taxable year immediately preceding the acquisition that are properly allocable to such trade or business must be at least 25 percent of the average ordinary gross income of such entity, or (ii) the average of such deductions for the 5-taxable year period (or shorter period of existence if the entity has not been in existence 5 years) ending with the taxable year immediately preceding the year of the acquisition must be at least 25 percent of the average ordinary gross income of the entity for such period.
>
> If an entity has never generated ordinary gross income, these requirements would be treated as met if 75 percent of the total expenditures of such entity for the taxable year immediately preceding the acquisition are directly or indirectly allocable to developing, manufacturing or producing computer software.[2]

It should be noted that this definition would not encompass all purchases of businesses that may be involved in software development. The tests defining a "qualified software business" are derived from current-law section 543(d), which governs the treatment of active business computer software royalties for purposes of determining personal holding company income. Software-related acquisitions that do not meet these tests, but that rise to the level of a "trade or business" under section 1060[3], will continue to be subject to the general section 197 rules.

Recognizing that section 197 relief for computer software is necessary even in situations involving the acquisition of a trade or business, the proposal carves out a class of business purchases from the general rules. Congress in 1993 drew a similar conclusion, but provided relief for a certain limited class of software assets rather than a class of businesses. The 1993 Act allows for 36-month amortization for computer software acquired in conjunction with a trade or business acquisition that is (1) readily available

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[1]It would appear that this reference should be to section 162. (See section 543(d)(4)(A)(i)).

[2]Staff of the Joint Committee on Taxation, "Description of Miscellaneous Tax Proposals," Comm. Print JCS-19-95 (July 1995).

[3]Intangibles purchased as part of the acquisition of a "trade or business," as defined under section 1060, generally are subject to 15-year amortization under section 197. The 50/50 proposal would not change the definition of "trade or business" for purposes of section 197.

for purchase by the general public; (2) subject to a non-exclusive license; and (3) not substantially modified. The effect of the proposal would be to provide broader amortization relief.

Section 197 exclusion for "stand-alone" software acquisitions

The proposal before the committee would not affect a separate exclusion from section 197 for stand-alone acquisitions of computer software. Section 197(e)(3)(A)(ii) provides for a 36-month amortization period for software that is "not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof."

The scope of this important exclusion will be interpreted in section 197 regulations now being developed by the IRS and Treasury. The IRS in June 1994 issued an "advance" notice of proposed rulemaking specifically requested input from the public on the section 197(e)(3)(A)(ii) exclusion. The Coalition, as well as a number of other taxpayer groups, provided written comments urging that the regulations not narrow the scope of the stand-alone software exclusion envisioned by Congress in 1993.

Conclusion

The Coalition generally supports the goals of the proposal before the committee to exempt the acquisition of certain software and software services businesses from the 15-year amortization rules under section 197. Like the exclusion from section 197 for stand-alone acquisitions of computer software, the proposal recognizes that the actual economic life of software is substantially shorter than 15 years. The Coalition stresses that the possibility of Congressional action on the 50/50 proposal should not influence the development of regulations on the stand-alone software exclusion, and that it is vitally important that the regulations maintain the scope of the exclusion envisioned by Congress in 1993.

Statement of John Engler
Governor of Michigan
U.S. House of Representatives
Committee on Ways and Means
Hearings on Miscellaneous Tax Reforms.
July 11-13, 1995

For the past several years, Michigan has instituted major reforms to move families from welfare dependency to self-sufficiency. A major cornerstone of Michigan's welfare reform initiative, "To Strengthen Michigan Families," (TSMF) is rewarding work for families who receive public assistance.

The Earned Income Tax Credit (EITC) is a powerful tool to encourage work and increase the ability of parents to care for their children. However, in many cases, eligible families don't know they are eligible for the credit and don't file a return to claim the EITC. In addition, far too many low-income workers are not able to take advantage of the option to receive their EITC in each paycheck. Instead, they receive the credit for the full year when filing their taxes. For working poor families, the advance EITC offers them a more immediate reward for their efforts and provides financial benefits to them throughout the year.

I strongly urge this Committee to approve the provision offered by Representative Dave Camp, which would allow states to advance the EITC. In Michigan, by providing increased incentives to work and setting clear, self-sufficiency expectations for AFDC recipients, the percent of working AFDC families in Michigan increased from 15.7% in September 1992 (the month before TSMF began) to 29.4% in June 1995. Michigan's reforms saved taxpayers over $100 million in the first 2 years.

I believe that Michigan and many other states can do even better in increasing work among low-income families, and advancing the EITC by states will help achieve that goal. In Michigan, the process of the state advancing the EITC is straightforward. Working welfare clients already report their earnings to the states. At the request of the client, the Michigan Department of Social Services would calculate the appropriate advance EITC based on their earnings, and provide the advance in their check. The amount of the EITC would be highlighted to drive home to clients that work pays. The amount of the advance EITC would be forwarded by the state to the Internal Revenue Service. Clients would reconcile their EITC at the year's end by filing a tax return.

The process is simple, and the potential benefits enormous. By approving the provision offered by Representative Camp, Michigan and many other states will be on the way to making work pay for low-income families. I urge the Committee to act immediately.

College Savings Plans Network

STATEMENT IN SUPPORT OF EXCLUSION FOR EDUCATION SAVINGS PLANS
HEARING ON MISCELLANEOUS REVENUE ISSUES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 12, 1995

Ohio Tuition Trust Authority, Barbara Jennings, Director
Alabama Prepaid Affordable College Tuition Program, Brenda Emfinger, Director
Alaska Advance College Tuition Program, Jim Lynch, Director
Florida Prepaid College Program, William Montjoy, Director
Kentucky Educational Savings Plan Trust, Jo Carol Ellis, Administrator
Louisiana Office of Student Financial Aid, Jack Guinn, Director
Massachusetts Education Finance Authority, Peter Mazareas, Director
Pennsylvania Tuition Account Program, Joseph Rice, Director
University of Wyoming, State Treasurer Stan Smith, Director

Mr. Chairman and members of the Committee, these comments are being submitted by the membership of the College Savings Plan Network, a national association which has been created under the auspices of the National Association of State Treasurers to represent the common interests of state-operated college savings plans.

Majority of States Have an Active Interest

Our Network represents approximately sixteen states, each offering some form of college savings plan. State-issued college savings bond offerings are the most prevalent activity, but educational savings account plans and prepaid tuition plans are rapidly growing in number. There are currently eight states with operating prepaid tuition programs -- Alabama, Alaska, Florida, Massachusetts, Michigan, Ohio, Pennsylvania, and Wyoming -- with two other states that are soon to be operational -- Texas and Virginia. These state-operated prepaid programs currently represent well over 400,000 prepaid tuition accounts.

Two states have created educational savings account programs -- Kentucky and Louisiana -- and four other states have passed legislation to create some form of college savings plan, but are not yet operational -- Arkansas, Indiana, Mississippi and Oklahoma.

There are an additional eighteen states that have contacted our Network and actively expressed interest in creating and offering some form of college savings plan for their citizenry. These include: Arizona, California, Colorado, Idaho, Illinois, Maryland, Minnesota, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Tennessee, Vermont, and West Virginia.

Sound Public Purpose Served

College savings plans around the country seek to provide important assurances about the future:

1) that higher education remains affordable and accessible to a large portion of the population;

2) that an increasing number of children have greater opportunities to go to college and pursue postsecondary education, and, in turn, create a better-educated population; and

3) that, by encouraging early savings by middle-income families, as an alternative to reliance on borrowing, and, by encouraging public policy that provides reasonable incentives for such saving, limited state and federal financial aid dollars will be better utilized to maximize access to higher education.

Variety of Plans, All with Common Elements

Although each state's college savings plan may have its own unique features to correspond to the interests and needs of that state, our Network has defined six elements to be common to a state-operated college savings plan:

1) statutorily created;

2) administered by the state and/or governed by a Board appointed by the state and comprised of state officials and others;

3) administered by state personnel with strict financial and program accountability requirements;

4) limited to prescribed investment policies and standards;

5) open to all citizens of the state; and

6) savings dedicated to the provision of higher education, with prescribed limitations governing the return of savings or prepayments only in the event of such circumstances as death, permanent disability, or the failure of the beneficiary to meet entrance requirements. If the beneficiary chooses not to go on for higher education, a refund with applicable penalty would be allowed.

The full faith and credit would not be required.

The Network believes these same definitional criteria should qualify these plans for federal tax exemptions that will maximize incentives for early college savings and keep state-operated plans as affordable and accessible as possible.

Specific Tax Amendments Required

The Network respectfully requests that the Internal Revenue Code be amended as follows to resolve three specific tax issues related to college savings programs:

1) Clearly specify that state-operated college savings account programs and prepaid tuition programs that meet defined standards are exercising essential government functions and, as such, the income earned by such plans is not subject to tax.

2) Provide that the student (beneficiary) shall not be taxed on the value of the tuition benefits received in excess of the amount saved or prepaid, if the value is used to pay an institution of higher education for qualified educational expenses. Any earnings not used for educational purposes shall be taxed at the rate of the refund recipient, usually either the beneficiary or the purchase (The Internal Revenue Service has ruled to the contrary in a private letter ruling to Michigan).

3) Provide that parents, family members, and friends (prepaid purchaser or contributor to savings) that create college savings accounts or prepaid tuition accounts shall not be subject to gift tax on amounts paid into a college savings program (Again, the IRS has ruled to the contrary in a private letter ruling to Michigan).

Support for Proposed Legislation

The College Savings Plan Network strongly supports and endorses the thrust of the legislative proposals of both Congressman English of Pennsylvania and Senator Mitch McConnell of Kentucky. Congressman English's legislation focuses more on tax reform for prepaid tuition programs and Senator McConnell's bill currently focuses on educational savings trust accounts, because they are appropriately representing the interests of the type of college savings plan being offered in each of their respective states.

Our Network encourages the Committee to consider these college savings-related tax issues with a comprehensive perspective that will be inclusive of the multiple types and designs of state-operated programs that have been and will continue to be created to best fit the needs and circumstances of each individual state.

In Conclusion

In a recent Gallup Poll, consumers indicated that their two greatest financial concerns were paying off their mortgages and paying for their children's college education. Most parents do not save and those that do save are starting to save too late. Many do not save because they believe savings will only limit financial aid eligibility in the future. They perceive greater incentive to borrow than save to cover college expenses.

The College Savings Plan Network urges the Committee to amend current tax law to help encourage families to plan, prepare, and save rather than rely totally on student loans to educate their children.

Thank you for providing this opportunity to comment.

TESTIMONY OF GARY L. MULLER
UNITED FIDELITY LIFE INSURANCE COMPANY

Mr. Chairman and Members of the Committee, thank you very much for this opportunity to present to you and to the Congress, once again, an idea which would permit American families to better utilize their own financial resources to finance their children's higher education expenses.

Mr. Chairman my name is Gary L. Muller. I am chief operating officer for United Fidelity Life Insurance Co. of Kansas City, Missouri. The purpose of my testimony is to advocate that Congress, as it has in the past, adopt legislation to permit penalty free withdrawals from annuities for higher education expenses.

This Committee has endorsed the merits of just such legislation in the 102nd Congress, when, with strong bipartisan support, it adopted legislation identical to that which I am addressing today. Moreover, the provision subsequently was passed by both the full House and the Senate. Unfortunately, for reasons wholly unrelated to this proposal, the legislative vehicle in which this provision was included, H.R. 11, ultimately was vetoed by President Bush. However, as I know the Members of this Committee realize, the need to ease the tremendous financial burden on families who send their children to college has grown more pressing.

As this Committee has recognized before, permitting penalty free withdrawals from annuities for higher education expenses is a substantial step towards meeting that goal without interposing any government bureaucracy or incurring the expense of direct subsidies. In the past, we called the idea the "Higher Education Savings Plan" ("HESP"). It still fits today. In essence, HESP would work by amending the Internal Revenue Code of 1986 (the "Code") to promote savings for qualified higher education expenses.

I don't have to tell you of the soaring costs of higher education.

Right now, the cost of sending a child to a private university for four years now averages more than $65,000. The cost of a four-year public university education averages about $23,000. The Department of Education now estimates that the total cost to attend a private university will continue to escalate over the next decade to about $200,000, and $60,000 for a public university.

I believe that two statistics, in particular, underscore the immediate need for legislation to permit Americans to pay for their children's higher education.

- Beginning in the early 1980s, college costs have increased at a rate nearly twice that of the cost of living. Since the mid-1980s, this trend has been most pronounced among four-year private institutions, with costs escalating at a rate of roughly 8.5% annually. In comparison, tuition costs as public schools increased by about 5.4% annually.

- These increases constitute a larger and larger share of overall family income. During the 1980s, the cost of a four-year private institution rose from 16.5% of the median family income to about 22.1% of that income. During the same period, the cost of four year public institutions rose form 4.1% to 4.8% of the median family income.

There is, of course, no dispute about the importance of ensuring that quality higher education remain affordable in the middle income families of America. As usual, Abraham Lincoln, 16th President of the United States, said it best in an 1832 public address:

> Upon the subject of education . . . I can only say that I view it as the most important subject which we as a people can be engaged in.

President Clinton, much to his credit, is as attuned to this issue as any of his predecessors. He recognizes that our ability to compete in the global marketplace is

dependent almost entirely upon the skills and educational achievement of our work force. Accordingly, he has insisted, correctly, that the upcoming Budget Reconciliation package include means to keep income families meet their educational expenses. Mr. Chairman, I respectively submit that the proposal passed by the Congress in 1992 properly should be a component of any reforms to the tax treatment of educational expenditures.

There is absolutely no question that saving after tax dollars sufficient to cover these higher educational costs will be very difficult for most, if not all, middle-income parents. Therefore, it is essential that middle-income taxpayers be afforded some relief under the tax code to enable them to meet these mounting costs.

Under the HESP legislation, the text of which is appended to this testimony, such assistance would be made available by providing that when a taxpayer purchases a predesignated annuity for the child to cover qualified higher education costs, the withdrawal of funds from the annuity to pay such education costs would be exempt from the 10 percent penalty for premature distributions from annuity contracts under Internal Revenue Code section 782(q). Safeguards would be provided by requiring that the annuity be designated for education costs at the time of purchase. Qualified higher education costs are defined to include only undergraduate expenses incurred at institutions of higher education. Finally, under the terms of the plan, the annuity premium payments to cover the education costs would not count against the first tax annual exclusion.

Other Code sections provide direct benefits to taxpayers' financing the cost of higher education. Section 135 allows income from U.S. savings bonds to be excluded from income under certain circumstances if the income is used to pay educational costs. Section 2503 generally allows an unlimited gift tax annual exclusion for gifts which pay higher education costs. HESP provides a mechanism to directly address the needs of middle income taxpayers facing higher education costs of their children will be financially overwhelming.

A few years ago, as we visited Members of Congress on this great plan, accompanying me was Digger Phelps, the winningest basketball coach in Notre Dame history. And while certainly a popular, well-known sports figure, Coach Phelps holds an equally impressive record off the court. Every player who has competed for four years under Coach Phelps earned his degree. And in his 20 years as a collegiate coach, he also developed a reputation as a concerned, outspoken educator.

He once was asked if he felt that more government funds would solve the education problems. He replied:

> I don't know if the government is ever going to fund education. I do think the government is going to have to decide on one game plan for education. The problem is that state governments have 50 different game plans and obviously, none of them are working. I think funding is going to have to come from the private sector; corporate America is going to have to become more involved. I believe we need more tax breaks on areas of education, both on a family and corporate level. Whether it's financing teacher education or financing student education. I look at education as a choice. I don't think everyone has to be an electrical engineer, because we also need electricians. So I think we need to come up with one solid plan.

Well, one may not agree with everything Coach Phelps focused on but he certainly recognized the need for our Higher Educations Savings Plan.

The President, the Congress, and educational leaders are well aware that we have a crisis in education.

Obviously, I do not mean to suggest that HESP will, by itself, solve those problems. Other, more fundamental steps must be taken with respect to curricula, faculty, funding, and community commitment. But HESP is a part of the solution. It is an effective means of provide some help in addressing one of the most troubling developments in higher education: the dramatically escalating costs.

No, it's not a "new math" idea, thank goodness. No, it doesn't guarantee that all future graduates will be brilliant. No, all the Higher Education Savings Plan accomplishes is to lend a helping hand for American families to meet the constantly rising costs of higher education. And it does so with virtually no additional bureaucracy and a very modest revenue impact. For those reasons, Mr. Chairman, I urge this Committee, and the 104th Congress, to enact the Higher Education Savings Plan this session.

Mr. Chairman, thank you again for allowing me the opportunity to testify before this Committee.

EXHIBIT

SEC. 202. PENALTY FREE WITHDRAWALS FROM ANNUITIES FOR HIGHER EDUCATION EXPENSES.

(a) IN GENERAL.--Paragraph (2) of section 72(q) of the Internal Revenue Code of 1986 (relating to 10-percent penalty for premature distributions from annuity contracts) is amended by striking "or" at the end of subparagraph (I), by striking the period at the end of subparagraph (J) and inserting ", or", and by inserting after subparagraph (J) the following new subparagraph:

"(K) which is a qualified higher education expense distribution (as defined in paragraph (4))."

(b) QUALIFIED HIGHER EDUCATION EXPENSE DISTRIBUTION.--Subsection (q) of section 72 of such Code is amended by adding at the end thereof the following new paragraph:

"(4) QUALIFIED HIGHER EDUCATION EXPENSE DISTRIBUTION.--

"(A) IN GENERAL.--For purposes of paragraph (2)(K), the term 'qualified higher education expense distribution' means any distribution from a designated higher education expense annuity to the taxpayer if such distribution is used within 90 days of the date of the distribution to pay qualified tuition and related expenses (as defined in section 117(b)) required for the enrollment or attendance of such taxpayer, the taxpayer's spouse, or a child (as defined in section 151(c)(3)) or grandchild of such taxpayer at an eligible educational institution (as defined in section 135(c)(3)); except that such expenses shall be reduced by any amount excluded from gross income under section 135 by reason of such expenses.

"(B) DESIGNATED HIGHER EDUCATION EXPENSE ANNUITY.--

"(i) IN GENERAL.--The term 'designated higher education expense annuity' means any annuity purchased after December 31, 1992, and designated for purposes of this paragraph by the purchase at the time of purchase as an annuity to which this paragraph applies.

"(ii) CERTAIN ANNUITIES RECEIVED IN AN EXCHANGE NOT ELIGIBLE.--Such term shall not include any annuity acquired in an exchange to which section 1035 applies unless the annuity given up by the taxpayer in the exchange was a designated higher education expense annuity."

(c) GIFT TAX TREATMENT.--Subsection (e) of section 2503 of such Code is amended by adding at the end thereof the following new paragraph:

"(3) TREATMENT OF PREMIUMS PAID UNDER DESIGNATED HIGHER EDUCATION EXPENSE ANNUITIES.--

"(A) IN GENERAL.--Any premium paid for a designated higher education expense annuity shall not be treated as a transfer of property by gift for purposes of this chapter.

"(B) RECAPTURE RULES.--If any premium paid by any person for a designated higher education expense annuity is not treated as a taxable gift solely by reason of subparagraph (A)--

"(i) LIFETIME DISTRIBUTIONS NOT USED FOR EDUCATIONAL PURPOSES.--Any disqualified lifetime distribution from the portion of any annuity attributable to such premium shall be treated as a transfer by fit by such person.

"(ii) INCLUSION IN GROSS ESTATE.--The gross estate of such person shall include the value (as of the date of the decedent's death or applicable valuation date set forth in section 2032) of the portion of any annuity attributable to such premium.

"(C) DISQUALIFIED LIFETIME DISTRIBUTION.--For purposes of subparagraph (B), the term 'disqualified lifetime distribution' means any distribution which is not a qualified higher education distribution and which is made during the life of the person referred to in subparagraph (B) to or for the benefit of another person.

"(D) OTHER DEFINITIONS.--For purposes of this paragraph, the terms 'designated higher education expense annuity' and 'qualified higher education expense distribution' have the respective meanings given such terms by section 72(q)(4)."

(d) EFFECTIVE DATE.--The amendments made by this section shall take effect on January 1, 1996.

STATEMENT OF NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

On behalf of the six million members and supporters of the National Committee to Preserve Social Security and Medicare, we wish to submit for the record of the Miscellaneous Tax Proposals hearing some general comments on the suggested employment tax proposals listed on page three of Ways and Means Committee Advisory No. FC-8. We are particularly concerned with proposals which would exempt employment from Social Security coverage or which would directly or indirectly relieve employers from payment of the employer share of FICA taxes.

The National Committee supports universal Social Security coverage. In keeping with that stand, we oppose proposals to exempt additional categories of workers, broaden existing exemptions or exempt certain minimum salaries from payment of FICA taxes. Seasonal employees of children's camps and workers on fishing boats are cases in point. Social Security is not just a retirement program. Social Security offers significant disability and life insurance protection which, in early work years, are far more important to young workers than are retirement benefits to be paid in the distant future. No young workers or part-time workers should be denied this protection. Part-time and part-year workers especially need their work to be covered by Social Security so that they will earn the work credits they need for fully or recently insured status—without which they have no right to benefits.

Just as the National Committee believes in universality of Social Security coverage, it believes in universality of the employer tax burden. It is our position that every employer, regardless of the type of industry, should bear the same responsibility for FICA taxes on all employee earnings up to the maximum taxable wage base.

Section 13443 of the Budget Reconciliation Act of 1993 altered this equality by relieving a major segment of the food and beverage industry of responsibility for FICA taxes—not by cancelling the FICA tax itself, but by granting an offsetting tax credit for employer FICA taxes paid on employee tip income in excess of the minimum wage. The credit was limited to eat-in establishments and carried an estimate of a $1 billion, five year revenue loss to the U. S. Treasury.

Two proposals referenced in Committee Advisory No. FC-8 would further amend the restaurateur tax credit provision. One would alter the effective date and the other would extend the tip income FICA tax credit provision to all food and beverage industry employers. The National Committee opposes both proposals.

Exempting food and beverage industry employers of this tax obligation on a segment employee earnings while requiring all other employers to pay FICA taxes on all earnings up to the taxable wage base is unfair. Food and beverage employers should be treated no differently than other tip industry employers and tip industry employers should be treated no differently than wage-only employers.

It seems incongruous that this Committee would consider reducing the Earned Income Tax Credit to the working poor while expanding an FICA tax credit to a profitable industry. Rather than adding to the revenue loss by backdating the effective date of the 1993 amendment or by exempting the balance of the food and beverage industry from a fair share of taxes, we urge this committee to repeal of Section 13443 of the Budget Reconciliation Act of 1993. The seven year $1.4 billion savings will make an important contribution to efforts to balance the Federal budget by 2002.

STATEMENT FOR THE RECORD OF:

CONGRESSMAN PETER G. TORKILDSEN

COMMITTEE ON WAYS AND MEANS

REGARDING THE TAX STATUS OF FISHERMEN

July 11, 1995

Mr. Chairman,

I am submitting this statement to express the urgency to amend Section 3121 (b) (20) of the Internal Revenue Code. While the current problem does not affect a large number of my constituents, it does affect many in Massachusetts. As you know, in 1988 the IRS adopted a new interpretation as to whether the service performed by individuals on certain small fishing vessels constituted employment for the purposes of that section of the code. This new interpretation was retroactive and the IRS insisted that boat owners should have been withholding taxes for their crew all along. The IRS claimed that these fishermen were responsible for over $11 million in back taxes.

In the past, many boat owners were advised by the IRS that crew members could be treated as self employed, and were responsible for their own taxes. These fishermen were in total compliance with IRS regulations as they understood them. The Internal Revenue Service's new interpretation of these regulations has created many new and unnecessary financial obstacles for an industry which is already crippled by overfishing and over-regulation. The New England fishing fleet has been confronted with the closure of Georges Bank, once one of the richest fishing grounds in the world. Many fishing families are struggling to make ends meet. Additional financial burdens from the IRS, which are inconsistent with the original intent of Congress, are not necessary or welcomed.

In May of this year, I along with others from the Massachusetts delegation sent a letter to you expressing our concerns over the Internal Revenue Service's interpretation of this section of the code. In the letter we stressed that Congress has twice passed legislation which would have solved this problem for fishermen. Unfortunately, the fishing provision never became law because the two different tax bills which included the provision were vetoed by the President for unrelated reasons.

Mr. Chairman, now it is time to tell the IRS to get off the backs of fishing families. I ask for your support in amending Section 3121(b)(20) of the Internal Revenue Code to provide a fair and equitable solution for this unfortunate federal bureaucratic problem.

Governmental Affairs
American
Hotel & Motel
Association

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July 26, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Archer:

The American Hotel and Motel Association (AH&MA) is a federation of state and local lodging associations representing over 10,000 properties. The lodging industry employs over 1.5 million people and has annual sales exceeding $60 billion. Our association represents all of the major lodging chains and also contains a significant number of smaller properties. On behalf of our member properties we offer the following comments for inclusion in the record of the hearing held by your committee on July 12 and 13, 1995 on miscellaneous tax reform. First, we support the view of the Chairman that there should be no deficit increase as a result of any tax reform proposal and further, we encourage the committee to avoid past practices of allowing an industry to target some other industry or some segment of its own industry to obtain desired tax relief. Specifically, we offer the following comments on provisions before your committee.

Extend FICA tip credit to all employees who receive tips.
Effective date of FICA credit.

The focus of the discussion on the FICA tip credit extension is to add additional categories of tipped employee for food and beverage establishments for example off-premises delivery personnel. We believe, however, in light of the recent attention and promised future attention of the IRS on other industries where tipping is customary, that any extension of the deductibility of FICA on tips should cover all taxpayers who pay FICA on tips and not just focus on additional employees for one category of taxpayer. Such an approach would avoid future inequities for employers of non food and beverage tipped employees who may find themselves paying increased levels of FICA on tips of their employees as a result of IRS attention.

With regard to the effective date of the FICA tip credit we believe there is ample evidence that the intent of Congress was to cover all tips paid after December 31, 1993 regardless of when services were performed. It is unfortunate that subsequent Congressional action is needed to counteract Treasury regulations which misinterpret the law, but in light of Treasury's insistence on their point of view it appears necessary. Since the original revenue estimates contemplated the correction now deemed necessary, this item should be treated as having no budget impact.

Finally, we would refer the committee to earlier comments we have filed with this committee on the issue of targeted jobs tax credit, social security earning limit increase and capital gains changes. As consideration goes forward on appropriate tax revision under the budget process we renew the comments contained in our earlier testimony and are prepared to offer more detailed comments as potential tax revisions are narrowed.

Sincerely,

James E. Gaffigan

James E. Gaffigan
Vice President, Governmental Affairs

Leading the Foodservice/Hospitality Industry

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NATIONAL RESTAURANT ASSOCIATION

TESTIMONY OF

ELAINE Z. GRAHAM, SENIOR DIRECTOR OF GOVERNMENT AFFAIRS

CLARIFICATION OF THE FICA TAX-ON-TIPS TAX CREDIT

JULY 27, 1995

Mr. Chairman, on behalf of the National Restaurant Association -- the leading trade association for the nation's 739,000 foodservice establishments -- we want to express our strong support for clarifying the FICA tax-on-tips tax credit's application to FICA taxes paid on unreported tips.

The IRS has issued regulations pertaining to the Section 45(B) tax credit which do not conform to the statutory language enacted in 1993. The National Restaurant Association strongly encourages the Committee to correct this problem as a part of the forthcoming Miscellaneous Revenue bill.

OBRA 93 included a provision authorizing an income tax credit for FICA taxes paid on tips in excess of the minimum wage. This provision was patterned after the original legislation: H.R. 1141 introduced by former Representatives Mike Andrews and Don Sundquist, and S. 573, introduced by Senator John Breaux.

On December 23, 1993 the IRS issued regulations which significantly altered how the credit is applied. The IRS chose to implement the credit so that it applies only to "taxes paid on tips reported" after January 1, 1994. This is contrary to the statutory language which states the credit should apply to "taxes paid" after the effective date. The statutory language is consistent with federal laws regarding tipping.

Under the Fair Labor Standards Act, all tips belong to the employee. The employer is neither authorized nor allowed to report tips on behalf of an employee. However, the Internal Revenue Code holds an employer liable for the payment of FICA taxes on unreported as well as reported tips. Thus, there are instances when an employer is made to pay additional FICA taxes because their employees underreported their tips. The IRS assesses no penalty in such cases, and the statutory language provides a tax credit when this occurs. This is consistent with the original legislation and consistent with Section 3121(q) of the IRC which deems FICA taxes as due "on the date on which notice and demand for such taxes is made to the employer" by the IRS.

By not allowing the tax credit in such cases, the IRS regulations could have a significant negative impact on restaurants who undergo IRS audits and are made to pay additional FICA taxes because their employees underreported their tips. For this reason, the National Restaurant Association is strongly opposed to the temporary regulations.

The IRS based its interpretation on the belief that Congress did not intend for the credit to apply to additional FICA taxes paid **even if the payment was due to employees not reporting the full amount of their tips**. The IRS has adhered to their interpretation despite the fact that the authors of the original bill along with over 100 Senators and Representatives wrote Treasury Secretary Bentsen stating that the FICA credit legislation was written exactly the way Congress intended, and the IRS is mistaken when interpreting the statute in any other manner.

Given the consistency of the Section 45(b) tax credit with related provisions of the Internal Revenue Code and the strong Congressional support for the statutory language, we encourage the Committee to clarify the language in Section 45(b) to further amplify the credit's availability for those restaurants who are made to pay additional FICA taxes due to employee underreporting of tip income.

Mr. Chairman, we appreciate your consideration of our views on this important issue.

PIZZA HUT / 14841 DALLAS PKY / DALLAS, TX 75240-2100 / PHONE (214) 338-77CC

STATEMENT BY LARRY H. WHITT
VICE PRESIDENT GOVERNMENT AND COMMUNITY AFFAIRS
PIZZA HUT, INC.

COMMITTEE ON WAYS AND MEANS HEARING
ON MISCELLANEOUS TAX PROVISIONS
(EMPLOYMENT TAXES ITEM 3)

IN SUPPORT OF CORRECTION OF FICA TIP
CREDIT AS APPLIED TO TIPS FOR OFF-PREMISE
DELIVERY OF FOOD AND BEVERAGES

JULY 11, 1995

On behalf of Pizza Hut, Inc., and other restaurant employers that provide delivery-only service or both delivery and on-premise food and beverage service, I urge Congress to amend Section 45 (B) of the Internal Revenue Code. As written, Section 45 (B) is an inequitable, counter-productive and complicated provision that currently creates a myriad of accounting problems for some restaurants, discriminates against those restaurants that engage in delivery, and places them at a competitive disadvantage with restaurants that provide only on-premise sales.

The Omnibus Budget Reconciliation Act of 1993 created a business tax credit to give restaurants a dollar-for-dollar reduction in federal income

taxes for the FICA taxes they pay on employee tips in excess of the minimum wage. The tax credit applies to federal income taxes for 1994 and after, and can be taken only for FICA taxes paid on tips earned by employees who serve food and beverages for on-premise consumption in establishments where tipping is customary. When making these changes in 1993, the tax writers drafted such changes in a manner which excludes the use of FICA tip credit by those restaurant employers whose employees receive tips from customers through off-premise sales.

As a result of this anomaly in the tax code, tips for one class of employee must be treated differently than tips given to another class of employee. In some instances, the same employee may receive tips from customers in both the restaurant and from off-premise delivery sales creating an accounting morass. Treating these groups differently not only causes accounting problems but discriminates against those employers who have a delivery business. The law should be applied equally to all food service employers who have tipped employees, not just those who serve food and beverages for on-premise consumption.

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Congress of the United States
House of Representatives
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CLASS WHIP
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THE SPEAKER'S WELFARE ADVISORY GROUP

July 11, 1995

The Honorable Bill Archer
1236 Longworth House Office Building
Washington, DC 20510

Dear Mr. Chairman:

I am writing to urge the House Ways and Means Committee to consider the extension of the FICA tip credit to all persons who receive tips in the food and beverage service industry. Currently, tips earned off-premises by delivery personnel are not taken into account under the credit for employer social security tax.

I introduced a bill in September 1993 which would have amended the Internal Revenue Code to include tips received for providing food or beverage outside the employer's establishment. It does not make sense that there are two sets of laws for restaurant employees that work in the establishment and those employees that work in the delivery business. Because of the imbalance in the tax credit, those businesses without a delivery service are afforded an unfair competitive advantage over those which provide delivery service.

We need to level the tax playing field for the food and beverage service industry. I strongly recommend the Committee votes to extend the FICA tip credit to include delivery service personnel.

Sincerely,

Jim Talent

Congressman Jim Talent

STATEMENT BY THE INDEPENDENT BAKERS ASSOCIATION

IN SUPPORT OF THE PROPOSAL TO CLARIFY THE EMPLOYMENT

TAX STATUS OF DISTRIBUTORS OF BAKERY PRODUCTS

Hearings on Miscellaneous Tax Proposals
House Ways and Means Committee
July 11-12, 1995

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to present the views of the Independent Bakers Association and the bakery industry on a proposal to amend IRC § 3121(d)(3)(A) relating to the employment tax status of bakery distributors. The Independent Bakers Association is a national trade association of over 400 small- to medium-sized, mostly family-owned, wholesale bakeries and allied industry trades.

Description of the Issue

The issue we bring before the Committee is whether bakery distributors should be classified by statute as employees for employment tax purposes even though they may be treated as independent contractors for income tax purposes. Our proposal (which is attached to this statement as Exhibit 1) would delete the phrase "bakery products," from section 3121(d)(3)(A) of the Code. Section 3121(d)(3)(A) presently provides that certain driver-distributors, including bakery distributors, will under certain circumstances be treated as employees for employment tax purposes.[1/]

We believe it is important to clarify for the Committee what this proposal will and will not do. The proposal under consideration today does not seek to classify bakery distributors as independent contractors. Neither does it seek to change in any way the common law test by which individuals are classified as either employees or independent contractors. The proposal would simply eliminate the irrebuttable presumption that bakery distributors are employees for employment tax purposes and would place them on the same footing with other individuals by making

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[1/]Section 3121(d)(3)(A) provides:
(d) EMPLOYEE.--For purposes of this chapter, the term "employee" means--
(1) ...; or
(2) ...; or
(3) any individual (other than an individual who is an employee under paragraph (1) or (2)) who performs services for remuneration for any person--
(A) as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;
(B) ...;
(C) ...; or
(D) ...;
if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed; or
(4) ....

distributors subject to the same common law test for employment status as everyone else.

Section 3121(d)(3)(A) overrides the normal, common law test for employment status; thus, even though a bakery distributor would be treated as an independent contractor for income tax purposes, if that person falls under section 3121(d)(3)(A), he or she will nevertheless be considered an employee for employment tax purpose.[2] We contend that this treatment as statutory employees is completely inappropriate in view of existing relationships between bakeries and distributors of bakery products. Classifying bakery distributors as statutory employees is disruptive of sound business arrangements, is technically unworkable and serves no identifiable tax or retirement policy goal. Current law discriminates against driver-distributors by creating an irrebuttable presumption that they are employees for employment tax purposes even though they may be independent contractors for income tax purposes.

History of the Statutory Employee Provision

Section 3121(d)(3)(A) was enacted in 1950, at a time when the combined FICA tax rate for employees was higher than the tax on self-employed individuals.[3] Section 3121(d)(3)(A) was enacted as remedial legislation. Congress concluded that "the usual common-law rules for determining the employer-employee relationship [fell] short of covering certain individuals who should be taxed at the employee rate under the old-age, survivors, and disability insurance program."[4] Congress apparently concluded that it was important to secure for driver-distributors the higher Social Security benefits that would accrue to them as a result of the higher tax rates.

While originally drafted to apply to house-to-house sales persons, the language eventually enacted referred to individuals distributing certain goods and services, such as bakery, meat, vegetable and beverage products, and laundry and dry cleaning services.[5] The statute excepted from its coverage individuals who had a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation).[6]

It is apparent that the world has changed dramatically from the time the statute was enacted in 1950. Door-to-door deliveries of bread, milk and cakes have generally long since gone the way of the dinosaur.[7] Today, local wholesale bakeries

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[2]Section 3121(d)(3)(A) classifies certain driver-distributors as employees for employment tax purposes. It was made applicable to the unemployment tax in 1972. It has no application or effect on their classification for income tax purposes.

[3]In 1950, the combined FICA tax rate for employees was 4% while the tax on self-employed individuals was 2.5%. The "combined" FICA tax rate for employees is the sum of the equal taxes paid by employers and employees on wages paid to the employee.

[4]*See* Senate Report 1669, 81st Cong., 2d Sess. 144 (1950).

[5]Indeed, the legislative history of the statute is replete with references to house-to-house sales.

[6]The statute also provides an additional exception in a case where the contract does not contemplate that substantially all of such services shall be performed personally by such individual.

[7]Throughout the 1940s and 1950s, bakeries were essentially local operations. Bread and layer cakes were baked daily and delivered to the homes of customers. These products were typically sold by individuals who used delivery vehicles to cover certain neighborhoods or routes. The vehicles used may or may not have (continued...)

have typically disappeared, having been consolidated into regional and national concerns. Bakery products are no longer sold door-to-door. Instead, these products are often distributed by individuals owning their own territories, who purchase their products directly from the bakeries, and who distribute the products to commercial customers (such as retailers and restaurants) for resale.

Just as important is the change in the respective rates of tax for employees and self-employed individuals. As previously discussed, the combined FICA tax rate for employees in 1950 was 4 percent while the tax rate on self-employed individuals was 2.25 percent. In 1984, these tax rates were equalized.[8] Today, both the self-employed tax rate and the combined FICA tax rate stand at 15.3 percent. Therefore, the primary reason for the enactment of the statutory employee rule -- the higher tax rate for employees and the higher benefits derived from that higher tax rate -- no longer exists. Section 3121(d)(3)(A) is an anachronism in today's world.

<u>Why Is The Statutory Employee Issue Important Today?</u>

Some members of the Committee may wonder why this issue is so critical in 1995 when the statute has been in effect since 1950. The answer is simple. For many years the bakery industry considered section 3121(d)(3)(A) inapplicable to most distributors. This position was supported by various rulings from the Internal Revenue Service dating back to the early 1950s. It was not until 1991, when the Internal Revenue Service issued GCM 39853 reversing its long\held position, that the industry's view was called into question.

As previously discussed, the statute provides an exception where the individual has a "substantial investment in facilities." Throughout the years, many bakery distributors have purchased their territories from the bakeries or from the previous owners of the territory. The distributor's ownership of the territory has been consistently interpreted as a substantial investment in facilities, thus exempting the distributor from the statutory employee provision.[9]

This interpretation of the substantial facilities exception was never, to anyone's knowledge, challenged by the Internal Revenue Service on audit. Indeed, in 1985, the Internal Revenue Service concluded in a technical advice memorandum that investment in a territory constituted a substantial investment in facilities.[10] It was not until that technical advice memorandum was withdrawn in 1988 and the IRS, in 1991, released General Counsel Memorandum 39853 that the issue became one of concern to the bakery industry.

GCM 39853 takes the position that the term "facilities" in section 3121(d)(3)(A) does not include distribution rights, such as a territory. There is serious doubt that the GCM is correct. Its reasoning is suspect, its logic weak and its timing (31 years after the statute was passed) is suspect. It is the

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[7](...continued)
been owned by the individuals. Similarly, meat and vegetable products were sold off of vehicles making house-to-house deliveries. Milk was also delivered house-to-house, although dairy products were excepted from the final version of the bill without explanation. Finally, laundry services were typically provided on a house-to-house basis.

[8]<u>See</u> Social Security Amendments of 1983, P.L. 98-21 section 123.

[9]It should be noted that many distributors have substantial investment in equipment in addition to their investment in their routes or territories.

[10]<u>See</u> TAM 8607001.

near-unanimous opinion of tax advisors to the bakery industry that the position taken in the GCM would not prevail in court if the issue were litigated. Nevertheless, many bakeries currently under audit are being forced to concede the issue because they lack the resources to litigate. This has created tremendous uncertainty in the bakery industry which, in turn, makes legislative action to clarify the issue imperative.

Effect on the Bakery Industry

1. Technical Problems

Application of the statutory employee rules to bakery distributors would create numerous technical difficulties. First, the distributor would be required to compute his or her income two different ways -- once as an employee and once as a self-employed individual -- since certain expenses are deductible for self-employed individuals but not for employees. The absurdity of requiring two sets of books for the same person, especially a small business person, is self-evident.

Second, if the bakery is required to treat the distributor as an employee, what amount does the bakery report to the distributor and to the IRS as wages paid? Bakeries sell their products to distributors. The distributor then resells the product to retailers or other wholesalers. The bakery has no information about the profit the distributor has made. The distributors income is the profit made from this resale. If the bakery were to report the price paid by the distributor for the product, that would grossly overstate the amount of income actually earned by the distributor since it would totally fail to take into account the purchase cost of the products and any of the distributor's expenses (such as fuel, marketing costs, wages paid to the distributor's employees, etc.), as well as any discounts or allowances given to the distributor's customers directly by the distributor.

The distributor system, as it has evolved through the years, bears no resemblance whatsoever to a wage-based compensation system. The industry would be forced to completely restructure itself in order to comply in any meaningful way with the statutory employee rule. The costs of this restructuring would be wholly disproportionate to the benefit (if any) derived.

Finally, classification of distributors as statutory employees is particularly confusing in light of the fact that many distributors have their own employees. In particular, distributors with large, heavily populated or prosperous territories may have several employees of their own and operate in corporate form. It has not been made clear how a corporation can be an employee!

Many questions arise as to how the employees of the distributor are to be treated. A few of those questions include: (1) Will they be considered employees of the distributor or the bakery? (2) If the latter, how will that affect their treatment by the bakery for income tax purposes. (3) What about benefit plans maintained by the bakery? Are these employees of the distributor eligible for benefit plans maintained by the bakery? (4) If they are not treated as employees of the bakery, how are their wages treated for purposes of computing the FICA tax on the distributor's income. If the distributor were an independent contractor, their wages would be deductible in computing self-employment income. But that is not true if the distributor is an employee. This means that the distributor will pay (and have withheld) FICA tax on amounts the distributor pays in wages to his or her employee. Without question, this is the wrong outcome. Yet it would be required if the statutory employee rule applies.

The result is even more egregious under the Omnibus Budget Reconciliation Act of 1993. Before passage of the Act, there was a cap on the wages or self-employment income subject to

FICA or self-employment tax.[11] Section 13207 of the Act repealed the cap on amounts subject to the hospital insurance portion of the employment tax (now equal to 2.9 percent) beginning in 1994.

For example, assume that a distributor employs 2 employees at an average annual wage of $20,000 ($40,000 total). If the distributor were considered an independent contractor, the wages paid to the employees would be deducted in computing the distributor's income subject to self-employment tax. On the other hand, if the distributor were considered a statutory employee, the wages paid by the distributor to its employees would not be deductible. Thus, the distributor and the bakery would each pay, <u>on behalf of the distributor</u>, FICA tax of 1.45 percent on the $40,000 of wages the distributor paid to its employees. At the same time, the distributor and the employees would each pay FICA tax of 1.45 percent on the same amount <u>on behalf of the employees</u>. The $40,000 in wages would be double taxed!

It is not difficult to see that application of the statutory employee rule to bakery distributors creates bizarre results. Without any policy rationale remaining to support its existence, this potential for bizarre results is a compelling reason to eliminate the rule.

2. <u>Effect on Entrepreneurship</u>

The eventual outcome of applying the statutory employee rule to the bakery industry is likely to be a complete restructuring of the industry. A part of that restructuring will no doubt be a severe cutback on the use of independent bakery distributors. Such a result would be truly unfortunate in view of the benefits that both the bakeries and the distributors have gained from the use of independent distributors.

Application of the statutory employee rule would deny an entrepreneurial opportunity to those individuals desiring to operate a wholesale distributorship business. Independent wholesalers have significant opportunities to develop a successful distributorship and earn profits substantially greater than the salaries that would be paid to employees. In addition, if the distributor owns his or her distribution rights, the distributor has the opportunity to build the value of the distributorship that he or she may eventually sell for a greater profit. All these incentives are lost, however, if the distributor cannot be an independent wholesaler.

Moreover, application of the statutory employee rule to existing ownership arrangements would substantially undermine the value of the distributorships already in place. The value of these existing arrangements was premised on an assumption of independent contractor status. Application of the statutory employee rule would severely lower those values to the detriment of the distributors owning distribution rights.

<u>Compliance Initiative</u>

Our proposal includes not just an amendment repealing the statutory employee rule. We recognize the concern of some that some compliance problems may arise as a result of classifying some independent distributors as independent contractors. Therefore, we have included in our proposal a reporting requirement that would apply to all bakeries using independent distributors.

Our proposal would add new Code section 6041B. Section 6041B would require, in general, that bakeries with direct sales to independent distributors for resale report to the IRS the

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[11]For 1993, the caps were 57,600 for the OASDI portion of the tax and 135,000 for the HI portion of the tax.

amount of such sales. This added reporting requirement would provide the IRS with information it needed to ensure that independent distributors were reporting correctly. Since the reporting requirement would apply for both SECA and income tax purposes, its beneficial effect would be far broader than the statutory employee rule. While the revenue effect of the combined proposal has not yet been completed, we believe the reporting requirement could actually raise revenue in excess of the revenue lost by the repeal of the statutory employee rule.

Conclusion

It is understandable that Congress would seek to prevent abuses in the employment tax system that can occur from classification of an individual as an independent contractor rather than an employee. However, the bakery distributor system is not riddled with those abuses. Even if the system were, however, application of the statutory employee rule is clearly the wrong answer to the problem. Indeed, its application would create far more problems than it would solve. For all the reasons stated above, we urge the Committee to endorse the proposal of the Independent Bakers Association to repeal the rule with respect to bakery distributors.

Thank you very much, Mr. Chairman.

Written Statement

of

The Association of Christian Schools International

John C. Holmes, Ed. D.
Director for Government Affairs

Concerning

H. R. 1492

Submitted to the

**Committee on Ways and Means,
U. S. House of Representatives
The Honorable Bill Archer, Chairman**

July 11, 1995

Mr. Chairman and Members of the Committee on Ways and Means:

The Association of Christian Schools International is grateful that you have chosen to include Representative Phil Crane's bill, H. R. 1492 in your Committee's consideration of appropriate miscellaneous legislation. H. R. 1492 would restore equity of treatment of lay-board religious schools with other religious schools which come under the Federal Unemployment Tax Act (FUTA).

The Association of Christian Schools International is the largest association of evangelical Christian schools in the nation with over three thousand one hundred schools and colleges here. We now serve 732,000 students world-wide. All ACSI schools follow a policy of racial non-discrimination. This policy is reaffirmed in writing on an annual basis when our member schools renew their membership. It was my privilege to testify about this issue before the Subcommittee on Select Revenue Measures with Congressman Charles Rangel as Chairman on September 8, 1993, in the 103rd Congress. ACSI continues its plea that the unfair treatment and inequity within the tax code concerning about fifteen percent (15%) of our member Christian schools and nearly all of the Jewish Day Schools that are represented by Agudath Israel of America must be rectified.

Approximately one out of five religious schools in America is not owned or affiliated with a particular church or synagogue. The elementary and secondary schools we seek to exempt from mandatory participation in the Federal Unemployment Tax Act are as pervasively religious as a church or synagogue owned or affiliated schools would be. They are denied equal treatment, without anyone even suggesting that they are not pervasively religious, because they lack formal church affiliation and are governed by boards of religious laymen.

Because of this distinction, without difference, this small portion of religious schools in America has been forced to participate in FUTA. On their own, the fifty states could make participation in state unemployment laws mandatory. However, an overwhelming majority of states choose to mirror the federal statute, which exempts church and synagogue related or affiliated elementary and secondary religious schools. Congressman Crane's H. R. 1492, would offer the same choice of voluntary participation in FUTA to lay-board religious schools and alleviate the inequity faced by these schools because of the technicality of control. To predicate treatment of religious schools which are essentially the same on the legal niceties of control is to elevate form over substance. Surely it is the religious character of such schools which should be determinative, not something as potentially artificial as the definition of who is in control. For religious schools, their existence as a community of faith is far more important than their organizational structure, whether or not they are owned or affiliated with another religious body.

In a lay board religious school, the teachers are the same as a church school; the chapel services are the same; the curriculum is the same; the Bible classes are the same--everything except the relationship with the church is the same. But the lay board religious schools, which were considered too religious to be eligible for participation in various federal and state funding sources, are no longer exempt from mandatory participation in federal unemployment tax. This is a triumph of form over substance.

Each of the states has slightly different ways of handling unemployment tax, but approximately 46 states largely mirror the federal code. The wording of Congressman Crane's "The Fair Treatment of Lay Board Religious Schools" (H.R. 1492) asks no more or less than what private religious schools that are operated or affiliated with a church or synagogue now have by virtue of Section 3309 (b)(1) of the Internal Revenue Code of 1986, which relates to exemption. Back when the exemption section was enacted, Congress exempted employees who worked for churches and religious organizations operated by churches. Subsequently, in 1981 in St. Martin Evangelical Lutheran Church v. South Dakota, the U. S. Supreme Court ruled that the exemption extended to elementary and secondary schools that churches operate.

Any religious elementary or secondary school that would receive exemption as a result of this measure would have already established the fact with the Internal Revenue Service that it "operated primarily for religious purposes, which is described in section 501(c)(3), and which is exempt from tax under section 501(a)."

Lay-board religious schools provide excellent education and moral training for American young people with a caring environment where students can achieve academically. My own doctoral research in Los Angeles on why black, Hispanic and white parents chose to send their children to evangelical Christian schools attests to this fact. Parents of all ethnic backgrounds chose to re-enroll their children because of the caring environment that they found in evangelical Christian schools.

We believe that Congress failed to exempt lay-board controlled religious schools from FUTA because these schools are not numerous, and Congress was simply unaware of the difference in the technicalities of affiliation from other religious schools. This oversight was not intentional discrimination on Congress' part, merely inadvertent. Back in 1988, an identical amendment to H. R. 1492 was sponsored by Senator Strom Thurmond. The amendment was unanimously adopted by the Senate during consideration of the tax technical corrections bill. Unfortunately, the amendment was dropped in conference. We do not know why. Amendment No. 3443 (in the 100th Congress) was viewed by the Joint Committee on Taxation as revenue neutral. The Joint Committee on Taxation said the "net budget effect of this bill would be a gain of less than $5 million in the fiscal year. . .and a negligible effect each year thereafter." *(Congressional Record, 100th Congress, S14861-2)* Thus, there is no fiscal burden to the government to provide tax equity and simple justice, not to mention equal protection of the laws.

Groups that whole heartedly support H.R. 1492:

Agudath Israel of America
American Association of Christian Schools
Association of Christian Schools International
Coalitions for America
Concerned Women for America
Marian [Catholic] Secondary Schools Association
National Association of Evangelicals
Traditional Values Coalition

We urge the Committee on Ways and Means to carefully consider this remedial measure. Its passage would help lay-board religious schools that are helping American children succeed morally, spiritually and academically. Religious schools look forward to your support of this small, but important piece of tax equity legislation.

WRITTEN STATEMENT OF STANLEY W. ROSENKRANZ OF SHEAR, NEWMAN, HAHN & ROSENKRANZ, P.A., GENERAL COUNSEL TO FLORIDA CLINICAL PRACTICE ASSOCIATION, INC., A FLORIDA NOT FOR PROFIT CORPORATION AND SPECIAL COUNSEL TO THE UNIVERSITY OF FLORIDA AGENCY FUNDS AND THE UNIVERSITY OF SOUTH FLORIDA COLLEGE OF MEDICINE'S FACULTY PRACTICE PLAN SUBMITTED IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 125(a) OF P.L. 98-21 (THE "PROPOSED LEGISLATION")

PROPOSED LEGISLATION

Section 3121(s) of the Internal Revenue Code of 1986, as amended (the "Code") speaks to "FICA responsibility" when two or more related corporations concurrently employ the same individual compensated through a common paymaster which is one of such corporations. Section 125(a) of Public Law 98-21 (the "Special Act"), under certain circumstances, treats as related corporations for purposes of that Code section, a state university which employs health professionals at a medical school and a faculty practice plan which employs faculty members of such medical school.

The Proposed Legislation would amend the Special Act as follows:

"Sec. 125(a) of P.L. 98-21, TREATMENT OF CERTAIN FACULTY PRACTICE PLANS OR UNIVERSITY ACCOUNTS.

"(a) General Rule -- For purposes of subsection (s) of Section 3121 of the Internal Revenue Code of 1954 (relating to concurrent employment by 2 or more employers) --

"(1) the following entities shall be deemed to be related corporations that concurrently employ the same individual:

"(A) a State university which employs health professionals as faculty members at a Health Science Center that includes a College of Medicine, and one or more of the following: a College of Dentistry, a College of Public Health, a College of Nursing, a College of Veterinary Medicine, a College of Health Related Professions, or a College of Pharmacy, and either

"(B) a faculty practice plan described in section 501(c)(3) of such Code and exempt from tax under section 501(a) of such Code --

"(i) which employs faculty members of such medical school, and

"(ii) 30 percent or more of the employees of which are concurrently employed by such medical school; or

"(C) an agency account of a State university which is described in (a)(1)(A) of this section and from which there is distributed to faculty members of any of the colleges described in (a)(1)(A) of this section, payments forming a part of the compensation the State, or such State university, as the case may be, agreed to cause to be paid any such faculty member, and

"(2) remuneration which is disbursed by either:

(A) such faculty practice plan to a health professional employed by both of the respective entities referred to in paragraph 1(A) and (B) of this section; or

(B) such agency account to a faculty member of any of the Colleges described in (a)(1)(A) of this section

shall be deemed to have been actually disbursed by the State, or such State university, as the case may be, as a common paymaster and not to have been actually disbursed by such faculty practice plan or agency account, as the case may be.

"(b) Effective Date --"

An alternative to the Proposed Legislation is to amend Section 3121 of the Internal Revenue Code of 1986, as amended, by adding a subsection (t) (the "Alternate Proposed Legislation"). The Alternate Proposed Legislation would amend Section 3121 of the Internal Revenue Code of 1986, as amended, as follows:

"(t) Concurrent compensation paid by two or more entities pursuant to a single contract of employment.

(1) In general -- For purposes of Sections 3102, 3111, and 3121(a)(1), if qualified compensation is paid to a qualified health professional, then, with respect to the qualified compensation, the total amount of taxes imposed under Sections 3101 and 3111 and the definition of wages in Section 3121 shall be determined as though said qualified health professional has only one employer and that such employer was the qualified institution.

(2) Definitions

(a) Qualified Compensation -- compensation paid pursuant to a single contract of employment to a qualified health professional by both a qualified institution and a qualified co-payor.

(b) Qualified Co-Payor

1. an agency account of a qualified institution from which there is distributed to qualified health professionals, payments forming a part of the compensation which, pursuant to a single contract of employment, a qualified institution agreed to cause to be paid the respective qualified health professionals.

(c) Qualified Health Professional -- a faculty member of a qualified institution.

(d) Qualified Institution -- a state or state university that operates a health science center that includes a College of Medicine and one or more of the following: a College of Dentistry, a College of Public Health, a College of Nursing, a College of Veterinary Medicine, a College of Pharmacy or a College of Health Related Professions.

(3) Operating Rules

(a) Qualified Institution - when otherwise reporting as required by Section 6011 or paying taxes in the manner prescribed by Section 6302 or, in either instance, pursuant to the Secretary's regulations, the qualified

institution shall report the payment of the qualified compensation as if it were the sole payor of such amount,

(b) *Qualified Co-Payor*

1. *Periodic - within two (2) days after the end of each of its pay periods, a qualified co-payor shall remit to the qualified institution cash in an amount equal to the sum derived when (i) an amount equal to the amount of tax imposed by Section 3111 which, if it were to be treated as a separate employer, the qualified co-payor would have owed by reason of having paid, during said calendar quarter, qualified compensation to each of the qualified health professionals, is added to (ii) an amount equal to the amount of tax withheld by the qualified co-payor, during said calendar quarter, pursuant to Section 3102, by reason of its having paid qualified compensation to each of the qualified health professionals.*

2. *Quarterly -- within ten (10) days after the end of each calendar quarter, a qualified co-payor shall provide the qualified institution which, along with it, paid qualified compensation, information as to*

   a. *the amount of taxable social security wages paid by the qualified co-payor in such calendar quarter; and*

   b. *the amount of taxable Medicare wages paid by the qualified co-payor in such calendar quarter.*

3. *Annually -- within ten (10) days after the end of each calendar year, a qualified co-payor shall provide the qualified institution with a list of each qualified health professional to whom it paid qualified compensation during said calendar year, which list shall include:*

   a. *the name, address, zip code and employee identification number of each such qualified health professional to whom it paid qualified compensation during said calendar year;*

   b. *the respective gross wages paid by the qualified co-payor to each qualified health professional to whom it paid qualified compensation during said calendar year;*

   c. *the respective social security wages paid by the qualified co-payor to each qualified health professional to whom it paid qualified compensation during said calendar year;*

d. the respective Medicare wages paid by the qualified co-payor to each qualified health professional to whom it paid qualified compensation during said calendar year;

e. the respective amount of tax deducted from each qualified health professional's qualified compensation during said calendar year;

f. the amount paid by the qualified co-payor to the qualified institution pursuant to Section 3(a)(iii)(x).

(c) Underpayments; Overpayments -- In connection with taxes imposed under Sections 3101 (and withheld under Section 3102) and 3111 by reason of payment of qualified compensation

1. Underpayment - the liability for any underpayment shall be deemed the joint and several liability of the qualified institution and qualified co-payor; and

2. Overpayment - the right to receive any overpayment shall be deemed to be the qualified institution's."

The need for either the Proposed Legislation or the Alternate Proposed Legislation emanates from the unique manner in which compensation is paid certain members of the respective faculties at the University of Florida (the "University") Health Science Center in Gainesville, Florida and at the University of South Florida in Tampa, Florida ("USF").

Based on our informal survey of medical schools, it would appear that the revenue impact of either the Proposed Legislation or the Alternate Proposed Legislation would be limited in scope. More particularly, the revenue impact should be limited to the employer's share of FICA that would otherwise be paid by the agency funds at the University of Florida and the University of South Florida. Assuming (i) a constant FICA tax rate and (ii) no dramatic increase in faculty compensation, it is estimated the annual revenue impact would be approximately $1.6 million. These dollars would otherwise be available to support (i) the respective medical colleges' academic and research activities and (ii) the delivery of health care services to indigent and underfunded patients.

FACTUAL BACKGROUND

As an integral part of their respective University teaching or research activities, or both, members of the respective faculties of the University's College of Medicine, College of Dentistry and College of Health Related Professions (singularly, a "College" and collectively, the "Colleges") generate patient fees (collectively, the "Fees"). The same would hold true for faculty members of USF's College of Medicine.

Pursuant to rules of the Board of Regents of the State of Florida (the "Board"), each such faculty member, as a condition of employment by the respective colleges, agreed that all Fees generated by his/her faculty activities will belong to and be deposited into the practice plan created by his/her respective

College. There is no employment relationship between any faculty member and any practice plan.

The Florida Clinical Practice Association, Inc., a Florida Not for Profit Corporation, which is exempt under section 501(c)(3) of the Code (the "FCPA"), is the repository of all patient fees generated by clinical activities of any member of the faculty of the University's College of Medicine. From time to time, subsequent to collection of the Fees by the FCPA or any other practice plan, a substantial portion of such plan's monies are deposited into an identifiable account within the University of Florida agency funds (the "University Fund"). The latter, itself, is merely a statutorily authorized bank account outside of the State Treasury. The FCPA also collects a portion of the patient fees generated by the activities of faculty members of the University's College of Health Related Professions, all of which fees it deposits in the University Fund. The University's College of Dentistry effects a direct collection of fees generated by its faculty members. All of such fees are deposited into the University Fund.

The monies in the respective practice plans are used to support (i) the educational and research activities of the respective Colleges and (ii) the delivery of health care services to indigent and to underfunded patients. Indeed, the FCPA, the University's College of Medicine's practice plan, provides approximately fifty-two percent of that College's entire budget.

Additionally, on a continuing basis, the assets of a particular practice plan are the means by which a significant capital project can be undertaken by the University. As an example, the FCPA's gross revenues are the main source of security for the bonds from the sale of which emanated the capital to build and equip an academic research building at the University's Health Science Center.

Each faculty member is employed by his/her respective College pursuant to a single contract of employment. Pursuant to pertinent rules of the Board, the compensation provided for in such contract is approved annually by (i) the Dean of the respective College, (ii) the University's Vice President for Health Affairs, and (iii) the President of the University. Pursuant to the single contract of employment, each faculty member is compensated for services rendered in his/her role as a teacher for both his/her teaching duties and for health care services provided individuals concomitant to those teaching responsibilities. For a substantial portion of the pertinent faculty members, payment of total compensation is effected in the form of two documents: a warrant from the State Treasury and a check from the University Fund. The pertinent compensation payments from the University Fund represent a procedure of paying such faculty member's compensation with both State and University Fund provided monies.

As noted, a faculty member is employed by the University pursuant to a single contract of employment. For this reason, the Special Act, which contemplates a duality of employers, is of no benefit in this situation. Accordingly, by reason of such compensation payments, the State and the University Fund, for its respective component of such member's compensation, <u>each</u> issues a Form W-2 to each faculty member whose total compensation is fixed and paid as indicated in the first and last sentences of the prior paragraph, respectively. The State and the University Fund have separate federal taxpayer identification numbers. Utilizing its own respective taxpayer identification number, the State and the University Fund each also files a Form 941.

The State, by reason of its "Section 218 Agreement", pays employer FICA taxes and withholds employee FICA taxes on that portion of the wages paid directly by the State to each affected

faculty member. In effecting compensation payments on behalf of each of the Colleges, the University Fund, as required by the Internal Revenue Service, also pays employer FICA taxes and withholds employee FICA taxes as if it were an employer and as if the State had not caused FICA payments to be made. (This situation is presently the subject of a controversy between the University Fund and the Internal Revenue Service.) Such is the case despite the fact neither the State, the University, any of the Colleges nor the University Fund deem the University Fund, a mere bank account, a separate employer. Indeed, an appellate court in Florida has held that such a fund is not an employer. See, Bryant v. Duval County Hospital Authority, et al, 459 So. 2d 1154 (Fla. Dist. Ct. of App, 1984).

The essence of the matter before the House Ways and Means Committee's Subcommittee on Select Revenues is the payment of "Double FICA" by respective agency accounts at the University of Florida (Gainesville, Florida) and the University of South Florida (Tampa, Florida). The situation is caused by the inability (i) of the agency funds to utilize Section 125(a) of Public Law 98-21 because neither is a practice plan and an employer and (ii) of the Comptroller of the State of Florida (a constitutional officer) to agree to effect payment of faculty compensation in a manner that would obviate the need for legislation. At a meeting with a member of the staff of the House Ways and Means Committee's Subcommittee on Social Security, amplification of point (ii) was requested.

As the agency accounts, particularly the University of Florida Agency Fund, attempted to prevent the "double FICA" situation, an obvious solution presented itself. In lieu of multiple sources effecting payment of the compensation due under a faculty member's single contract of employment, such payment would be effected solely through the Office of the Comptroller of the State of Florida (the "Comptroller").

In an attempt to effect such an arrangement, negotiations over a protracted period of time were carried on with top officials of the Comptroller's Office. In addition to members of the staff of one of the involved universities, as well as assorted legal counsel, the meetings were attended by either the Chancellor of Florida's State University System (the "Chancellor") or one of the Vice Chancellors.

No mutually satisfactory agreement could be reached with the Comptroller. Among the many concerns expressed and vigorously discussed were the following:

1. When, if at all, would the money transferred to the Comptroller by the respective Agency Fund become "state funds"? What legal ramifications would result?

   If the funds were to be deemed "state funds", the thought was that a marked actuarial adjustment under the Florida Retirement System would be required. Having just recently suffered the economic consequences ($6 to $7 million) of such a re-adjustment, the University of Florida College of Medicine was less than enthusiastic concerning such a possibility.

2. Non-academic intrusion into the academic decision making process.

   The question is particularly pertinent in the State of Florida. Historically, the State's university system has been subjected to the micro management proclivities of both the legislative and executive branches of State government. At the University of Florida, faculty practice plan

funds represent approximately fifty-two percent (52%) of its College of Medicine's budget, while at the University of South Florida, fifty-five per cent (55%) of its College of Medicine's budget. Given such facts, the Chancellor, along with the Academic leadership, felt it most important to ensure academic control and oversight by mandating funds be placed in an agency account, thereby, in turn, assuring continued University oversight.

3. Loss of flexibility in connection with fixing the compensation of clinical faculty. At a time when the health care system is undergoing tremendous change, particularly as regards physician compensation, the prospect of such loss of flexibility was of grave concern. The health care delivery system environment mandated, it was felt, affording a College of Medicine increased flexibility as to the compensation to be paid to members of its clinical faculty staff. It was thought that this important flexibility element would be markedly compromised if funds were deposited with the Comptroller.

At the termination of these negotiations, the Chancellor concluded that it was not possible to frame a solution that adequately addressed the concerns of each of the involved parties. Accordingly, it was impossible to arrange for compensation to be paid from one source.

AUTHORITIES

In other situations, such duality of the source of compensation has not prevented a result similar to the result that either the Proposed Legislation or the Alternate Proposed Legislation would provide. For example, the Regulations promulgated under Section 218 of the Social Security Act indicate that

> "(W)here an individual in any calendar year performs covered services as an employee of a State and as an employee of one or more political subdivisions of the State, or as an employee of more than one political subdivision; and the State provides all the funds for the payment of the amounts which are the equivalent to the taxes imposed on the employer under FICA on the individual's remuneration for services; and no political subdivision reimburses the State for paying those amounts; the State's agreement or modification of an agreement may provide that the State's liability for the contributions on that individual's remuneration shall be computed as though the individual had performed services for only one political subdivision. The State may then total the individual's covered wages from all these governmental employers and compute contributions based on that total, subject to the wage limitations in Section 404.1047." See Regulation Section 404.1256.

The University Fund, of course, being a mere bank account, cannot be considered a political subdivision for purposes of the foregoing.

Acceptance of the dual source of funds concept is also suggested by Code Section 3121(u)(2)(D) which specifically states that all agencies and instrumentalities of a single state shall be treated as a single employer. This language manifests recognition that where an employee of a state performs services for more than one agency or instrumentality of that state then such service will be viewed as services for a single employer.

This section recognizes the singularity of the employment relationship and limits the state's liability to a single wage base for each of its employees for all agencies and instrumentalities.

A similar view that dual sources of funds, by themselves, should not prevent the existence of a single employer is also suggested by the legislative intent indicated in the Senate Bill Report for the Special Act. That law amended Code section 3121(b) and (s) to include a provision applicable when a state university employs health care professionals at a medical school and a tax-exempt faculty practice plan employs a significant percentage of those same physicians. Given such a situation, the Special Act mandates that the disbursements by the faculty practice plan are to be deemed to be actually disbursed by the university. Thus, the singularity of the employment relationship is clearly recognized and is deemed to require a single calculation of the wage base. In short, the Special Act provides that remuneration disbursed by the faculty practice plan to a health professional employed both by the plan and the university, will be deemed "to have been actually disbursed by such university as a common paymaster and not to have been actually disbursed by such faculty practice plan." Result: one FICA tax payment, in a situation in which there is clearly two separate employers. This is to be distinguished from the University's situation which involves one employer hiring each of its faculty members pursuant to a single contract of employment and compensating such faculty members from two sources.

That the existence of two paying entities could give rise to a situation involving two taxpayer identification numbers should be of no significance. A review of Private Letter Rulings makes it at once apparent that such a situation is not unknown to the Internal Revenue Service. Private Letter Ruling 6609164800A (the "Letter Ruling"), for instance, contemplated a situation involving two separate corporations, A and B, each having its own taxpayer (employer) identification number, which operated under a joint contract. Under the contract, all employees performed duties for both corporations. Only Corporation A, however, filed employment tax returns.

Addressing the question as to which corporation had the responsibility for filing such returns, the IRS determined that the two entities were truly distinct employers and therefore, each should file Forms 941 and 940. However, for those years which corporation B, had failed to collect, report and pay FICA employee tax, it was relieved of doing so, since corporation A had already reported and paid the requisite amounts. In order to satisfy the IRS, corporation B simply attached a supporting statement to its employment tax returns, setting forth the entire factual situation, that is, that FICA taxes had previously been paid by corporation A.

Rev. Rul. 57-22, 1957-1 C.B. 569 (the "Revenue Ruling") also suggests Internal Revenue Service familiarity with dual payor situations. Factually, the Revenue Ruling was concerned with a cooperative agreement between a federal agency and a state for the investigation of the water resources of the state.

Under the terms of the agreement, each party paid a certain amount of the expenses of the project. The agreement also provided that the field and office work pertaining to the investigation was to be under the direction of the federal agency. The state, however, agreed to carry the individuals on its payroll and to make payment to them for their services.

The individuals involved in the project, worked for, took orders from and were under the control and direction of the federal agency. The state payroll claim, however, was made up by the federal agency and approved by an officer of the state.

Moreover, the state did not select, or have any voice in the selection of, the individuals performing the services. For FICA purposes, the Revenue Ruling held that, based upon the applicable common law rules for determining an employer-employee relationship, the individuals were employees of the federal agency.

SUMMARY:

As a result of effecting their respective contractually obligated teaching or research activities concomitant with patient care activities, or both, members of the respective faculties of the Colleges generate Fees. The Fees belong to and are deposited into the practice plan created by a particular faculty member's respective College. From time to time, a particular practice plan pays a substantial portion of the Fees to the University Fund, a statutorily authorized bank account outside of the State Treasury.

For services rendered in his/her role as a teacher and in the health care services provided as incident to those teaching responsibilities, each faculty member is compensated pursuant to a single contract of employment. Generally, payment of such compensation is effected in the form of two documents: a warrant from the State Treasury and a check from the University Fund.

An obvious solution to the "double FICA" situation -- i.e., all payments to be effected solely through the Comptroller -- was not available, because no mutual satisfactory agreement could be reached with the Comptroller. His office's concerns revolved around questions such as (i) when, if at all, would the money transferred to the Comptroller by each of the agency funds, become "state funds" and (ii) what would be the legal ramifications of such monies becoming state funds, such as requiring unacceptable levels of actuarial adjustments in Florida State Retirement System contributions. For their part, the respective agency funds were concerned about (i) non-academic intrusion into the academic decision making process and (ii) loss of flexibility in connection with fixing faculty compensation.

The State and the University Fund each possesses a taxpayer identification number. Each withholds the maximum FICA on the compensation paid by it; albeit, neither deems the University Fund either an employer for purposes of FICA or an entity required to withhold and pay over FICA taxes. Rather, given the existence of separate taxpayer identification numbers, the dual paying over and withholding was utilized solely to insure the Treasury Department that each faculty member's total compensation had been properly recognized for FICA purposes.

The Employment Tax Regulations list a number of factors to be looked to in determining whether an "employer-employee" relationship exists. Treas. Regs. §31.3401(c)-1(b). None are present in the instant situation. Manifestly, there is but one employer -- the State of Florida.

The concept of multiple sources of payment and one employer is not unique. See Regulation Section 404.1256, Code section 3121(u)(2)(D), Senate Bill Report for Section 125(a) of Public Law 98-21, April 20, 1983, PLR 6609164800A, and Rev. Rul. 57-22, 1957-1 C.B. 569. There being one employer, the University Fund should be exempted from FICA responsibility to the extent the State has carried out such responsibility.

Statement
of the
National Technical Services Association
submitted to the
Committee on Ways & Means
U. S. House of Representatives
for the
July 11, 1995
Hearings Record

"Oversight Hearings on Miscellaneous Tax Reforms"

I. The Issues

Mr. Chairman and members of the Committee, the National Technical Services Association (NTSA) appreciates this opportunity to comment on certain tax revenue and simplification proposals reviewed by your committee on July 11, 1995. We focus our comments on § 1706 of the Tax Reform Act of 1986, § 530 of the Revenue Act of 1978, and other worker classification proposals before your committee.

Two weeks ago, your committee reviewed a proposal to repeal § 1706. We submit that until § 530 is materially narrowed, and new employment classification guidelines are forwarded by Congress, § 1706 should not be repealed. It has restored some rationality to the worker classification issue in the technical services industry and there should be no retreat from that gain except in the case of a fresh start for all industry.

How Congress approaches the issue of worker classification in the future is a key issue which does need to be resolved. Central to any discussion involving § 1706 is first, the establishment of clear employment classification guidelines and second, striking balance between IRS enforcement, taxpayer protections, and other laws which are predicated on elements of the common law test. We note that a number of bills have recently been introduced to simplify the classification of workers for federal income tax purposes. We favor such simplification, note that the pending bills seem to favor independent contractor classification, and caution that these efforts should not favor one classification over another.

II. About NTSA

NTSA is a non-profit organization which exists to promote the legal, legislative, regulatory, strategic business development, and continuous process improvement interests of member firms. NTSA members supply a wide range of design, drafting, engineering, project management, computer programming, systems analysis, staff augmentation, and technical publication services, for profit, to industry and government clients. Members number among their clients most major American corporations, thousands of small industrial companies, government agencies, and colleges and universities across the United States. Our 200 corporate members operate 800 technical services offices, employ more than 280,000 technical personnel, and generate between $6 - $9 billion annually in sales of technical staffing and other support services.

III. NTSA Member Concerns

When the IRS, applying the common law test, has addressed the issue of worker classification in the technical services industry, the IRS has consistently been of the view that the personnel are employees of the technical services firms for purposes of federal income, social security, and unemployment tax withholding.

While NTSA has never advocated a preference for one classification over another, we have repeatedly noted that the protections afforded under § 530 had the effect of fostering and encouraging misclassification of workers in our industry through a combination of

two effects. First, § 530 is frequently perceived as giving the "OK" to independent contractor classification almost as a matter of choice. Second, by limiting IRS' rule-making authority, § 530 reinforces the perception that § 530 gives carte blanche to companies and workers to choose independent contractor status if so desired. One effect feeds on the other.

In its discussion of the motivation for Congressional enactment of § 1706 which concerns technical service workers, the Treasury stated:

> "Section 530 affects different taxpayers differently, depending on whether they satisfy the conditions for relief contained therein. In particular, some taxpayers that have consistently misclassified their employees as independent contractors are entitled to relief under § 530, while other taxpayers in the same industry (that, for example, have take more conservative position on classification issues) are not, because they cannot satisfy the consistency requirements of the Section."[1]

The uneven playing field arising out of § 530 was the stimulus for NTSA's support of enactment of § 1706.[2] Section 1706 removed the protections offered under § 530 for firms which supply technical services. This limited exception applies only to multi-party business transactions which involve 1) firms which supply or broker the services of technical personnel, 2) technical personnel, and 3) the clients that benefit from the services of the technical personnel.[3]

Section 1706 does not change the common law rules for classifying workers as employees or independent contractors, nor does it change the employment status of anyone covered by the provision. It simply permits the IRS to interpret and enforce the underlying rules for technical services workers without regard to § 530. Remember, an employer is only entitled to § 530 relief it has, in fact, misclassified its employees as independent contractors.

The Consistency that § 1706 brought to the tax treatment of workers within the technical services industry has worked. Organizations like NTSA have communicated the tax laws effectively to their members. As a result, companies in the technical services industry have benefited due to the issuance of industry-specific classification guidelines, treated their employees in accordance with the law, and, we believe, greater awareness and tax compliance has been achieved.

IV. Policy Recommendations for the 104th Congress

Repealing § 1706 is not the answer. Simply codifying § 530 is not the answer either. That law was designed merely to maintain a status quo for a short period of time -- it was a "time-out" call intended to keep things as they were until new rules were crafted. Its safe harbors and consistency requirements were never intended as policy judgments which would endure far into the future. Clearly, Congress could not have intended to reward the "consistent" conduct of a company that aggressively misclassified its workers as independent contractors over the inconsistent conduct of a company which in good faith searched for the correct approach amidst shifting rules. Moreover, a rule that treats companies in the same industry differently based on how long a company has been in existence or based on a company's past practice is patently unfair.

A. Amend § 530 "Prior Audit Rule"

NTSA recognizes that § 1706 repeal language is present in the Misclassification of Employees Act, HR 510. If passed, this bill would institute a limited scope taxpayer amnesty program concurrent with amending § 530. Under this bill, the list of reasonable bases for treating a worker as an independent contractor would be modified to incorporate a much more contemporary application of the "prior audit" rule.[4]

NTSA would likely support repeal of §1706 if such action were concurrent with amending the prior audit rule to make it specific to "employment classification compliance checks or audits" conducted within a reasonable time frame.

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1 See Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, U.S. Treasury Department, March 1991, pp. 32-33.

2 P.L. 99-514, § 1706, 100 Stat. 2095, 2781 (1986).

3 Rev. Rul. 87-41, 1987-1 C.B. 296.

4 See for example, HR 510 legislative summary "an IRS audit conducted solely for employment tax purposes within three years before the period in question, which audit includes an examination for employment tax purposes of workers holding substantially similar positions to the worker in question, and following which audit the employer is notified in writing by the IRS that the employer has classified the workers correctly and the IRS notification is not revoked before the period in question; or..."

B. Establish Independent Contractor and Employee Classification Safe Harbors

NTSA continues to urge Congress to provide significant guidance by setting forth a limited number of factors which employers, individual taxpayers, and the IRS may use to make worker classification determinations. These factors should be based on common law and expressed as safe harbors.

Taxpayers who fall within one of these "safe harbors" would be assured that they would not be subjected to large retroactive penalties should the employment status of their workers be questioned. Likewise, NTSA believes that if a worker disputes the classification, the worker should be able to request a ruling from the IRS based on the broader application of the 20 common law factors. This request would be made through a version of the current Form SS-8 procedure.[5]

NTSA has reviewed, with great interest, the provisions offered under the Independent Contractor Tax Simplification Act of 1995, HR 1972. Under this bill, the 20 common law factors would be replaced -- for purposes of determining who is not an employee -- by a new set of criteria which, if met, would allow any employer or individual to determine "electively" whom among their labor force to class as employees and whom to class as independent contractors. There would be no requirement for consistent worker status treatment. There would be no "service recipient" tax liability as long as 1099's are properly filed, a qualifying written contract exists, and the "service supplier" meets one of 5 safe harbor requirements.

While H.R. 1972 and similar proposals represent a new, creative approach to the issue of worker classification, we suggest that, in the end, simplification can be achieved without introducing a whole new set of independent contractor criteria.

For example, we believe that worker classification objectivity would be equally achievable by simply structuring new safe harbors around key elements of the present common law test. Such safe harbors might specify that:

1) A worker is an independent contractor if:

- the worker works for several bona fide customers at any one time and, subject to agreed upon due dates, schedules the order in which the work is done; and
- the worker performs substantially all of the work at the worker's place of business, which is not furnished by the customer, or if it is furnished by the customer, for which the worker pays fair market rent; and
- the worker bears the economic risk of the business because the worker's remuneration is directly based upon output or deliverables and not upon the number of hours which the worker works.

2) A worker is an employee if:

- substantially all of the work performed by the worker is done during regular business hours at one company's (or that company's customer's) place of business; or
- the company schedules the hours (including instituting flex-time scheduling) the worker is to work; or
- the worker is paid by the hour, week or month for time worked; and
- payment for work done for one company, directly or indirectly, is the worker's sole or major source of income for the worker's services.

V. Other Considerations for Congress

The application of worker classification standards, whether in their current form, or as may be amended, however, currently focus on tax related questions. For example, under H.R. 1972, a worker may be classified as an independent contractor for tax purposes but would remain an employee under the criteria set forth in the Fair Labor Standards Act,

[5] See "Statement of the National Technical Services Association," Hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations House of Representatives, 101st Cong., 1st Sess., June 8, 1993.

Title VII of the Civil Rights Act, the Americans with Disabilities Act, the Family and Medical Leave Act and various state unemployment and workers' compensation laws. This dichotomy would occur because most of these laws also are principled upon elements of the common law test. When considering the adoption of a new independent contractor test, we believe the effect such a new test will have on other bodies of law must also be considered.

VI. Summary Remarks

Until § 530 is materially narrowed, and new employment classification guidelines are forwarded by Congress, § 1706 should not be repealed. It has restored some rationality to the worker classification issue in the technical services industry and there should be no retreat from that gain except in the case of a fresh start for all industry. As new worker classification proposals are forwarded, we urge Congress to consider the effects these proposals will have on the administration of other laws as well. Congress must weigh its fiscal and employment policy objectives with the understanding that a worker classified as an independent contractor for tax purposes might later successfully challenge a failure to pay premium overtime or make a claim for an uninsured work-related injury. This anomalous but very real result can only lead to more confusion and may be compounded if new employment classification standards vary materially from the present common law test.

We look forward to working with your committee and staff on these important policy issues and would be happy to furnish further supporting information.

Respectfully submitted,

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TESTIMONY OF DENNIS WEST, PRESIDENT
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UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISC. TAX PROPOSALS
JULY 11, 12, AND 13, 1995

Mr. Chairman and members of the subcommittee, my name is Dennis West and I am the President of Eastside Community Investments, Inc. a private not for profit community based development corporation. (CDC). In the Spring of 1992, I testified before the Ways and Means Committee with respect to the proposed enterprise zone legislation. My testimony addressed the need for federal policy that encouraged capital formation strategies in poor communities. In my statement, I encouraged the Committee to utilize the expertise of community development corporations (CDCs), like ECI, as the vehicles to increase private investment in poor communities with the goal of developing both the human and the economic assets in our communities. Congressman Andy Jacobs, who represents the Tenth District Indiana where ECI is based, fashioned this concept into legislation, the Community Development Corporation Tax Credit, which was eventually passed as part of the 1993 Omnibus Reconciliation Act. The law created a program which mirrors the Low Income Housing Tax Credit in structure, but is intended to stimulate those CDC ventures which are aimed at job creation and economic development.

I am honored to be testifying again before the Ways and Means Committee in support of the CDC Tax Credit and to encourage the Committee to expand the credit and allow more CDCs to participate in this program. ECI is part of a CDC movement which numbers about 2,200 groups scattered across America and which are working to bring value, build capital and revitalize some of our most distressed places.

I am offering this testimony to you as someone who has significant perspectives on the work of community economic development, creating public and private partnerships, and the use of tax incentives to foster corporate and individual investment. I have been President of ECI for eleven years, while I have lived in the community which ECI serves for the past fifteen years. ECI has used its ability to attract capital to put together one of the most comprehensive efforts of community revitalization in the Country (see Exhibit A). ECI has created thirteen limited partnerships, using the low income housing tax credit, historic preservation tax credits and the targeted jobs tax credit. This work is testimony to public-private partnership and the transforming power which occurs when corporate America becomes the partner to community and government to address poverty.

I would like to provide the Committee with some background information on Community Development Corporations (CDCs), an industry that has been growing steadily in this country since 1980, and their development activities in low income urban neighborhoods and poor rural communities. CDCs are locally based and controlled non-profit organizations committed to the social and economic revival of their communities.

According to a recent survey by the National Congress for Community Economic Development (NCCED), the national trade association of organizations engaged in the economic revitalization of poor communities, there are between 2,000 and 2,200 CDCs operating around the country. According to the survey, 63% of these CDCs serve urban areas, while 19% serve rural communities and 15% serve mixed urban-rural communities. These CDCs have produced approximately 40,000 units of affordable housing, developed 23 million square feet of commercial / industrial space, created 67,400 full time jobs (not including jobs due to construction activities) and lent over $200 million to business enterprises in their communities.

CDCs take a comprehensive approach to community development combining economic development activities and affordable housing construction with a wide ranges of community building activities, ranging from job training, community organizing, small business lending and technical assistance, teen counseling and senior care. CDCs develop their work agenda in response to the many needs of distressed communities.

CDCs have proven their capacity to attract private investment into their target areas. In many cases, CDCs undertake projects that the private sector has passed up because of stronger markets elsewhere and the risks associated with doing business in low income communities. CDCs have creatively used Federal funds to leverage private investment capital in their development activities benefiting poor communities and individuals. For instance, a recent survey of rural CDCs utilizing funds from USDA's Intermediary Relending Program (IRP) showed that, on average, CDCs leveraged $7 of additional investment for every federal IRP dollar invested in a business deal.

The Low Income Housing Tax Credit authorized by Congress in 1988 is a good example of a tool which is being used to attract private investment to projects which otherwise would not have been done. In particular, the Credit has been responsible for ECI's development of over 300 units of housing in seven real estate syndications. The result has been over $10 million dollars invested by individuals and corporations into the revitalization of what was once the worst housing stock in our community. The impact on neighborhood stability created by the return to productive use has been enormous. Over 80% of ECI's tenants renew their leases annually; we hope that this is reducing turnover in the local schools as well.

CDCs have also used the Community Economic Development grants program administered by the Office of Community Services of the Department of Health and Human Services to great effect in improving vacant or underutilized buildings and creating jobs for residents. On average, CDCs leverage $2 dollars of private sector funds for each $1 of Federal funds.

Why this incentive and why now?

The CDC Tax Credit has provided a new tool for CDCs to use in attracting private investment capital to poor urban and rural communities for use in economic development activities. The Community Development Corporation Tax Credit, as authorized in the 1993 Omnibus Budget Reconciliation Act, granted the Department of Housing and Urban Development (HUD) the authority to designate twenty CDCs as eligible to market and utilize a tax credit as a tool to encourage private investment in the development activities of CDCs in designated poor communities. The program grants eligible CDCs the authority to accept up to $2 million in contributions from private individual and business investors who in turn would receive a five percent tax credit for their qualified cash contributions each year for a ten year period.

In June of 1994, HUD designated twenty CDCs to participate in the CDC Tax Credit. Twelve of the CDCs chosen serve urban communities, while eight are based in rural areas. The list of designated CDCs is attached to this testimony as Exhibit B. At present, most of the selected CDCs are marketing the credit to a range of investors in hopes of having secured commitments within the next year.

Though ECI was not one of the twenty CDCs chosen in 1994, I am here to testify in support of expanding the tax credit and making it available to additional communities around the country. In a time when Federal funds are being trimmed back, it is essential that flexible tools like the CDC Tax Credit be available to organizations like Eastside Community Investments to encourage private investment in our communities.

I want to take this opportunity to tell you more about the near eastside community in Indianapolis which is served by ECI. This community, where I work and live, has unemployment which traditionally doubles the local City rate. There are approximately 28,000 persons residing in about 10,000 households. Another significant factor is the relative youth of this area - about 32% of the population are under age 18. However, the issue we face and what is so critical to economic progress is the lack of education and marketable skills which exists. Our community

has 46% of its adults who lack a high school education and, while we have less than 3% of the County population, we have 12% of its caseload for Aid For Dependent Children. This creates a paradox. On one level, we daily see the tremendous capacity of our friends and neighbors to take their gifts, talents and skills and create enterprises and opportunity. Our work in microenterprise is confirmation of this fact. But on the other had, we see the limits which our neighbors face when lack of skills and formal education stifle their ability to move beyond low income and low skill employment.

The problem comes as we look at the cost of living, even in a poor community. Average rent in our community is $350 per month. The average level of public assistance for a family of three is $288 per month. By the same token, holding a low skill low wage job will probably result in a net take home pay of around $600 per month. Neither the public assistance wage, nor the low skill wage is providing enough income to make a budget that can work, particularly if the households are headed by a single parent. Overall, one third of the families in our community are living in poverty. One in four families is single parent headed.

For our community and many like it to move beyond poverty, we must create opportunity which means the ability to secure more education and skill sets which can be marketed in the larger economy. In order to transform our community, families need the ability to generate more income and build assets. Supporting economic development ventures is a challenge. When ECI decided to develop a project to improve the quality, reliability and quantity of child care, we needed fifteen funding sources to fully fund the project's capital and two year operating expenses. We imported money from California, Illinois, Kentucky, Maryland, Michigan, New York and Washington D.C. to put the project together. Soliciting and securing money from so many sources depletes the energy and likelihood for many groups to embark on ventures which are experimental. Having a venture fund pool available to seed start up expenses or to make loans to the day care entrepreneurs would have greatly facilitated the process.

This past year we have demonstrated that when economic opportunity is offered families participate. ECI has provided 5,000 hours of construction training and 3,000 hours of child care training to 57 students in our YouthBuild program. The YouthBuild program sent twelve of these students to receive their high school diplomas this June. Our microenterprise program is attracting twice as many people to its orientation as classes can accommodate (30 participants in an 11 week course). Also this past year we caused over 70 families to grow assets, either as homeowners, owners of business, possessors of individual development accounts or home ownership development accounts. At the same time, an ECI enterprise, Shelter Systems, has brought steady employment to ten community residents who will also have the chance to apprentice in the Carpenter's Union and achieve journeyman status in four years. These efforts, modest as they are, are growing. They are also fostering new ways for a community and its residents to see itself.

The CDC Tax Credit would be used by ECI to support equity investments in local business ventures which would continue to support the training and employment of low income, low skilled individuals. In addition, ECI would use the CDC Tax Credits to attract investment to the Opportunity Factory, a training program of computer skills, self assessment, educational skills and communications skills which will focus attention on elevating worker's ability to participate in the private economy.

We should expect that for the next decade that we will have labor shortages. Those shortages are a demographic phenomena caused by the baby bust which followed the baby boom. There will be a significant outcry from businesses which are striving to find workers who have the social skills, a work ethic, and the personal stability necessary to be productive. This phenomena means that we must engage every able bodied American into helping to produce for our economic well-being.

Encouraging and guiding people to economic participation is something which CDCs are doing well. They have important contributions to offer in order to intermediate between the residents of their communities and the opportunities of work force participation. This role in intermediation is something which the tax credit will make possible.

My purpose in offering this testimony is to request that you expand the Community Development Corporation Tax Credit which was authorized as part of the Omnibus Budget Reconciliation Act of 1993. This demonstration has shown that it can work. In south Dallas, Texas Instruments invested in a venture which is bringing 250 quality jobs to benefit a community characterized by high unemployment and significant poverty. This shows that the result which Congress intended - to offer a product for partnership to extend new opportunities in the private sector - can, in fact, work.

I also ask that the Committee consider making the following changes to the CDC Tax Credit in an effort to perfect what ECI and many other urban and rural CDCs feel is an important new development tool.

First, I encourage the Committee to consider extending the credit to apply to twenty additional CDCs. As I mentioned earlier in my testimony, there are more than 2,200 CDCs operating around the country and only 20 are currently able to take advantage of this tax credit. Expanding the number of eligible CDCs by 20 would allow twice as many communities to benefit from the program while at the same time managing the growth of a new development tool.

Secondly, I encourage the Committee to increase the amount of the tax credit each CDC can raise from $2 to $4 million and retroactively apply this higher limit to CDCs that were selected to receive tax credits in 1994. Since the CDC Tax Credit is new to both CDCs as well as their potential investors, it is not surprising that most of the CDCs designated by HUD last year have not yet reached their $2 million investment goal. However, the designated CDCs currently marketing the credit see the potential to secure significant investments over time.

Thirdly, in an attempt to make the tax credit more user friendly for rural CDCs, I urge the Committee to craft technical changes to the current statute that deal with the difficulties some rural CDCs have had with the geographical constraints associated with the tax credit. In other words, establish alternative criteria for a "rural operating area" that would reflect the fact that many rural CDCs operated statewide and serve "pockets of poverty" that are scattered throughout a region - not concentrated in a specific neighborhood.

In addition, a number of the CDCs are interested in shortening the period in which an investor can take advantage of the credit. CDCs currently trying to market the credit and attract investors feel that the credit would be more attractive to investors if the ten year return on the credit were shortened to perhaps five years or less.

The tragedy of poverty in urban America can grasp and hold the attention of the private sector in this environment. The violence, stress, transience and homelessness which permeate our poorest communities requires community attention and community solutions. We have seen the results of public-private partnerships which utilize the Low Income Housing Tax Credit. This tool which Congress created has demonstrated that mobilizing private capital will create jobs and opportunity the way that it has in Dallas. We ask your help to provide this incentive to twenty more communities across America to mobilize private capital into the business of good jobs and economic opportunities in the places where it is most needed.

EXHIBIT A

EASTSIDE COMMUNITY INVESTMENTS, INC.
Production 1976-1995

Investments in Land

- Developed a 40 acre industrial park at Rural & I-70. Home to 32 businesses;
- Developed 14 units of new construction (through 1995) in conjunction with the Career Education Center Builders and students of Arsenal Technical High School;
- Developed Byrne Court, a 50 unit housing for the elderly and handicapped;
- Annually (since 1990) conduct tree planting, urban reforestation and landscaping projects utilizing volunteers. The project, known as "Just Say Grow," includes a seedling nursery; the 500th tree was planted in 1994.
- Developed Ohio Street Townhomes, a 20 unit building.

Investments in Buildings

- Bought, rehabilitated and sold 238 units which had been boarded and vacant;
- Bought, rehabilitated and rent 172 units which had been boarded and vacant;
- Conducted self help rehabilitation assistance for 800 families;
- Bought a closed public school and converted it into a 24 unit apartment building, Whittier Place Apartments;
- Renovated the Brookside Building, providing 24 units of housing, ten dedicated to mentally disabled homeless, and 8,000 s.f. of commercial space;
- Annually (since 1986) conduct Caulk of the Town, a weatherization project which engages 1,000 volunteers to weatherize units and provide minor home repairs;
- Renovated the former Holy Cross Church Parish House into a 15 unit apartment building, Providence Place.
- Renovated the former St. Philip Neri church Parish House into a 13 unit apartment building for the elderly and 5,000 s.f. commercial space for a day care center, Guerin Place.
- Developing 10.1 acres and 3 buildings with 164,000 s.f. of manufacturing spacefor new uses, the New East Industrial Center.
- Perform full service property management for over 350 rental units in five center city neighborhoods.

Investments in People

- Developed the cottage industry of child care into a cooperative of nine family day care businesses;
- Developed 21 units of transitional housing for families who had been victims of domestic violence;
- Conduct(since 1992) classes to teach the development of business plans leading to investments by ECI, through the Eastside Community Fund Microloan Program.
- Developed the ECI YouthBuild Program, a work and education program which assists young people who have dropped out of school and who have parenting responsibility to invest in their future economic self-sufficiency; job training in 2 career tracks, annually for 30 youth.
- Developed a Special Needs Housing Program to establish permanent housing for 16 adults with chronic mental illness in conjunction with 8 caregiver families; provide job coaching.
- Assists individuals to build assets through Individual Development Accounts (IDAs), restricted, leveraged savings accounts.
- Assists individuals to build assets through Home Ownership Development Accounts (HODAs), restricted, leveraged savings accounts to assist tenants to become homeowners.

Investments in Industry

- Invested over $1,000,000 through a Small Business Investment Company, Circle Ventures;
- Established the Eastside Community Fund (capitalized at $800,000), which is investing in small businesses.
- Established Arsenal Construction Corporation to provide general contracting, and construction management.
- Established Shelter Systems, LLC to manufacture wall panels and roof trusses in order to provide training and employment opportunities.

grants\Prodsum
March 17, 1995

EXHIBIT B

Community Development Corporations Selected for CDC Tax Credit Program

__Urban CDCs__

New Economics For Women
379 South Loma Drive
Suite One
Los Angeles, CA 90017

Marshall Heights Community Development Organization, Inc.
3917 Minnesota Avenue, N.E.
Second Floor
Washington, DC 20019

Tacolcy Economic Development Corp., Inc.
645 N.W. 62nd Street
Suite 300
Miami, FL 33150

Grasp Enterprises, Inc.
55 Marietta Street, N.W.
Suite 2000
Atlanta, GA 30303

Bethel New Life, Inc.
367 North Karlov
Chicago, IL 60624

Urban Edge Housing Corporation
2010 Columbus Avenue
Boston, MA 02119

Southeast Development, Inc.
10 South Wolfe Street
Baltimore, MD 21231

New Community Corporation
233 West Market Street
Newark, NJ 07103

Bedford Stuyvesant Restoration Corporation
1368 Fulton Street
Brooklyn, NY 11216

Hough Area Partners in Progress
8610 Hough Avenue
Cleveland, OH 44106

Free the Children, Inc.
1192 Peabody
Memphis, TN 38104

The Southern Dallas Development Corporation
1201 Griffin Street West
Dallas, TX 75215

__Urban CDCs__

El Pajaro Community Development Corp.
318 Main Street
Suite 208
Watsonville, CA 95076

Kentucky Highlands Community Development Corporation
P.O. Box 1738
London, KY 40743

Coastal Enterprises, Inc.
P.O. Box 268
Wiscasset, ME 04578

Delta Foundation
879 Main Street
Greenville, MS 38701

Chautaugua Opportunities Inc.
168 South Erie Street
P.O. Box B
Mayville, NY 14757

North Cambria Community Development Corporation
P.O. Box 174
Barnesboro, PA 15714

National Rural Development & Finance Corp.
711 Navarro Street
Suite 350
San Antonio, TX 78205

Virginia Mountain Housing, Inc.
930 Cambria Street, N.E.
Christiansburg, VA 24073

TESTIMONY OF AMERICAN INSTITUTE OF ARCHITECTS

July 27, 1995

The Hon. Bill Archer
Chairman
U.S. House Committee on Ways and Means
Washington, DC 20510

Dear Mr. Chairman:

The undersigned organizations request that our views on the proposed "Commercial Revitalization Tax Credit Act" be included in the record of hearings on miscellaneous tax provisions. Senator Kay Bailey Hutchison has introduced this measure as S 743, and since the hearings were held, Representative Phil English has announced his intent to submit a companion bill in the House.

We believe that this legislation would fill a significant gap in the range of tools now available to states and localities for economic revitalization. The legislation would provide qualified taxpayers with a choice of two tax credits: 1) 20 percent of creditable expenses, which may be taken all at once or carried forward or backward, or 2) five percent/per year for ten years. Creditable expenses would be the costs of commercial new development, expansion and rehabilitation in areas specifically designated for revitalization by federal, state, or local governments. Such expenses would include design services and construction costs, along with a portion of environmental clean-up, land acquisition, and demolition costs. A maximum of $10 million in credits per project is allowed.

The proposed tax credit program would operate like the highly successful Low-Income Housing Tax Credit, enacted in 1986. Its cost would be $1.5 billion in available tax credits over five years, beginning in calendar year 1996 at $100 million and rising to $200 million in 1997, and to $400 million in each of years 1998-2000.

According to Kermit Baker, the economist for the American Institute of Architects, based on the experience of the Low-Income Housing Tax Credit, the proposed commercial revitalization tax credit could generate as much as $5.5 billion in construction and related industry wages, plus another $6 billion in commercial activity, of which about $4 billion would go for wages with as much as $500 million in federal, state, or local taxes.

We believe that this legislation has numerous advantages: 1) It is modeled on a known, proven program--the Low-Income Housing Tax Credits. 2) It fills a gap in available revitalization incentives. 3) There would be little federal beaurocracy. 4) The total amount of credits is fixed, so the total cost is known. 4) It will reduce the risk of investment in distressed communities, thereby encouraging new and enhanced business activity. 5) It relies on state/local/partnerships. 6) It will work for a wide range of retail, industrial, health care, and other facilities. 7) It is based on the principle of pay for performance, and can be claimed only after the investment is made, the project completed, and the assets remain in use. 8) Most importantly, the measure will generate new jobs, tax revenues, higher property values, and a better quality of life for areas that have known only decline.

We hope that your committee will favorably consider this measure for inclusion in any omnibus tax legislation that it will report during this Congress. If you have any questions, please call Al Eisenberg, Director of Federal Legislative Affairs for the American Institute of Architects, at 202/626-7384.

Sincerely,

American Association of Enterprise Zones
International Downtown Association
American Institute of Architects
National Congress for Community Economic Development
National Association of Industrial and Office Properties
LISC (Local Initiatives Support Corporation)
National Conference of Mayors

TESTIMONY OF WILLIAM A. POLF
COLUMBIA UNIVERSITY

My name is Dr. William A. Polf and I am the Deputy Vice President for External Relations and Strategic Programs at the Health Sciences Division of Columbia University. My testimony focuses on the potential for the recently enacted empowerment zone legislation to attract biotechnology companies to economically distressed areas.

Columbia University is currently developing the Audubon Biomedical Science and Technology Park within the New York City Empowerment Zone. Audubon combines three crucial functions. The Park is expected to become a major center for public and private biomedical research. It will also serve as a mechanism for technology transfer by offering facilities and programs which translate university-based scientific discoveries into commercial products. Finally, the project will foster local economic development by creating new businesses and jobs in the inner city.

The development of the Audubon Park is a key component of the New York empowerment zone strategy. There are five research and technology related buildings planned for this site. The first building, the Audubon Business and Technology Center, was recently completed and has 60,000 square feet of core and shell laboratory space for established and new biotech companies and 10,000 square feet of general level space for retail firms. The Center is the first university-related incubator facility designed to stimulate the growth of the biotechnology industry in New York. Approximately 40 percent of the lab space will be set aside for start-up companies. Audubon Center management will help tenants locate financial and venture capital sources, provide market and product analysis, help prepare business plans, assist in dealing with licensing and regulatory matters, and help recruit and train technical personnel. The Center also will provide general business assistance to entrepreneurs interested in starting a biotechnology or other business in the Washington Heights/Inwood neighborhood. Construction has also been started on the second building, the Center for Disease Prevention. When all five facilities planned for the Audubon Park are developed, nearly 2500 new jobs will be created including scientific, research, laboratory, clerical, administrative, retail, and building operations and support.

The success of our project depends in large part on our ability to persuade start-up biotechnology companies to move within the empowerment zone. One of the major incentives adopted by Congress to attract companies to these areas was the employment tax credit. Under this provision, qualified businesses may receive up to a 20 percent credit for the first $15,000 in wages paid to individuals who live and work within these zones. Policy analysts have viewed the employment tax credit as one of the best mechanisms for stimulating new job opportunities in these zones. The limited tax incentives can only be earned by creating jobs in the zone for residents of the zone. However, the tax credit is not an effective incentive for most start-up technology companies. These companies are precisely the types of firms that have the greatest potenual for transforming some of our core cities. Small technology-based businesses are the fastest growing sector of the economy. They are often backed by venture capital and rarely earn taxable income during their early research and development phases. Consequently, the existing credit has little value and does not encourage these firms to locate in the empowerment zones, as was originally intended.

This problem is not limited to New York. There is a major medical/research center located in or adjacent to almost all of the empowerment or enhanced enterprise zones. Examples include: Johns Hopkins and the University of Maryland Medical Centers in Baltimore; Cleveland Clinic and Case Western Medical School in Cleveland; Wayne State Medical Center in Detroit; University of Missouri Medical Center in Kansas City; and the University of Illinois Medical School in Chicago. However, all of these cities face the same problem. While there is enormous potential for creating technology and biotechnology related jobs, significant incentives are needed to convince new start-up firms to locate in these depressed areas.

For these reasons, we would like the Committee to adopt a technical correction that would permit a C corporation to transfer all, but not less than all, of its Empowerment Zone Employment Credit to the holders of its common stock. With this amendment, the employment credit will be an attractive incentive for investors even if the start-up technology or biotechnology firm is not expected to generate any income during its early years. This

modification would ensure that the credit has the maximum intended impact in generating jobs. Draft changes to the tax code that would accomplish this objective are set out below:

Empowerment Zones

Permitting C Corporations to Transfer Employment Credits to Shareholders

A. Amend Subparagraph (2)(B) of Section 38(c) by changing "For purposes of this paragraph," to "For purposes of this paragraph and of paragraph (3)."

B. Renumber paragraph (3) of Section 38(c) as paragraph (4) and insert new paragraph (3).

(3) Empowerment Zone Employment Credit may be Passed Through to Shareholders:

(A) In General. - A C corporation may elect to transfer all, but not less than all, of its Empowerment Zone Employment Credit for a calendar year to the holders of its common stock.

(B) Election. - A corporation electing to transfer its Empowerment Zone Employment Credit to its shareholders shall do so by including a written election (in the form prescribed by the Secretary) in its timely (including extensions) filed return for the taxable year with or within which the calendar year ends. Such corporation shall inform each shareholder (in writing in the manner prescribed by the Secretary) as to the amount of Empowerment Zone Employment Credit to which the shareholder is entitled.

(C) Shareholders to Whom the Credit is Transferred. - Any transferred Empowerment Zone Employment Credit shall be apportioned among those persons who are shareholders of the transferor on the last day of the transferor's taxable year. If the transferor corporation has more than one class of common stock, the credit shall be apportioned among the classes in proportion to the aggregate value of each class.

(D) Taxable Year for Applying the Transferred Credit. - A shareholder who is the transferee of a corporation's Empowerment Zone Employment Credit shall treat the transferred credit as a current credit for the transferor's taxable year with or within which the transferor's taxable year to which the credit related ends.

We believe that these changes will make a significant difference in the potential value of the credit and will add an important element to the package of incentives needed to attract new firms and create new jobs in these severely depressed areas.

We appreciate the opportunity to submit our testimony to the Committee.

Statement for the Hearing Record
House Committee on Ways and Means
Hearing on Miscellaneous Tax Reform Provisions
Submitted by Local Initiatives Support Corporation
New York, New York
July 27, 1995

We welcome the opportunity to express our views on the proposed "Commercial Revitalization Tax Credit", and request that they be included in the record of hearings conducted July 11,12 and 13 on miscellaneous tax reform provisions. Congressman Phil English intends to introduce this measure as a bill in the near future. Since the hearings, we understand that Representative Jose Serrano has introduced the measure as H.R. 2097. A companion bill, S. 743, was previously introduced by Senator Kay Bailey Hutchison.

Local Initiatives Support Corporation (LISC) strongly supports the proposal for a Commercial Revitalization Tax Credit (CRTC). We believe the CRTC would make a tremendous contribution to the economic development of distressed low-income urban and suburban neighborhoods and rural areas.

LISC is the nation's largest non-profit supporter of grass-roots low-income community development corporations (CDCs). In 15 years, LISC has raised $1.7 billion from the private sector to help CDCs rebuild communities with 57,000 homes and 9.6 million square feet of commercial facilities.

Through our work, we have come to appreciate how neighborhood residents can join together to take responsibility for revitalizing their communities, with the active participation of the private and public sectors. CDCs have attracted broad support because their work is grounded in mainstream American values: self-help, community, partnership, investment, local decision making, and tangible results. In a time of widespread pessimism that anything constructive can be done in our toughest communities, CDCs offer real proof that visible, sustainable progress is within our grasp.

Over the past several years, most of the attention in community development has focused on housing. This has been extremely valuable in stabilizing the population and physical condition of neighborhoods, meeting a pressing need for affordable shelter, developing community leadership and demonstrating to justly skeptical observers that tangible results can be achieved and sustained.

But housing is just a first step. We all know that investment in economic development is needed to connect isolated communities to the mainstream, move welfare recipients into work, and make neighborhoods good places to raise families and do business. To address one part of this agenda, LISC last year established The Retail Initiative, an unprecedented $24 million equity pool that will invest in inner-city supermarkets and shopping centers developed by CDCs. The investors include some of America's most sophisticated companies, including Bankers Trust, Bank of America, First Interstate Bancorp, Home Savings of America, GE Capital, Great Western Bank, J.P. Morgan, Metropolitan Life Foundation, Philadelphia Board of Pensions and The Prudential. These supermarkets will bring low-cost food, jobs, physical revitalization, and a new sense of hope to the inner-city. We recognize that private financing can carry most of the costs, but there will still be some modest gap that only the government can fill. Until now, the federal government has not had the right tools for this kind of job.

We believe that the Commercial Revitalization Tax Credit has the potential to be one of the most important of these tools. It is targeted to the communities that need it most. It is flexible enough to accommodate a range of retail, industrial and other facilities from the inner city to rural areas as diverse as the Colonias, Appalachia, the Mississippi Delta, and Alaska. It stimulates investment, and does not offer an operating subsidy to which a business could become

addicted. It marshals the business discipline and investment rigor of the private sector. It is performance based, so tax incentives will support only successful ventures. It operates through state government with a minimum of federal bureaucracy. And it encourages community residents themselves to lead the revival of their own home towns.

The CRTC is a bold and innovative idea, but is based on the solid foundation of the Low Income Housing Tax Credit and the Historic Preservation Tax Credit. These credits have been enormously successful. The LIHTC is now responsible for 60% of all multi-family housing starts and virtually all new affordable multi-family housing. We at LISC have used the LIHTC to attract $1:2 billion in corporate equity investment to CDC housing. LISC's National Equity Fund has generated more investment based on the LIHTC than any other organization, even though we invest exclusively in housing sponsored by CDCs.

We believe that a Commercial Revitalization Tax Credit could achieve similar results in stimulating economic development in distressed communities. A major obstacle to attracting and retaining businesses in distressed low income communities, is a lack of investment capital for business facilities such as shopping centers, supermarkets, industrial facilities, and community centers, all of which provide job creating economic activity and services, and are essential to stable, healthy communities. The CRTC proposal builds upon the Enterprise Zone strategy of tax incentives to encourage investment in targeted communities.

While tax incentives and direct spending programs can achieve some of the same objectives, they are not interchangeable. The private sector role tends to be greater when tax incentives are the policy instrument. Many private investors shy away from direct government spending programs but respond well to tax incentives because they involve less bureaucracy and red tape. Only a handful of federal employees oversees the Low Income Housing Tax Credit, which got off to the fastest start ever for a federal low-income housing program., In addition, tax incentives can be structured on a pay-for-performance basis. If public benefits are not sustained, tax subsidies can be recaptured through the IRS. Finally, because tax incentives stimulate equity investments and are subject to recapture if projects fail, owners have a much greater stake in the project's success. This means investments will be chosen carefully and protected aggressively.

Three categories of investors could be attracted to invest in distressed communities through a CRTC.

The first category is socially motivated corporate investment funds. Several public purpose organizations, including LISC, The Enterprise Foundation, state governments and local civic groups have used the Low Income Housing Tax Credit to attract major corporations as investors in low-income housing. The corporations receive a competitive rate of return and have the opportunity to participate in a public/private/community partnership to address serious low-income community problems. The CRTC offers a similar opportunity. We do not, however, anticipate the emergence of a tax syndication process geared to individuals, because of passive activity restrictions, the higher risks associated with nonresidential development, and the lack of any real precedent for marketing socially motivated nonresidential investments to individual investors.

The second category of investor includes companies locating in distressed communities, such as major supermarket chains and manufacturers. Such companies would build facilities for their own use and claim the credits themselves. These investments would create jobs and stimulate additional economic activity.

The third category of investors includes existing small-scale property owners. The CRTC would provide them with an incentive to make capital improvements and claim the credit.

Our experience with the LIHTC leads us to believe that the CRTC has tremendous potential for success. We appreciate this opportunity to submit our views to the Committee. We would be happy to answer any questions that you might have. Please feel free to contact Benson F. Roberts, Vice President for Policy, at (202)785-2908.

Statement by the
Independent Petroleum Association of America
before the
Committee on Ways and Means
United States House of Representatives
July 11, 1995

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The Independent Petroleum Association of America would like to report on the state of the domestic oil and natural gas producing industry and to urge prompt congressional action to help this industry survive. Domestic independent oil and gas producers are facing what could very well turn out to be their most difficult challenge. Since mid-October, 1993, oil prices have fallen by more than 25 percent, and the industry has lost another 17,900 jobs this year alone. Hundreds of thousands of U.S. oil wells are on the brink of economic ruin. The very existence of the oil industry in many states is threatened with extinction.

The domestic oil and natural gas industry entered this current economic downturn without the internal financial wherewithal to sustain operations on the basis of "boom time" cash reserves, as had been the case in past. Rather than the bust and boom cycle of the past, this time the oil price crash comes after nearly seven years of relatively low prices for both oil and gas. The years which followed the 1986 price collapse have cost this industry more than 450,000 jobs, have seen the drilling rig count set new lows year after year and settle in at levels barely half that of the average drilling rate of the previous twenty years. We have seen domestic oil production drop by nearly two million barrels per day. During that same time, natural gas prices fell to their lowest levels since the 1970s, and natural gas reserve replacement fell significantly below historic trends. The industry, with notable exceptions, has not been drilling and replacing the reserves it is producing. Consolidation, acquisition and mergers have become a primary means for independents to acquire new reserves and to survive the lean times. Many of the multinational oil corporations are shifting a larger share of the exploration and production budgets overseas. Now, on top of the dismal statistics of the late 1980s and early 1990s comes the current oil price crisis.

There is a dire need for urgent congressional action if the U.S. is to maintain the existing level of domestic natural gas and oil production, especially from economically marginal wells. There is, likewise, a need to encourage investment in new drilling in this country. Without changes in U.S. energy, environmental and tax policy, we are gravely concerned that our nation will grow, on an accelerated basis, ever more dependent on imported crude oil as more domestic wells are plugged and abandoned, their resources lost forever, and as investment in new exploration and development in the U.S. is further reduced.

NATIONAL SECURITY. Our domestic natural gas and oil wells are a national security asset. Every barrel of oil and every cubic foot of natural gas produced in the United States creates wealth, jobs and tax revenues at every level of government. Unfortunately, our nation is at risk of losing a substantial share of its ability to domestically produce the country's primary sources of energy -- oil and natural gas, which account for about 65 percent of total energy consumption in the United States.

On Friday, March 11, 1994 the IPAA and dozens of companies and other industry organizations filed a petition under Section 232 of the Trade Expansion Act, requesting that the Clinton Administration immediately begin an investigation to determine the impact of crude oil and petroleum product imports on the national security of the United States. That law gives the president the authority to adjust imports, and we have asked the president to seriously consider that option. At the very least, we expect the president to come up with a comprehensive plan to preserve this vital industry which plays such an important role in maintaining the national security of the world's greatest superpower.

IMPORT DEPENDENCE CLIMBS. Consumption of natural gas and crude oil in the United States, by all official estimates, will continue to rise well into the future. Last year, our petroleum demand was almost 18 million barrels per day, and 50.8% of this demand was supplied by foreign oil imports. That's a new record, exceeding the 50% of demand in 1993, the previous peak year for oil imports.

There are substantial domestic natural gas and oil resources that, if developed, can significantly reduce future foreign oil imports. However, these resources will not be discovered and developed so long as this country sits idly by while every other nation with energy resource potential provides inducements for oil and natural gas investments. On a worldwide basis, the U.S. energy tax policy is simply not competitive, and needs to be changed.

Regulatory policies in the United States are also crippling new investments and driving up the cost of doing business in the United States. There is a greater risk here in the United States of having one's energy investment "confiscated" by the government--especially if it is on public lands offshore--than in any other part of the world.

Independent producers, who currently produce about 66 percent of domestic natural gas and about 40 percent of domestic oil, are eager for economic conditions which would allow them to increase domestic supplies of natural gas and oil. This will not happen unless our government takes action on several fronts.

MARGINAL WELLS. The nation operated slightly less than 850,000 oil and natural gas wells in 1993, according to *World Oil*. Slightly more than 580,000 of those wells are oil wells, and of that total, nearly 78 percent of the nation's oil wells are stripper wells, with an average production per well in 1993 of 2.1 barrels per day. Most of these wells are now uneconomic, operating at a loss.

These marginal wells--defined in the tax code as those wells that daily produce less than 15 barrels of oil (or the natural gas equivalent) or which produce heavy oil--are essential to our domestic energy supply. They provide approximately 19 percent of domestic oil in 1993 production in the lower 48 states.

Although many of these wells are uneconomic, producers have continued to operate them in hopes of higher prices in the future. But economic reality is beginning to set in, and many of these producing properties are being shut in, plugged and abandoned before the mineral deposit has been fully recovered. Stripper oil wells, which represent over 13% of domestic proved reserves, have been abandoned at a rate of over 17,000 wells per year for each of the past 10 years. That abandonment rate could double or triple this year. Once these wells are abandoned their production and proved reserves are permanently lost, and our foreign energy dependency grows.

If we are to maintain this production, Congress must enact measures that improve the economics of investment in marginal wells. The world marketplace is not going to do it for us. Indeed, OPEC nations probably would relish seeing this segment of our domestic energy supplies wiped out. It will help improve economic clout and help restore their dominance of world oil markets. OPEC will be the beneficiary of the status quo, and make no mistake about it.

To the contrary, the greatest beneficiaries of tax policy changes affecting marginal wells will be states not traditionally viewed as "oil producing states." There are more than 450,000 domestic stripper oil wells in the country. Oklahoma, well known as an oil producing state, has over 70,000 of these wells. But the remaining 381,000 producing stripper wells exist in 27 other states, including New York (3,629 stripper wells), California (22,063 stripper wells), Illinois (31,838 stripper wells) and Kentucky (20,019 stripper wells).

DOMESTIC DRILLING. Just as we must preserve the productive capacity of existing wells, the nation must also encourage investment in drilling for new wells. In 1994, drilling for domestic natural gas and crude oil hit the lowest level since records were kept beginning in the

1940s, and 1993 was only slightly better. It is not inconceivable that a new record low for drilling could be set this year.

NATURAL GAS DRILLING. Tax policy changes to encourage new drilling are needed and will create jobs in all geographic regions of the country. The industry needs to increase drilling levels, especially for natural gas, to meet growing demand. Over half of the natural gas we used this year came from wells drilled in the last five years or less. If we are to use more natural gas, a primary objective of recent energy reforms and the announced energy policy of the Clinton Administration, then the country needs to drill new gas wells. The IPAA believes that a production based credit is the best way to achieve new gas drilling. It has a record of proven success.

Equally important, the production-based credit will give a signal to domestic producers that their industry's contributions are viewed as necessary to achieve the administration's goals of greater economic growth and energy security. It will also signal that the health of the domestic oil and gas industry is important to this Congress and the Clinton Administration.

A NEW WAY OF THINKING. The U.S. oil and natural gas industry is undergoing a revolutionary change, a change that requires a new way of thinking. This new way of thinking must reflect the new economic realities that are shaping the independent oil and gas industry in America today. It calls for a new relationship between the government and the private sector. It is not a wild guess on our part to say that most independent producers loath to ask for more government involvement in their industry. There is a perception that government involvement has meant higher taxes, restricted access to public lands, and greater, more costly, and often unnecessary regulation.

Yet, we recognize that governments are very much involved in this industry worldwide. In fact, nationally owned oil companies control 87.2 percent of total world oil reserves, two-thirds of which are in the Middle East. These 20 nation/companies produce nearly 6 of every ten barrels of oil. Those same governments want a greater share of the world oil market, and the way they will get it is by driving marginal production out of the marketplace. Time is on their side. Meanwhile, here at home, it is becoming increasingly clear that the marginal barrel in this so-called "free world market" is the high-cost U.S. production. That is the oil that is being forced out of the marketplace. And this trend will continue unless our government, too, gets involved.

TECHNOLOGY AND RESOURCE POTENTIAL. We have an advantage here in America. As Fortune Magazine recently observed: "American oil men are on the cutting edge of developing technologies that drive down the expense of finding and producing oil." That's true. Recent technological innovations that have revolutionized exploration, drilling and production processes also have greatly expanded our knowledge of America's vast potential for domestic supplies of natural gas and oil. There is an abundant natural gas and oil resource base in the United States, but to unlock that potential requires our nation to re-think the old ways, to seize change and the opportunity it brings.

According to geologists and petroleum engineers who participated in a recent IPAA oil and gas resource survey, America has abundant potential resources. Their resource estimates (including proved reserves) indicate that the United States has total potential supplies of 204 billion barrels of oil and 1,295 trillion cubic feet (TCF) of natural gas--a resource/production ratio of 62 years for oil and 68 years for natural gas. Nearly half of the resources lie in new exploratory development, and half in existing fields.

But these American resources--the reserves of the future--will by and large be found and developed in small increments. It is the nature of our geology in the United States that we have vast amount of reserves held in these small increments or jack rabbit fields. Although certain trends (particularly the deep, unexplored portions of several major basins) contain potential for the discovery of giant gas fields, new fields will be generally less than 100 billion cubic feet (BCF) of gas. Often they are as small as 10 BCF of gas or less. Development of reserves in existing fields or geological trends likewise will be in small increments, with additions of 1 to 2 BCF of gas for each well drilled. To keep drilling costs down in the search

for these smaller reserves, independents are turning increasingly to new seismic and computerized technologies. Ironically, under the tax code a producer would probably be better off economically using the dry hole method of searching for these new resources.

Before the recent price collapse, independent producers were aggressively going after this resource base, scoring impressive successes using new geological concepts, innovative drilling techniques and computerized seismic technology. In the process, these entrepreneurs are creating jobs and new economic wealth--and discovering new oil and natural gas resources--in some 40 major production areas in 20 states.

The IPAA's resource base study entitled, The Promise of Oil and Gas in America, natural gas and oil plays/trends with significant discoveries or developments since 1986 were analyzed. The survey resulted in 56 cases of significant discoveries or developments in 16 states, providing just a sample of significant events, not necessarily the largest reserve additions during the period. This sample does form a good cross-section of how productive E&P activity is undertaken. Some important themes are evident:

- New reservoirs were often found with new technology--mostly improved seismic and 3D seismic data, and better drilling and completion technology.
- However, the most important development is improved geological concepts. In many cases, old seismic tests "condemned" a large area or a trend; improved vision, based on better gas-finding ideas was necessary to successfully find and develop reserves. Pay zones with anomalous responses may have been bypassed, but can now be recognized. Wells without reservoir rock may represent local anomalies rather than regional truths.
- Drilling technology was also critical to the success of many projects. This includes proper fracturing techniques, mud systems, economical drilling, and better logging and evaluation methods.
- Reservoir characterization was critical to most infill drilling projects. A solid understanding of the hydrocarbon reservoir is replacing "blind" spacing reduction in improving field recoveries.
- Major hindrances to development in urban areas, besides high costs and low prices, include difficulties with log evaluation, and wetlands/environmental regulations.

THE FRONTIER WILDCARDS. In addition, the report highlights the fact that the United States has an immense hydrocarbon frontier consisting of basins which have not produced gas or oil yet; areas of producing basins which have not been adequately tested; deeper parts of producing basins, or downdip of known production; and unrecognized or "unconventional" reservoirs.

Overall, some fifty basins or portions of basins in 38 states are judged by the IPAA Task Force to have possibly significant potential for future reserve addition. This is not meant to be exhaustive nor predictive, but does indicate the scope of potential activity. In addition, one should take into consideration the "stumble factor." It has been said that more oil or gas was found on wrong geology than right geology. Major new plays have often resulted from chance encounters on the way to a dry deep objective.

Our resource base report shows that independent producers can meet our country's need for natural gas for many years to come, through intelligent and efficient exploration and development. But these needs can only be met through drilling. To convert the resource into reserves and production on the time scale needed by the American economy will require a significant increase of industry effort and increased coordination between various segments of the industry including the service industry. It will require the ability to form sufficient capital to mobilize the rigs and create these jobs. And it will require a partnership with government to make the resource base accessible.

THE ROLE OF THE INDEPENDENT. Independents are ideally suited to find and develop the resource base in the United States. There has been a fundamental change in the domestic

industry. It used to be that independents were the primary "wildcatters" in the business, drilling over 85 percent of the exploratory wells. Although they have always been the principle natural gas producers, producing over 66 percent of the natural gas and 50 percent of the oil, they used to make the deals, find the natural gas and oil and then sell the proven property to a major company to develop using the capital to invest in the next new wildcat. Today, not only are the independents finding the resource but they are also the main purchasers of the proven properties for the first time in our history. This trend will continue with more properties (some estimate in the neighborhood of $10 to $15 billion worth) are transferred into the hands of independents who are skilled at recovering reserves in the ground at the lowest cost.

INDEPENDENTS OFFSHORE. To further underscore the fundamental change in the domestic industry, is the role now being played by the independent in production offshore the United States. Over 28 percent of our supply of natural gas is produced offshore. The independents have won 51.5% of the 3,551 offshore federal leases issued from 1988 through March 1993. In addition, independents have drilled 85.1% of all wells on tracts leased since 1988, recorded 120 of 129 discoveries and installed 48 of 52 offshore structures. Of the 70 recently leased tracts with production, independents operate 66. Even in this more difficult and expensive environment, the independent is the key domestic player.

Independent producers have smaller staffs, lower overhead costs, and can act aggressively and move quickly to capitalize on new opportunities and adjust to meet these new challenges. The successful independent has developed his own niche, becoming the world's leading expert in a certain geological trend or technology. They use these advantages to reduce finding costs and increase success rates. The domestic industry provides high-tech jobs which are generally better paying than other industry's on the whole.

The Twenty-First Century holds great promise for a renaissance in the entrepreneurial spirit that founded America's natural gas and oil industry near Titusville, Pennsylvania in 1859. To fulfill that promise, the private sector, the government and the American public must change the way they look at the industry and recognize the expanding and, indeed, dominant role that independent producers have particularly in the natural gas industry's present and future in this country.

THE ROLE OF THE AMERICAN GOVERNMENT. Independents will lead the domestic natural gas and oil industry into the future. But, if there is to be a domestic industry, American leaders must decide that it is a priority and then act on that priority. While there is great promise, the domestic industry today is facing perhaps its greatest threat yet. This is a very serious situation and the very survival of the oil industry in many states is at risk; the domestic oil and natural gas industry will survive, but it could be greatly reduced in size and capability. As a nation we cannot afford to lose this fight.

The IPAA has also begun a comprehensive public education program focusing on the public schools, the capital markets, the national media and on shoring up our grassroots in the oil patch. A number of state associations have shown the way, with the Oklahoma Independent Petroleum Association leading the pack, with their own state program. For the last two years, the IPAA has sponsored a Wildcatter's Week in Washington, erecting a drilling rig in front of the Capital and the Washington Monument and putting together displays highlighting the role of domestic production. We are starting a national environmental stewardship program where independent producers will be highlighted, focusing public attention on all the good we do. We know that public leaders must have public support for an initiative of the scope we believe is necessary to prevent the collapse of the domestic industry.

We are also grateful for the tremendous leadership that members of this Committee have shown, organizing a bipartisan coalition of concerned members of Congress, and getting more than a hundred of your colleagues to join in urging the President to meet with you to discuss policy options to address the crisis in the domestic industry. The IPAA supports that effort and is proud to participate to the fullest extent.

The IPAA recommendations are summarized below:

- Price is everything. Imports need to be adjusted directly through a floor price and import fee for oil or indirectly by increasing domestic production through tax incentives. The primary goal should be to maintain our vital existing marginal production as well as to encourage new drilling. The IPAA believes that a domestic production credit for oil and gas triggered by the fall in oil or gas prices should be enacted that focuses the greatest help on the high-risk, high cost wells. Additional percentage depletion relief would also be of great assistance to the independents. In addition, allowing for expensing of all geological and geophysical expenses would encourage the new high tech methods of exploration and production and adjusting the enhanced oil recovery credit to assist in advanced oil recovery would also help greatly. In addition, to assist marginal wells, IPAA joins the National Stripper Well Association in recommending that the Department of Energy establish an emergency program to purchase stripper well production for the strategic petroleum reserve.

- Reform regulation and improve compliance technologies. Increasingly stringent environmental compliance requirements are severely limiting industry's ability to meet the nation's demands for oil and gas. The cost of complying with government regulations are simply going through the roof. Relieving those burdens on the domestic industry doesn't take a big legislative program. It takes common sense. More cost-effective methods for adequately protecting the environment while permitting E&P are required. This can be done by establishing regularity requirements that are scientifically based on the site-specific risks; making the costs of compliance commensurate with the risks posed; and developing lower cost compliance technologies and practices.

- Access to technology and access to the resource base is important to independents because that is our future. Projects like the Petroleum Technology Transfer Council--a joint effort between IPAA, all the state and regional producer organizations, the service industry, and other resource organizations in and out of government to provide access to the latest information about technology through workshops and computerized data resource stations--need support from the private sector and the Department of Energy to become a reality.

- Access to the resource base is critical. The U.S. has a tremendous "promise of oil and gas". Approximately 20% of our oil production and 33% of our natural gas production is found on federal lands. However, we can only realize that resource if we have the capital and if the government allows us access through reasonable leasing policies. The federal government owns a total of 650 million acres of land in the United States, 28% of all American land area. A substantial portion of the nation's recoverable reserves and potential petroleum resources underlie the public lands. In 1983, over 167 million acres of federal and Indian lands, 23% of the total, were covered by oil and gas leases issued under the supervision of the Department of the Interior. The amount of acreage under lease has dropped drastically to only about 66 million acres in 1990, just 9% of all federal and Indian lands. As I shared with you earlier Independents are increasingly becoming the dominant player on federal lands as well in the U.S. Last year we formed the Public Lands Coordinating Committee with RMOGA, IPAMS, AAPL and others to better advocate our shared positions on these issues. This coordination has been particularly important in the last six months as we are facing a large number of new legislative and regulatory policy initiatives by the Department of Interior that adversely affect natural gas and oil exploration, production and transportation on federal lands. These initiatives include the notice of proposed rule-making on the OPA '90 which appears to require proof of financial responsibility of $150 million (up from $35 million) for operators of "offshore facilities." The IPAA is hopeful that on this issue at least we can work through our problems in cooperation with the Administration and Congress, although we believe that legislative changes may be necessary.

THE PRIVATE SECTOR. There is still a great need for a partnership between our government with our industry. Independent producers still need to convince others to move away from initiatives that would still damage us. Additionally, a new way of has evolved in the private sector of the natural gas side of the industry. This is so important to independents because we produce over 66 percent of the natural gas produced in this country. With FERC Order 636 in place, it has allowed the natural gas industry to build bridges like never before. Most of the players in the natural gas industry have finally realized how much they need each other if they are going to realize the promise that natural gas hold for America's future. With the formation of the Natural Gas Council, the leaders of the natural gas business meet regularly to discuss--to communicate--about problems both real and perceived to growing the market for natural gas. They talk about helping each other on exploration, production, transportation and marketing issues. They are working together to improve reliability through emergency planning and improved information and technology. They are teaming together to meet regulatory (including environmental) challenges. The new way of thinking about independents as a team is permanent and, while not universal in the industry, is moving in that direction. There is a new relationship and understanding between the local gas distribution companies and the producers about problems producers are facing in forming capital and how they need to work on them together.

In summary, independents are looking beyond the old way of doing things and are embracing a new way of thinking. A new way of thinking about our American resource base, about the use of new tools and technology, about encouraging a partnership with our government and other parts of the private sector. We don't believe the American oil industry is lost, but we do face a struggle if they are to preserve anywhere near its present size and ability. If we are to realize the great promise of the future, we must fight to hold on to the resource base we now have, as well as encouraging new drilling in order to preserve the industry's infrastructure during this period of extraordinarily low prices.

The committee's examination of specific aspects of the tax code is a welcome opportunity to discuss specific changes which impact the future of the domestic oil and natural gas industry. Here are our recommendations with regard to specific proposals before the committee:

Allowing the section 29 credit to be claimed against the AMT

We believe that the full repeal of the Alternative Minimum Tax, such as would be accomplished by the House-passed bill, H.R. 1215, is the best solution for eliminating the problems and distortions caused by the tax. The AMT is a counterproductive part of the tax law that restricts business investment, placing severe impediments on capital intensive industries. Removing barriers to investment, such as the inability to claim regular tax credits against the AMT, including the section 29 credit, should be made fully applicable against AMT liability.

Determination of independent oil and gas producer status

IPAA supports the provision dealing with the determination of independent oil and gas producer status. Currently, the tax code classifies a number of gas companies as integrated oil and gas producers because of their regulated retail sales. As a result of rapid change in the natural gas industry due to deregulation, some independent natural gas producers have fallen prey to the technical definition of independent producer in the tax code, written primarily with the oil producer in mind. This technical change would make the tax laws better comport with the actual practices of the natural gas industry.

Allowing geological and geophysical costs to be expensed in the year incurred

The oil and natural gas industry derives 2/3 of its investment capital from company funds and other industry partners. This forces independents to constantly reinvest their capital into new drilling expenditures in order to replenish their depleting resources base. Allowing geological and geophysical costs to be recovered immediately, rather than amortizing them over a period of years, allows independents the access to capital which they desperately need in order to continue drilling. For many producers on the economic margin, the ability to recover their G&G expenses immediately is critical in utilizing the high tech tools which the industry needs in order to survive.

TAX TREATMENT OF G&G COSTS. Since 1950, the IRS has ruled that some G&G costs are not deductible as ordinary and necessary business expenses, but are inherently capital in nature and must be added to the cost of property acquired or retained on the basis of data obtained from an exploration project. The current policy discourages the use of today's technology for exploration purposes and should be changed.

SUBMITTED FOR RECORD ONLY

WRITTEN TESTIMONY OF ROSEBUD SYNCOAL PARTNERSHIP

SUBMITTED TO THE SUBCOMMITTEE ON OVERSIGHT

OF THE COMMITTEE ON WAYS AND MEANS

HEARING DATE JULY 11-13, 1995

WRITTEN SUBMISSION: JULY 27, 1995

Chairman Archer, members of the Committee, Rosebud SynCoal Partnership is pleased to have the opportunity to submit testimony concerning the Production Tax Credit for Nonconventional Fuels (Section 29) and a possible extension of this credit. Rosebud SynCoal strongly supports a continuation of the Section 29 tax credit.

Rosebud SynCoal Partnership (Rosebud) is a general partnership between Scoria, Inc. an indirect subsidiary of Northern States Power Company, and Western SynCoal, a wholly owned subsidiary of Western Energy Company (WECO), an indirect subsidiary of The Montana Power Company. Rosebud owns and operates a 300,000 ton-per-year clean-coal demonstration facility at Colstrip, Montana. The SynCoal® product from that facility is eligible for the Section 29 tax credit.

Rosebud advocates a two-year extension of the "placed in service," "binding contract," and "production" deadlines in Code Section 29(g). Rosebud further believes that such an extension should be limited annually to the first one million tons of solid nonconventional fuels produced and sold from a qualifying facility at any one location and that these tax credits should not be negated by the application of Alternate Minimum Tax. A two-year extension of Section 29 and allowing the credits to offset AMT liability, together with a one (1) million tpy per facility per site cap, would allow vialbe technology developers the opportunity to demonstrate the technical scale-up potential to commercial scale of the involved technologies. This proposed cap is also large enough to allow for the capacity necessary to demonstrate market acceptance of the alternate fuel.

Rosebud believes that Congress created the Section 29 tax credit to recognize and help manage the substantial risk during the precommercial development stages of alternative energy projects. However, once commercialization is achieved the necessity for tax credits diminishes. Our experience and research suggest that nonconventional solid fuels from coal can be competitive with other fuels when those facilities can operate at two to three million tons-per-year of product produced and sold. A two-year extension of Section 29, and allowing the credits to offset AMT liability, together with a one million tpy cap would allow several promising technologies the opportunity to advance to the threshold of economic commercialization and is consistent with the original purposes of the Tax Credit for Nonconventional Fuels.

The federal budget issues currently facing our country make the fiscal impacts of any proposed extension a critical aspect of the legislative process. A limitation based upon production and sale quantity efficiently targets the incentive at a level appropriate to support technology development, while preventing abuse of this incentive as a tax shelter. Additionally, this approach leverages the incremental new public investment represented by the incentive against billions of dollars in prior strategic investments which have been made by both the public and private sectors under programs such as the Clean Coal Technology Program.

Rosebud and WECO have a long history in the development of alternative solid fuels. In the late 1960's and early 1970's, WECO conducted research into improving the

quality of low rank coals. Significant technical problems with this early work soon became apparent and WECO was unable to develop the technologies.

By the early 1980's, WECO became aware of a concept advanced by Mountain States Energy (MSE), the company that for many years operated the Department of Energy's (DOE's) Magneto Hydro Dynamics(MHD) research facility in Butte, Montana. WECO and MSE conducted bench tests on a process to remove moisture and sulfur that were promising enough to warrant the construction of a pilot plant. WECO built and operated a 130 lb/hr pilot plant in Butte. Results from the pilot plant led WECO to submit a proposal to the DOE in Round 1 of the Clean Coal Technology Program.

In June of 1990, negotiations between WECO and DOE concluded with the commitment to build and operate a $69 million, 300,000 tpy demonstration project at Colstrip, Montana. WECO then formed a partnership with Northern States Power that led to the formation of Rosebud. Construction began in December of 1990 with the demonstration operational phase beginning in April of 1992. The plant was declared to be in-service in August 1993.

The experience gained from bringing forth a new energy product from the concept stage to the threshold of market acceptance has given WECO and Rosebud valuable perspectives on the evaluation of new technologies. We also have gained an appreciation of the importance and the role of federal tax incentives and the time necessary to develop technology and markets for new products.

New energy technologies must go through several stages of development to prove viability. Bench scale tests of technological concepts must be followed by construction and operation of larger pilot plant facilities which, if successful, are then followed by even larger demonstration phases before commercial operations are possible. Attempts to shortcut these steps lead to unacceptable technical risk and increase the probability of failure. Some companies have attempted to shortcut the development process with devastating results.

Technology development activities require long lead times for planning, permitting, financing, construction and startup. Rosebud's experience has shown that a generous allowance of time is necessary to resolve the many unforeseeable issues that confront all technology developments. For example, Rosebud's demonstration plant took 15 months to shake out after initial startup and no amount of expenditures could have resolved these issues much sooner. The universal experience of all coal based alternative fuel developers has been that it has taken more effort and time than originally anticipated. As a result these technologies have not matured yet and as such are not able to compete with conventional fuels in today's market place. However, these technologies have made great strides in recent years and are on the cusp of economic viability, only lacking one further generation of development. Once this is accomplished, no further incentives should be necessary.

Following a measured development program increases the likelihood of success and mitigates risk. Federal tax credits play a role in the development of new technologies by mitigating market risk and allowing the private sector to fund and develop these technologies.

IRS has complicated Rosebud's developmental activities when they recently withdrew the private letter ruling qualifying Rosebud's current facility and took nearly a year to rule on two private letter ruling requests for the next generation developments. IRS did subsequently issue the requested rulings and has reinstated the withdrawn letter ruling. However, these actions have significantly increased the perceived project risk for next generation developments that are crucial to the ultimate commercialization of these technologies.

The attached development schedule is aggressive and shows why an extension of the inservice date and binding contract dates are necessary for continuing technology development.

Rosebud's plant is now operating at well over design capacity at high availabilities; however, the market has been slow to accept the new product.

Rosebud's experience has shown that once a new technology has successfully made the jump to small scale demonstration, market acceptance is critical to promote the technology's development to a commercial level. Utility and industrial fuel customers are concerned about reliable supply. In our case, their fuel needs are typically severely mismatched with the relatively small production capacity represented by an initial demonstration scale operation, such as our 300,000 tons per year facility.

This mismatch makes long-term commitments from the customers that are needed to support these facilities or next generation facilities nearly impossible because of the perceived physical supply risk being absorbed by the customer. However, without committed customers, these facilities cannot be financed or operated which, in turn, results in stagnation of the technology development. That is why the continuation of the Section 29 tax credits is so important.

If the Section 29 tax credit is extended by the 4th quarter of 1995, Rosebud plans to build two (2) next generation SynCoal production facilities, approximately 500,000 tons per year each. These facilities would allow Rosebud to scale up the technology to a scale of 3 to 5 times greater than the throughput design of our existing demonstration process reactors. This design threshold is intended to allow demonstration of static fluid bed reactor technology at one scale less than that required for full scale commercial deployment, but large enough to secure commercial fuel contracts with customers.

The specific projects are: 1) an expansion of the Colstrip, Montana demonstration site and 2) a plant integrated into Minnkota Power's M.R. Young power plant site near Center, North Dakota. These next generation projects would employ different aspects of the specific knowledge gained at the Colstrip demonstration project, providing efficient opportunities to advance the technology. These advances would allow further opportunities to gain the additional knowledge and experience necessary to ultimately commercialize this technology. At the same time these projects would result in construction investments totaling nearly $80 million, increasing the tax base, directly and indirectly they would provide approximately 400 new permanent jobs and increase economic activity by about $30 million per year.

The development activities of alternative fuel producers like Rosebud provide opportunities for the United States to take better economic advantage of our existing industrial and utility infrastructure while displacing imported foreign energy sources. These projects would produce value added products from low quality domestic feedstocks. They would continue the significant progress made in reducing environmentally threatening emissions while efficiently using our most abundant energy resource--coal.

When the United States Congress enacted Code Section 29 in 1980, it did so to encourage the domestic production of alternative fuel sources to decrease our dependence on the use of imported energy. In 1980 petroleum imports were 6365 Mbbl/day or 37.3 percent of our total petroleum use. By 1994, petroleum imports had grown to 8017 Mbbl/day or 45.5 percent of our total petroleum use. The projections for 1995 indicate that 53 percent of our petroleum needs will be met by imports. The original purpose for Section 29 is even more pressing today as the United States is demonstrating increased dependence on imported oil.

Nonconventional fuels like SynCoal® have shown a direct ability to displace petroleum products in both utility and industrial applications. SynCoal® has been used in place of natural gas and propane in direct fired kiln operations and has shown an ability to deslag utility boilers more effectively than fuel oil.

The U.S. Congress enacted Code section 29 in 1980 to encourage the domestic production of alternative fuel sources to decrease our dependence on the use of imported energy. Section 29 provides an incentive for the production and sale of fuels from designated non-conventional sources. The Senate Finance Report accompanying the enactment of Code section 29 stated that:

> The Committee believes that a tax credit for the production of energy from alternative sources will encourage the development of these resources by decreasing the cost of their production relative to the price of imported oil.
>
> **These alternative energy sources typically involve new technologies and some subsidy is needed to encourage these industries to develop to the stage where they can be competitive with conventional fuels.** Information gained from the initial efforts at producing these energy sources will be of benefit to the entire economy.[1]

Based on this legislative history, Rosebud believes that Congress originally intended to limit the credit to noncommercial scale production facilities. We submit that this original intent was proper and it forms the basis of our recommendation for a limited, targeted extension of Section 29.

Section 29 is a performance based incentive that only can be realized upon the sale of the nonconventional fuel product produced from the qualified facility. The taxpayer bears all technology and production risks and only receives the incentive after establishing its technical and operating capability and actually consummates a sale of the alternate fuels product. This structure minimizes the public's risk of providing incentives that do not provide the desired beneficial effects especially when limited to the production levels that support logical technology development.

An extension of Section 29 would provide important benefits for the United States. As mentioned previously, the evolution of a viable nonconventional fuels industry would contribute to the energy security of our nation. Additional benefits include further environmental and energy technology development that would assist in achieving compliance with Clean Air Act requirements, while providing additional employment for US workers. The successful development of a domestic nonconventional fuel industry would also lead to technology transfer in the international marketplace. Such endeavors would improve our trade deficits with other nations.

Rosebud believes there are important and compelling reasons to extend Code Section 29 and would urge this Committee and Congress to look favorably on a limited, targeted extension.

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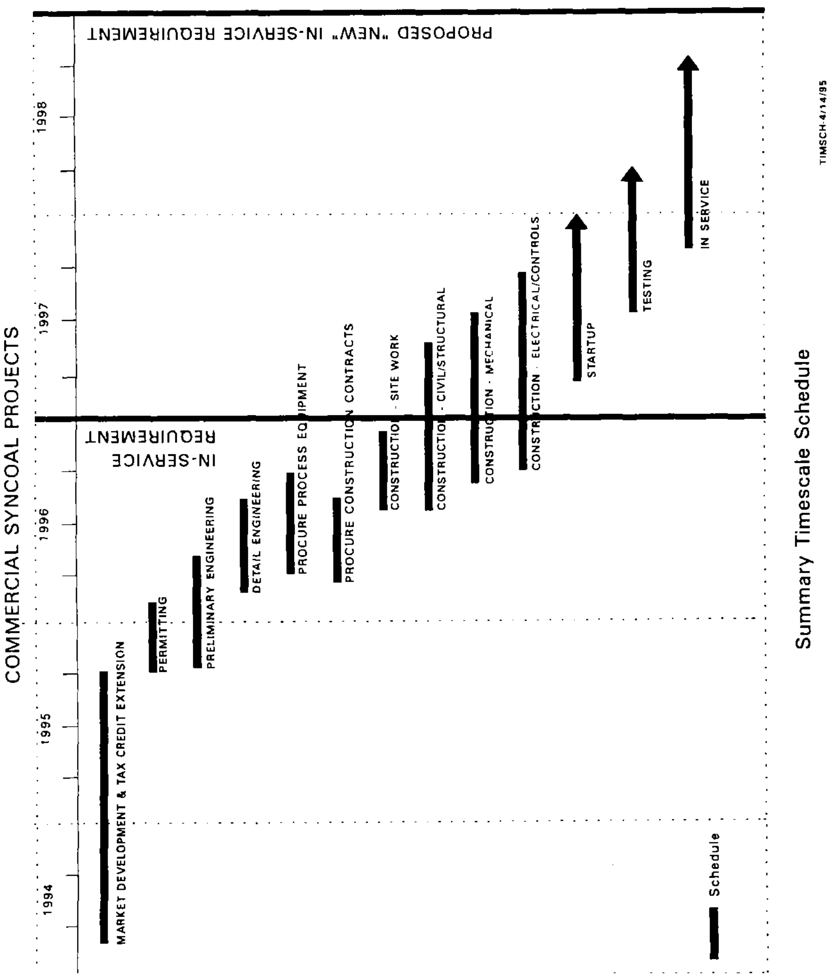
[1] S. Rept. No. 96-394, 96th Cong., 1st Sess. 87 (1979), 1980-3 C.B. 131, 205 (emphasis added).

COMMERCIAL PLANT TIME FRAME



Statement of Morley Chase, President
Tenby, Inc. d/b/a Chase Production Company
on Extending the Section 29 Credit for Qualified
Fuels Produced from Tar Sands

My name is Morley Chase. I am submitting this statement as President of our family owned company, Tenby, Inc. which does business through Chase Production Company and Oxnard Refinery. Our family holds approximately 500 acres located in southern California along with the mineral interest associated with that property which is part of the Vaca Tar Sands. We are engaged in the business of attempting to produce oil economically from a tar sands reservoir located below the surface of this property.

In 1980 the Crude Oil Windfall Profit Tax Act was signed into law. That measure included an "Alternative Fuel Production Credit" for qualified fuels, including oil produced from tar sands. The credit was designed to encourage the production of more expensive alternative fuels which compete for market share against conventionally produced oil. This was to be achieved by initially establishing a floor price and providing a tax credit only as the cost of oil dropped below a floor of $29.50 per barrel (adjusted annually for inflation). Producers of oil from tar sands could only benefit from the credit as oil prices declined below the statutory floor, as adjusted, and only if they actually produced oil eligible for the credit.

Shortly after this tax credit was enacted disputes regarding eligibility for the credit became routine as the IRS questioned whether producers qualified for claimed Section 29 credits. The IRS was unwilling to adopt a definition of eligible oil produced from tar sands based solely on the physical characteristics of such deposits and has instead maintained that for a producer to be eligible for the credit, the oil produced from tar sands must occur as a result of the use of new technologies to extract such oil and cannot be the result of conventional oil production methods.

To make certain that our production qualified for this credit, we submitted a ruling request to the IRS asking for a determination that the oil produced by Chase Production Company from the Vaca Tar Sands qualified for the Section 29 credit based on the extremely viscous nature and other physical characteristics of the oil produced or, in the alternative, on the basis of the unique, non-conventional methods employed by us to recover this oil. On December 28, 1990, the IRS issued a private letter ruling confirming our eligibility for the Section 29 credit.

However, the IRS District Office in Los Angeles was not immediately prepared to recognize that determination for purposes of income tax audits in progress for credits claimed in prior years. Not until July of 1992 was the IRS District office finally willing to agree that Tenby, Inc. and members of the Chase family were entitled to the Section 29 credits claimed in prior years. Shortly after this determination, on December 31, 1992, the credit expired for oil produced from wells drilled after that date.

As a consequence of the lengthy process involved and uncertainty about securing final confirmation that the oil produced from our tar sands deposits would be eligible for the Section 29 credit, it was neither prudent nor practical for us to invest significant additional capital in drilling new wells. We had already invested more than ten years of effort and over $9,000,000 before we could finally be certain that our oil, which is extremely heavy and viscous and priced substantially below light Texas crude could be produced with even minimal assurance that our investment might be economically justified.

As a result, the Section 29 Credit enacted in 1980 has yielded very little in the way of increased oil production from tar sands for the benefit of consumers to date and has been of no significant benefit to us as producers and investors in the effort to produce oil from tar sands.

Today there are more than 500 million barrels of proven reserves of oil yet to be recovered from the tar sands deposits that make up the Oxnard Project in the Vaca Tar Sands. An optimistic forecast estimates there may be as much as 800 million barrels of oil in this field. Unless more time can be provided for the drilling of additional wells from which production will be eligible for the Section 29 credit, we and the other owners of tar sands deposits will be unable to pursue oil production on an economic basis. In our own case, we are prepared to invest up to an additional $27,000,000 to drill more wells that will result in significant additional domestic oil production.

Without assurance of the availability of the Section 29 credit, planned drilling, production and refining that otherwise would take place will continue to be too risky to be undertaken and financed by conventional lenders. If we are to maintain a real domestic oil industry with the capacity to produce the necessary supply of oil to meet the needs of individuals and businesses located in this country, it is essential that the Section 29 credit as well as a broad array of other incentives for domestic oil production be maintained.

Moreover, favorable action on the proposed modification of the Section 29 credit becomes even more compelling when it is recognized that the direct expenditures for the production, refining and distribution of additional oil extracted from tar sands will produce additional Federal income tax revenues from the producers, refiners and distributors of this oil as well as from the individuals employed by these entities at wage levels above those such individuals may be receiving currently. And, payments for oil produced outside the U.S. would decrease, thereby reducing our balance of payments deficit as a greater percentage of domestic oil needs are met by added production in the U.S.

It must also be noted that for the Section 29 credit to be of benefit to individuals and businesses claiming the credit, the law must be modified to permit these credits to be claimed against the AMT.

Thank you for this opportunity to present the views of a beleaguered, small family owned business induced by stated government energy and tax policy to make substantial energy investments without ever receiving any significant benefit from that investment. We hope the Committee and the entire Congress will recognize that we and other small producers have been precluded, as a result of unduly lengthy government administrative review and inaction, from realizing any significant economic benefit from our good faith efforts to produce more oil. Consequently, we submit this statement to strongly urge the Committee on Ways and Means to act favorably on the proposal to extend the time period for drilling additional wells from which oil produced from tar sands will be eligible for the Section 29 credit and to permit such credits to offset the AMT.

STATEMENT OF
TECO ENERGY, INC.
ON MODIFICATION OF SECTION 29 TAX CREDIT

HEARING ON MISCELLANEOUS REVENUE ISSUES

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

JULY 11, 1995

Mr. Chairman and members of the committee, TECO Energy, Inc. has previously testified to the committee about a change that is needed in the section 29 tax credit -- the tax credit for the production of nonconventional fuel -- to enable our company to avoid costly and unnecessary red tape. Our suggested amendment has been thoroughly examined by the committee staff and by the Joint Tax Committee staff. We once again strongly urge the committee to approve it as soon as possible.

The problem addressed by our proposal is a rule in section 29 requiring the producer of nonconventional fuel to sell the fuel to an unrelated person in order to be eligible for the credit. The legislative history gives no indication of the purpose for this rule (and, in fact, the new section 45 credit that applies to electricity produced from certain renewable sources contains no rule requiring the taxpayer to purchase the fuel from an unrelated person).

Our company is building a state-of-the-art coal gasification facility in Polk County, Florida. When completed, the facility will turn high-sulfur coal into clean-burning synthetic gas, which we will use on site to generate electricity. The facility will be one of the first of its kind in the country.

It is important to us that the synthetic gas produced in our new facility qualify for the section 29 credit; the facility will implement technologies that have not yet been proven commercially, and the credit will help compensate for the risks inherent in those technologies. Unfortunately, in view of the unrelated person sale rule, we will have to adopt an unnatural, costly, ownership structure for the new facility to qualify for the credit. Specifically, we will have to interject an unrelated person between the gas production and the electricity generation. We can do that either by selling the gasifier or by selling the generation capacity. We would probably create a joint venture with another company to accomplish such a sale.

This is purely and simply unnecessary red tape. There is no conceivable reason why the tax code should make us adopt this sort of ownership structure to preserve the credit. Thus, we (and other companies) have suggested that Congress eliminate the unrelated person sale rule, at least in cases where the taxpayer uses the fuel on site for the generation of electricity for sale to unrelated persons. The Treasury Department has previously testified that the administration did not oppose the elimination of the unrelated person sale rule.

The important thing to keep in mind is that the issue is not whether the credit is available; the issue is simply what steps a taxpayer must go through to claim it. We will be producing a fuel that will qualify for the credit; the question is whether we will have to adopt an unnatural ownership structure at the same time.

Mr. Chairman, our proposal is a concrete example of how the tax code could be streamlined to eliminate unnecessary burdens on taxpayers. We urge the committee to adopt the amendment.

JULY 27, 1995

**STATEMENT ON
BEHALF OF THE WILLIAMS COMPANIES, INC.**

**SUBMITTED BY
J. ROGER MENTZ & LINDA E. CARLISLE
WHITE & CASE
WASHINGTON, D.C.**

**TO THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS**

**FOR HEARINGS ON
MISCELLANEOUS TAX REFORM PROPOSALS
JULY 11 & 12, 1995**

**REGARDING
THE SECTION 29 NONCONVENTIONAL FUELS CREDIT &
THE NEW UNDERGROUND COAL GASIFICATION TECHNOLOGY**

Mr. Chairman and Members of the Committee:

The Williams Companies, Inc. ("Williams"), a publicly-held energy, transportation and telecommunications company based in Oklahoma, proposes to commercialize technology to produce a synthetic gaseous fuel from underground coal in a safe and ecologically sound process. The underground coal gasification process will convert coal that cannot be mined using conventional technology into gaseous synthetic fuel through a chemical reaction occurring beneath the earth's surface in the coal seam itself. Because the coal is not mined, there is no damaging strip-mining of the earth's surface and no miners are subject to the dangers of working below the earth. Since coal is converted into energy underground, the pollution usually associated with coal combustion is greatly reduced. Thus, this process should produce significant environmental and safety benefits, and, if successful, would make possible the development of America's coal deposits that today are unrecoverable.

Section 29 of the Internal Revenue Code provides that a synthetic gas produced from coal will qualify for a ten year production credit if the "facility" for producing such gas is constructed pursuant to a binding contract in effect before January 1, 1996 and is placed in service before January 1, 1997. The Internal Revenue Service ("IRS"), however, has ruled that in the case of underground coal gasification, the "facility" required to be placed in service includes the underground chamber of coal or "module" in which the gas is produced. For reasons explained below, it is not realistic to construct modules for ten years in advance, thus this interpretation effectively denies underground coal gasification the full ten year credit envisioned by Congress and it disadvantages this technology relative to other Section 29 projects, particularly above ground coal gasification projects.

Accordingly, Williams requests clarification by Congress that for purposes of an underground coal gasification project, the term "facility," shall be defined so as not to exclude modules developed after January 1, 1997, provided the modules are developed from the coal resource defined in the mine permit application approved for the project prior to January 1, 1997.

Description of a UCG Facility

Underground coal gasification technology utilizing steeply dipping coal seam formations enables coal formations unrecoverable by conventional mining methods to be mined. To accomplish this objective, an underground coal gasification facility is constructed to convert coal into synthetic gas by reacting steam and oxygen with the underground coal. The process is initiated at

temperatures of near 3000° Fahrenheit and a pressure of 160 pounds per square inch. The process converts solid carbon (coal) into gaseous chemical mixtures which are significantly different than the solid carbon. The gas produced can be used as a fuel or as feedstock for conversion to end products such as ammonia, diesel fuel, naptha, kerosene, electric power, steam, natural gas or methanol. The gas produced will have an estimated energy content of 360,000 BTUs per 1,000 standard cubic feet of gas.

The coal gasification process requires the use of underground reactors called "modules" and surface equipment. The surface equipment generally consists of gathering pipelines, cyclone separators, gas outlet manifolds, miscellaneous valves, header and miscellaneous piping, and an administration building.

Each module consists of three types of shafts which extend to a depth of approximately 1500 feet below the earth's surface. Two types of shafts are used to inject steam and oxygen into the underground reactor. The third type of shaft transports the gas from the underground reactor to the surface. Steam and oxygen are pumped through the injection shafts after the coal formation has been ignited at the bottom of the reactor. Thus, the reaction occurs underground in the coal seam itself.

As the module burns, coal from the upper sections of the formation continuously falls into the underground reactor within the module. The fire within the module burns until the coal seam has been consumed up to about 400 feet from the surface, at which time the module is extinguished. At this point the module itself is burned out.

In a given project, a sufficient number of modules would be developed and burned simultaneously in order to achieve the project's desired production rate. As the original set of modules neared the end of its useful life, a second set would be prepared and ignited in order to maintain the project's output. The life of a module or set of modules would vary depending on project-specific factors, but one and one-half years would be typical.

All replacement modules cannot be drilled prior to the start of the project. Not only would the economics of pre-drilling modules be prohibitive, but also there are engineering, environmental and regulatory reasons why modules can only be prepared a certain time in advance of their use. Also, the shafts cannot be allowed to go unused for a period of years and maintain their integrity. As the project goes forward, and the nature of the coal resource being developed is better understood, modules could possibly be created more efficiently and with less risk of environmental problems.

Finally, the regulatory approvals are generally obtained in stages as the project progresses. For all of these reasons, it is unlikely that more than two sets of modules, representing three years of fuel, could be prepared prior to the facility's commencement of operations.

Underground Coal Gasification is Analogous to Above Ground Coal Gasification Facilities

The synthetic gas produced from an underground coal gasification facility is the same as that produced from an above ground coal gasification facility, where coal is mined and combusted in an above ground reactor. Underground coal gasification is a more efficient and environmentally safer method of producing synthetic gas than above ground gasification, because the environmental and safety problems associated with the mining and burning of coal above ground are avoided.

Congressional Action Necessary

The synthetic gas produced from coal gasification facilities is a qualified fuel under the terms of Section 29. However, the IRS has ruled that in the case of underground coal gasification, the "facility" that must be placed in service prior to the January 1, 1997 deadline includes the individual modules.

The practical impact of this ruling is to deny the Congressionally-enacted incentive provided in Section 29 of the Code to underground coal gasification projects. In enacting Section 29, Congress intended, by the plain meaning of the language, that a facility producing a qualifying fuel and meeting the placed-in-service requirements should receive the benefit of the credit for ten years. Yet in the case of underground coal gasification, if a project is placed in service just prior to the deadline, it can only receive the credit for three years, for it is only practical to have three years of modules ready to operate at the time of start-up. Congress could not have intended this result.

The impact of the IRS ruling is to disfavor underground coal gasification technology as compared to other Section 29 facilities, particularly above ground coal gasification. If an above ground gasification facility and an underground gasification facility were both placed in service on December 1, 1996, for example, the above ground facility would receive the credit for all of the gas produced for the next ten years even though most of the coal would be mined well after the in-service deadline. As noted above, however, the underground facility would only receive the credit for three years, even though the product produced is exactly the same. Surely Congress did not intend for different tax treatment to be provided to an underground coal gasification facility as compared to above ground gasification.

Conclusion

Use of the underground coal gasification technology involves significant commercial risk. The IRS interpretation creates further risk because of uncertainty with respect to the extent to which the gas produced from the new underground coal gasification technology will be eligible for the Section 29 credit. It is doubtful that the new technology would be deployed with both the commercial and tax risks. In order to eliminate the tax risk caused by the IRS's interpretation of the Section 29 credit, and to place underground coal gasification on a parity with above-ground coal gasification where all the synthetic gas qualifies for the Section 29 credit as long as the facility is operating before January 1, 1997, we urge that the following clarification of Section 29 be included in this year's tax legislation:

Clarification amending Section 29(d) "Other definitions and special rules."

> "(9) **Underground Coal Gasification Facility.** When producing solid, liquid or gaseous synthetic fuels from coal pursuant to underground coal gasification, a facility shall be the gathering lines, surface equipment, and other assets needed to produce a qualified fuel from an underground coal resource described in a permit to mine application which has been approved before January 1, 1997 in accordance with the Surface Mining Control and Reclamation Act of 1977, as amended.

Statement of the Shell Oil Company

Shell applauds the clarification found in H.R. 379. Oil from tar sands is an abundant domestic resource but which is difficult to refine into products such as gasoline and jet fuel. For this reason, oil from tar sands does not command as high a price in the marketplace as conventional crude oils such as West Texas Intermediate. Additionally, oil from tar sands is physically and economically more difficult to produce than such conventional crude oils.

Section 29 of the tax code was enacted to encourage the production of domestic energy sources when the average price of domestic crude oil production falls below certain trigger prices. The credit is not available when the average price of domestic production is above a trigger price. The congressionally stated aim of section 29 is to reduce the cost of these domestic energy sources relative to the cost of imported oil against which they compete.

For over fifteen years, the IRS has published no guidance upon which the public can rely as to what constitutes oil from tar sands for purposes of the section 29 credit. The IRS has taken the position that some taxpayer's production constitutes oil from tar sands while others' production do not constitute oil from tar sands on a case by case basis. However, the method by which the determination is made is vague and inadministrable. Additionally, the IRS' informal method of classifying oil from tar sands can create competitive disadvantages and penalize pioneers in the application of production technologies. For example, the IRS' informal method of determining whether a producer has oil from tar sands can result in a situation where two taxpayers unquestionably produce oil from the same reservoir and one will be treated as producing oil from tar sands and the other will be treated as not producing oil from tar sands. Moreover, an examination of the IRS' publication "The Statistics of Income" shows that the IRS' informal position has resulted in the credit not achieving the results expected by Congress as witnessed by the legislative history to the enactment of the predecessor to section 29. All of the uncertainty and the potential competitive disadvantage which surrounds the IRS' informal position has resulted in protracted litigation which not only makes the production of oil from tar sands more expensive, but could further frustrate the intent of the credit as it applies to oil from tar sands.

Enactment of H.R. 379 would clarify the application of section 29 as it applies to oil from tar sands to allow the credit to apply as originally intended. The extension of the time for the application of the credit is reasonable in view of a decade and a half of uncertainty surrounding the economics of producing oil from tar sands.

TESTIMONY OF ENSERCH CORPORATION
DALLAS, TEXAS

ENSERCH Corporation, of Dallas, Texas, with a solid business foundation spanning 85 years, has operations in gas and oil exploration and production, natural gas liquids processing, natural gas transmission and distribution and electric power generation.

ENSERCH has a direct interest in these hearings which are addressing a number of miscellaneous revenue issues. In particular, ENSERCH supports the independent producer proposal which we believe would simplify the Tax Code, provide fairness for taxpayers, ease the burden of tax compliance and stimulate natural gas E&P.

Currently the Tax Code Section 613A(d)(2) limits the scope of the independent producer exception. A taxpayer will be considered an integrated producer if the taxpayer sells natural gas or oil (domestically) through a retail outlet operated by the taxpayer or related person. ENSERCH, as with any gas company with local utility affiliates, is denied independent producer status due to our utility sales.

The Committee is considering a proposal that would permit the gross receipts from retail sales of natural gas by a utility that is a related party to be disregarded in determining whether a taxpayer is a retailer. ENSERCH supports this proposal since it would enable a producer to gain independent producer status, regardless of the amount of retail sales by the related utility.

Code Section 613A was added by the Tax Reform Act of 1975 as a reaction to increases in energy prices brought on by the foreign oil embargo. The legislative history suggests that Congress distinguished between majors and independents in that Act because the "25 large oil companies," who had reaped big profits from foreign oil price increases, did not need tax incentives. The intent was to disallow certain benefits to the major oil companies, who raise substantial capital through their gasoline marketing operations. Unlike retail sales of the majors, the retail sales of gas companies are subject to state regulation. Thus producers with gas distribution companies, such as ENSERCH, are unable to look to their retail sales as a source of substantial capital for domestic E&P operations.

Natural gas companies would not be treated equal to similarly situated taxpayers within the same industry if denied the independent producer status. Companies who sell gas and oil to an affiliate who produces electricity for resale at retail are designated as independent producers. It is certain that Congress did not intend to favor electric utilities over gas utilities.

It would also be contradictory with the U.S. energy and environmental policy to continue to discriminate against producers with retail natural gas sales. The 1990 Clean Air Amendments and the energy bill rely heavily on the expanded use of domestic natural gas to help clean up the environment and reduce dependence on foreign oil.

In summary, ENSERCH strongly supports the independent producer proposal. In addition to promoting tax simplification, fairness and investment, this proposal would enable natural gas to play a more critical role in the long-term economic health and security of the U.S. Natural gas can be utilized to help the nation attain cleaner air, energy efficiency, domestic energy security, more jobs and technological development.

STATEMENT OF LEIGHTON STEWARD
ON BEHALF OF
THE LOUISIANA LAND & EXPLORATION COMPANY

Before The Committee on Ways and Means Regarding Miscellaneous Tax Reforms Scheduled for hearings on July 11-13, 1995.

My name is Leighton Steward. I am the Chairman, President and Chief Executive Officer of The Louisiana Land & Exploration Company ("LL&E"). I appreciate the opportunity to present LL&E's views to the Committee with respect to a proposal to amend Section 613A of the Internal Revenue Code (the "Code") that appears on the Committee's listed measures as item numbered 2 of the provisions related to energy.

In general, Section 613A of the Code permits independent producers of oil and natural gas to continue to deduct intangible drilling costs and obtain percentage depletion on a portion of their production. To distinguish independent producers from the large integrated oil companies, the section disqualifies producers who have more than a significant amount of retail sales or refinery production. These producers with refining operations, otherwise qualified, are denied independent producer status if their refinery runs "on any day during the taxable year" exceed 50,000 barrels. This means they cannot claim percentage depletion or deduct 100% of their intangible drilling costs under Section 291 of the Code.

LL&E is engaged in the conduct of exploration and production activities in the United States and certain foreign areas. In 1975, LL&E built a 30,000 barrels per day refinery in Mobile, Alabama, at a cost of $19 million. In 1980, an expansion was begun to increase capacity to 74,500 BPD at a cost of $85 million. Due to the tax penalties in Section 291 enacted in 1982 that would accrue to independent producers if they exceed the 50,000 BPD limit, LL&E has restricted refinery runs in the last 6 years, (including 1995) to under 50,000 BPD. During that same period, LL&E has been forced to make expenditures to remain competitive and to comply with regulatory requirements, including approximately $2.0 million for a waste water treatment plant (which also added $300,000 per year in operating costs), $6 million for diesel desulfurization, $4 million for reducing gasoline RVP, and $1 million for other projects such as storm water management and NESHAPs compliance. In addition to the capital and operating cost of these units, the refinery has had to add 16 employees to operate the units and 6 more to comply with other EPA/OSHA standards imposed on the industry. This is one of the reasons why we have begun exploring options on selling the refinery.

Producers such as LL&E with refining capacity just above the 50,000 BPD limit must decide at the start of each tax year whether the marketplace will justify forgoing the tax benefits associated with independent producer status for potentially higher earnings that would accrue from refining runs in excess of 50,000 BPD barrels on any day in the taxable year. Because of today's narrow margins in the refining industry, LL&.E has been forced to maintain its refinery's production below 50,000 BPD -- that is, at a level that is significantly below the refinery's optimal level of production.

We submit that the 50,000 BPD limit in Section 613A represents bad tax, economic, energy and environmental policies.

The limitation is bad tax policy because it forces producers/refiners to make uneconomic choices based not on market needs but on tax considerations. It is bad economic policy because tax decisions override efficient economic use of refinery assets. It is bad energy policy because it acts as a disincentive to refining during a period when this nation faces a shortage of refining capacity. It is bad environmental policy because it prevents producers/refiners from using the economies of scale to produce the additional revenues necessary to pay for the rapidly expanding costs of compliance with our environmental laws.

The proposal before the Committee would require that two changes be made in Section 613A(d)(4). LL&E recommends that "75,000" BPD be substituted for the current law "50,000" BPD and that the 75,000 BPD limit is to be determined on the basis of the average refinery runs during the taxable year rather than on a day-to-day basis. LL&E strongly urges the Congress to enact such a proposal.

The 50,000 BPD any day limit is outdated. The Section 613A independent producer exemption is designed to distinguish between independent, relatively small, oil and gas producers and major integrated industry giants who actually engage not only in production but in refining and marketing, as well These major corporations generally operate refineries with capacities in excess of 150,000 barrels. The 50,000 BPD test, which was adopted in 1975 when Section 613A was enacted, no longer reflects the true nature of the domestic refinery industry.

In this context, three years ago, the Small Business Administration ("SBA") adopted a final rule revising its size standard for the petroleum refining industry by increasing the capacity limit from 50,000 to 75,000 BPD. In taking this action, the SBA made the following observations (57 Fed. Reg. 18810, May 1, 1992):

> Since the current size standard was established in 1975, the number of small refiners as well as their share of the industry's refining capacity have steadily diminished. Since 1975, most refineries with less than a 10,000 BPD refining capacity and almost half of the refineries with between 10,000 BPD and 50,000 BPD capacity are no longer operating. During this 16-year period the trend has been an increase in refineries with over 100,000 BPD refining capacity. In 1975 small refiners accounted for 7.8 percent of the U.S. refining capacity while by 1989, this share had decreased to 6.7 percent. New environmental compliance requirements may further diminish the small business share of industry capacity. A heavy investment is expected to be needed to change refining processing equipment and some small firms may not be able to meet the investment requirements.

The very factors cited by the SBA, the diminishing size of the small refinery segment of the industry and the increased costs of operations and investment required to comply with environmental laws, also favor providing the incentives under Section 613A of the Code to independent producers who operate refineries with capacities of up to 75,000 BPD. Such an amendment would simply recognize the changes that have taken place in the refining industry over the past 20 years.

One final comment. Under current law a producer/refiner loses its independent producer status under Section 613A if on any day during the taxable year production runs exceed 50,000 BPD. As a result, small refineries must be operated at a lower level than 50,000 BPD so as not to inadvertently exceed the limit. These precautions plus the necessary and unscheduled shut downs for maintenance and repairs, mean that the average daily refinery production runs will be significantly below that 50,000 barrels. For that reason LL&E strongly recommends the enactment of an amendment of Section 613A to provide that the BPD limit be applied on a yearly average BPD basis. Such a standard would protect producers/refiners from inadvertent loss of independent producer status and would permit them to operate their small refineries more efficiently and in accord with market demands.

I appreciate the opportunity to present the views of LL&E to the Committee and urge the adoption of the proposal contained in item 2 of the energy section of the hearing list to amend Section 613A(d)(4) of the Code by increasing the BPD limit to 75,000 by using daily refinery runs for the year to measure qualification.

Written Comments of
MDU Resources Group, Inc.
to the Committee on Ways and Means
U.S. House of Representatives
Regarding
the Determination of Independent
Oil and Gas Producer Status

MDU Resources Group, Inc. (MDU) is a multidimensional natural resources company having its principal offices in Bismarck, North Dakota. Montana-Dakota Utilities Co., the public utility division of the company, provides natural gas and electricity to customers in parts of North and South Dakota, Montana and Wyoming. The company, through a wholly-owned subsidiary, owns Williston Basin Interstate Pipeline Company, Knife River Coal Mining Company, the Fidelity Oil Group and Prairielands Energy Marketing, Inc. MDU appreciates the opportunity to submit this written statement in connection with the Committee's consideration of miscellaneous tax reform proposals that were the subject of hearings on July 11 and 12, 1995. MDU supports the proposal to expand the definition of independent oil and gas producer status for percentage depletion purposes. However, the proposal should be modified to allow a taxpayer to elect current law treatment in order to preserve certain tax benefits which would otherwise be unintentionally eliminated by the proposal.

BACKGROUND

A. Current Law

1. Percentage Depletion

Section 611 of the Code provides taxpayers with a deduction for the depletion of certain natural resources. The extent to which depletion is allowed is generally limited to the taxpayer's adjusted basis in the depletable property. Code section 613A(c), however, allows certain independent producers of oil and gas to take advantage of percentage depletion (the independent producer exception).[1] Percentage depletion provides taxpayers with a deduction to the extent of a specified percentage of the annual gross income generated by the depletable property. The deduction for percentage depletion constitutes a permanent tax benefit; it is not limited to the basis of the depletable property. In essence, as long as a depletable property is productive, an independent oil and gas producer may take advantage of the percentage depletion deduction.[2]

Code section 613A(d)(2) limits the scope of the independent producer exception. Specifically, independent oil and gas producers engaged in certain retailing or refining activities cannot take advantage of percentage depletion. A taxpayer meets the retailer exception and is considered an integrated producer if (1) the taxpayer sells oil or natural gas (domestically) through a retail outlet operated by the taxpayer or a related person, and (2) the combined annual gross receipts from the sale of such oil or natural gas exceed $5 million.

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1. Prior to the enactment of the Tax Reform Act of 1975 (Act), oil and gas producers were generally eligible for the percentage depletion allowance. Code section 613A, which eliminated percentage depletion with respect to integrated producers, was added by the Act in reaction to the windfall profits reaped by the 25 largest oil companies as a result of increases in foreign oil prices.

2. There is a 1000 barrel per day limitation on the amount of percentage depletion claimed by independent producers. The daily barrel limitation must be applied to the production of all entities related to the independent producer. Only the production barrels eligible for percentage depletion, however, need to be considered for each of the entities. For example, in calculating the limitation, an independent producer need not include the production barrels of a sister corporation required to use cost depletion for its entire production run.

In determining whether oil or gas sold "through a related party" would disqualify an independent producer from taking the percentage depletion allowance, Revenue Ruling 85-12 provided that:

> [w]here none of a producer's production is sold through a related retailer, the producer does not lose the benefit of the [Code] section 613A(c) exemption if an owner of 5 percent or more of its stock is a retailer because the producer does not benefit from the retailer's retail sale of oil and gas.

In other words, if an otherwise independent producer does not own or benefit from any gas or oil production which is directly or indirectly sold through a related party (for retail sale to customers), the producer will not be disqualified under the retailer exception. On balance, Revenue Ruling 85-12 allowed gas systems to avoid or lessen the impact of the retailer exception by establishing a separate subsidiary which sells none of its own production through a related utility company.

2. Current Deduction of Intangible Drilling Costs (IDCs)

In addition to qualifying a taxpayer for the percentage depletion allowance, independent producer status allows a taxpayer to deduct currently 100 percent of any intangible drilling costs (IDCs) it incurs. Integrated producers can deduct only 70 percent of IDCs in the year incurred and must amortize the balance over a five year period.

B. The Proposal

The proposal modifies the manner in which a natural gas production company's independent producer status is determined for percentage depletion purposes and for IDCs. MDU's specific concerns are that the proposal would permit retail sales of natural gas by a regulated public utility company to be disregarded in determining whether a related natural gas production company is a retailer for percentage depletion purposes. Accordingly, a natural gas production company would not be precluded from claiming percentage depletion merely because it was owned by a utility which made retail sales in excess of $5 million per year.

DISCUSSION

Due to its current corporate framework, premised on the guidance provided by the Service in Revenue Ruling 85-12, MDU would be negatively affected by the proposal. MDU's corporate structure currently allows one of its oil and gas subsidiaries to qualify for the independent producer exception and thereby claim a Federal income tax deduction for percentage depletion. MDU has relied upon the guidance provided by Revenue Ruling 85-12 for purposes of the expansion of its oil and gas activities. The effect of the proposal would be to qualify certain other MDU subsidiaries as independent producers, but in doing so, would thereby significantly reduce the percentage depletion tax benefits realized by MDU.

Although MDU understands the need to change the definition of the term "independent producer," MDU does not believe that such change should come at the expense of taxpayers that have gone to considerable effort to appropriately structure their oil and gas expansion efforts based upon the guidance provided by the Internal Revenue Service in Revenue Ruling 85-12. Accordingly, MDU suggests that any legislative proposal consider and rectify the impact of such an unintentional adverse change on taxpayers.

PROPOSED AMENDMENT

In order to preserve tax benefits currently available, MDU would amend the proposal to include an election out of the expanded definition of independent producer. In other words, while the general rule under the proposal would be to disregard incidental sales of natural gas to related public utility companies, MDU believes taxpayers should have the option of electing current law treatment and thus preserve the tax benefits gained as a result of their business structure.

MDU's suggested "election out" option will not affect the purpose behind changing the definition of the term independent producer. It will, however, ensure that taxpayers, like MDU, who have invested significant amounts of time and money to structure their operations in order to be eligible for independent producer status do not, as a result of legislation intended to be beneficial, lose the benefits of such efforts. MDU went to considerable effort to position itself to obtain independent producer status in order to obtain what MDU anticipated would be long-term benefits. MDU's return on its investment will be significantly reduced if the benefits associated with MDU's current structure are diminished as a result of a change intended to encourage domestic exploration and production and to distinguish the natural gas utilities from the major oil companies.

Placid Refining Company

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214/880-8477
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July 25, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Hearing on Miscellaneous Tax Reforms
July 11, 12, 13, 1995

Dear Mr. Moseley:

Placid Refining Company ("Placid") is the operator and 64% owner of a 50,000 barrel per day rated refinery in Port Allen, West Baton Rouge Parish, Louisiana. Placid operates the refinery on behalf of itself and two other owners. The various owners of Placid and the refinery are independent producers of oil and gas in the United States. Because of their ownership in the refinery they are subject to losing their independent producer status should Placid operate the refinery above 50,000 barrels per day on any one day of a tax year (the "any one day provision"). This loss of independent producer status would damage the various refinery owners causing them the loss of their percentage depletion allowance on oil and gas produced up to the first 1,000 barrels per day, and requiring them to capitalize and depreciate 30% of their intangible drilling costs ("IDC") rather than being able to expense 100% of the IDC.

The drastic consequences of operating the Port Allen refinery above 50,000 barrels on any one day forces Placid to operate the refinery at approximately 48,500 barrels per day, which it feels is the safe level required to avoid triggering the "any one day provision." This is a loss of 3% of its capacity because of the "any one day provision." In addition, Placid, although rated at 50,000 barrels per day, could operate the facility without significant capital investment at approximately 52,000 barrels per day. Thus, the present provisions of Section 613 A (d) (4) effectively impose a statutory inefficiency of nearly 7% of Placid's capacity and a corresponding loss of revenue to Placid and taxable income to the federal government. Moreover, with the "any one day provision," Placid cannot make up for volumes lost when the refinery is down for turnaround or maintenance requirements. If the "any one day provision" was changed to "yearly average," Placid could operate the refinery much closer to its 50,000 barrel per day capacity

Placid, as a small refiner, is being increasingly squeezed by the ever escalating costs of compliance with government regulations, especially the environmental and safety regulations, while lacking the ability to optimize the capacity and efficiency of the refinery and its people because of the arbitrarily set provisions and definitions of 613 A (d) (4). It should be noted that Placid must comply with all of the same environmental and safety regulations required of the larger refineries running 100,000, 200,000 or 400,000 barrels per day. However, the cost of this compliance is significantly greater on a per barrel basis for Placid than the larger refineries because of the economics of scale attributable to its capacity. Consequently, Placid is at a disadvantage in the market place unless it has the ability to make full use of its assets or even moderately expand its capacity, without penalty, as most of Placid's larger competitors have been doing.

The 50,000 barrel per day limit set in 1974 seems to have been arbitrarily chosen without any significant basis or reason for its selection. But notwithstanding the reasons for limiting the size of a small refiner to 50,000 barrels per day, the limit is currently inconsistent with other regulatory definitions such as those set by the Small Business Administration ("SBA"), which after due consideration, effective May 1, 1992, revised its definition of a small refiner for the petroleum refining industry, Standard Industrial Classification ("SIC") Code 2911, from 50,000 barrels per day to 75,000 barrels per day. This increase allows refiners up to 75,000 barrels per day to qualify as a small business for various SBA programs. The MMS also accepts the SBA definition of a small refiner (75,000 BPD or less) in considering the administration of its Royalty-in-Kind oil marketing program.

Placid, even though it is a small refiner, is the largest employer in West Baton Rouge Parish, Louisiana, employing approximately 210 people, whose incomes , in turn, support other businesses and industries in the area. Placid is also a major consumer of goods and services provided by many local area vendors. In addition, it is the largest tax payor in the parish and supports many of the parish activities. The SBA, in its review of the definition of a small refiner, stated that approximately one-half of the refineries with a capacity of between 10,000 and 50,000 barrels per day have ceased to exist since 1975. With the refinery business being very competitive, costs on the rise, and refinery margins being very slim, Placid may very well become part of this statistic in the future if it is not allowed to operate at its optimal efficiency.

Placid requests that Section 613 A (d) (4) be amended to increase the volume from 50,000 to 75,000 barrels per day and from the "any one day provision" to the "average during the taxable year." This change would allow Placid the ability to be more competitive and make operational and expansion decisions based on true economics and efficiency standards without unduly penalizing its owners. It would also allow Placid the ability to increase its own taxable income and to continue to provide employment to hundreds of citizens in the state of Louisiana. .

Very truly yours,

PLACID REFINING COMPANY

Daniel R. Robinson
President

TESTIMONY OF SAFETY-KLEEN CORP.
ELGIN, ILLINOIS

Re-refining of Used Engine Oil

Safety-Kleen's Role in Managing Wastes

Safety-Kleen is the world's leading recycler of automotive and industrial hazardous and non-hazardous waste fluids. The Company processes and reclaims more than 200 million gallons of contaminated fluid each year from approximately 400,000 customers. The Company believes that only through proper handling can the hazardous waste portion of the world's wastes be safely managed to ensure the preservation of human health and the environment.

Safety-Kleen is exceptionally proud that the vast majority of its customer base is made up of small businesses, where jobs are being created and the economy is having its greatest current successes. Safety-Kleen's unique US distribution system includes a network of 160 branches to collect wastes, 9 solvent Recycle Centers, one used oil processing facility and one used oil re-refinery to recycle, reclaim, or re-refine these wastes. Through these facilities, the Company provides services to customer locations throughout the United States.

The Company collects used lubricating oil from 64,000 customer locations in the US. These customers consist of car dealers, oil change outlets, gas stations, automotive garages and many other small businesses. In addition, Safety-Kleen provides service to many of the nation's largest companies.

In short, **Safety-Kleen teams effectively with small business**, removing what used to be environmental and human health concerns and allowing those small businesses to do what they do best--serve their customers and the economy.

Safety-Kleen's two used oil re-refineries in East Chicago, Indiana and Ontario, Canada processed approximately 112 million gallons of used oil during 1994. Since the majority of Safety-Kleen's customers are small businesses, the Company plays an additional key role beyond simply picking up used oil and other wastes. Safety-Kleen provides, as a matter of course, comprehensive and up-to-date information on the often complex environmental regulations and procedures with which its customers need to comply.

The used Oil Issue

According USEPA figures, approximately 1.4 billion gallons of used oil are generated annually. Only about half of this amount is collected for recycling. Of the used oil collected, approximately 85% is burned as fuel and 15% is re-refined into base stock for re-use.

The adverse effects on the environment of improper disposal of used oil are as startling as they are well documented. One gallon of stray oil can render one

million gallons of water undrinkable. Additionally, used oil frequently contains elevated concentrations of toxic metals, such as lead, which are picked up from contact with engine parts during use.

In response to the potential environmental damage posed by the improper management of used oil, the USEPA promulgated used oil management standards in March, 1993, aimed at ensuring that used oil is managed in a manner that is fully protective of human health and the environment. The used oil management standards appear in title 40 of the Code of Federal Regulations (CFR) part 279.

Although these regulations focus on proper management, they also recognize the value of used oil as a resource that can and should be re-used, either through re-refining into lube stock or through burning as a fuel in appropriate units. Thus, the used oil management standards assume that used oil will be recycled, and are written in a manner to encourage collection and reuse.

Benefits of Re-refining

Officials with the USEPA, as well as significant elements of the environmental community, have stated that re-refining is the preferred option for the recycling of used oil. Re-refining is considered by many to be a "higher use" than burning as fuel for energy recovery. Oil can be re-refined and re-used an unlimited number of times with no loss of quality, essentially renewing a resource once thought to be non-renewable. **Used oil is a home-grown, renewable resource and can be a significant component in America's efforts to be energy independent.** A state of the art re-refinery, such as Safety-Kleen's East Chicago facility, is capable of handling almost any used oil stream and converting it into quality lube stocks equivalent in all respects to virgin material.

Only two gallons of used oil are required to produce one gallon of lubricating oil, whereas, approximately 13 gallons of crude oil are required to produce one gallon of virgin lubricating oil. Thus, re-refining of used oil plays a role in reducing dependence on foreign energy sources and fossil fuels, both in regard to feedstocks used to produce lubricants and to energy requirements for the re-refining process.

The Re-refining Process

Safety-Kleen's re-refineries use advanced technology (this film evaporation and hydrotreatment, which is the most evolved form of re-refining). This process provides the highest quality lube stock and produces the least amount of waste. In addition to the primary product, lube stock, the re-refining process also produces other useful products, such as asphalt extender, which is used in the manufacture of shingles and asphalt for roadways.

Re-refining compliments the oil industry, in that it addresses the disposal side of "cradle to grave". Many oil companies actively support re-use and recommend Safety-Kleen as the preferred provider of re-refining and recycling processes.

Safety-Kleen's re-refineries have pioneered many of the more innovative techniques used in re-refining. The promise of this new technology has led Safety-Kleen to invest in excess of $75,000,000 in property, plant and equipment at the East Chicago, Indiana plant.

Re-refining has the additional benefit of generally decreasing superfund liability across the board.

The Used Oil Industry

Safety-Kleen and Evergreen Oil, Inc. of Newark, California produce the vast majority of re-refined oil in the United States. The US began re-refining and leads the world in this area. It is a home grown industry. Re-refined oil makes up about 15% of the total oil recycled in the country. At this time, the majority of used oil collected in the United States is processed for use as fuel by approximately 200 processing facilities. Both Safety-Kleen and Evergreen operate state-of-the-art re-refineries capable of producing quality lube stock that meets applicable industry standards for lubricants. Despite existing re-refiners success in producing quality products, the capital investment required to build or upgrade existing facilities into state-of-the-art re-refineries, coupled with slim profit margins, have generally discouraged entry into re-refining by other businesses.

In addition to raising the quality and the reputation of re-refined oil, Safety-Kleen's used oil collection and management procedures, which are modeled after the procedures it uses to manage hazardous waste, are the most stringent in the US and have set a standard for environmental protection for the rest of the industry.

Quality of Re-refined Oil

Re-refining technology has made major advances over the past 15 years. The successful adaptation of refining technologies such as hydrotreating, a process which removes or destroys contaminants such as chlorinated compounds, allows production of re-refined lube stock that meets or exceeds the standards set of lube stock refined from virgin oil.

Safety-Kleen has received International Standards Organization (ISO) 9002 accreditations for both its East Chicago and Breslau, Ontario, re-refineries. The Company's high-quality lube stock is blended, either by Safety-Kleen or by independent compounders-blenders or major oil companies, into a wide range of products. Safety-Kleen's own brand of engine oil made with re-refined lube stock is America's Choice, which is sold at Wal-Mart stores and other retailers.

Improvements in the quality of re-refined oil have led to increased market acceptance and interest. Several of the major oil companies are marketing their own brands of engine oil blended from re-refined lube stock produced by Safety-Kleen or Evergreen. Additionally, re-refined oil meeting the International Lubricant Standardization and Approval Committee's (ILSAC) GF-1 specifications received another important acknowledgment of its quality. The American Automobile Manufacturers' Association has stated that any oil, including re-refined motor oil, displaying the American Petroleum Institute's certification mark "starburst symbol" is suitable for use by its members, Chrysler Corporation, Ford Motor Company and General Motors.

Both the US government and a number of state governments are seeking to increase the market for re-refined oil by encouraging their own agencies to buy it through procurement preference guidelines. The USEPA's Office of Solid Waste, Municipal and Industrial Waste Recycling Section, in 1988 designated re-refined oil as an item that agencies should purchase after careful review of its quality. Re-refined oil was also designated for preferential procurement by operating units (the Park Service, GSA, etc.) of the Federal Government in Executive Order 12873 on *Federal Acquisition, Recycling and Waste Prevention* issued by President Clinton on October 20, 1993.

Additionally, in 1994, Safety-Kleen received the prestigious "Green Seal" certification for its re-refined engine lubricants. Green Seal, an independent, non-profit organization, awards its certification to products found to cause significantly less harm to the environment than other, similar products.

Economics

Entry into the re-refining business has been expensive for Safety-Kleen. Factors that hinder entry into the business include high capital costs required to produce quality lube stocks, and the extensive and complex requirements covering regulatory compliance, operating permits and waste water discharges.

To incentivize re-refining through tax reform would offer benefits on many levels and encourage more recycling while capturing more used oil in a management system rather than having it escape into the environment. The Company showed no return on investment in the oil re-refining business from the initial entry in 1987 until 1994, when a small profit was made.

Since the price of lube stock is tied to the price of virgin crude, which has been relatively low over the past few years, profit margins are slim. The capital investment in the re-refineries and the cost of operating the Company's collection system represent fixed costs that cannot be adjusted downward.

Conclusion

Beyond the obvious benefits to small businesses nationwide and to the environment, government and industry endorsement of high quality re-refined lube stocks, such as those produced by Safety-Kleen, underscores the importance of recycling used oil through re-refining. Because of the cost structure of the industry, however, re-refiners face stiff obstacles in order to produce re-refined products.

The process and promise of re-refining includes benefits to the environment as well as decrease reliance on imports. The hundreds of millions of gallons of used oil that have thus far been re-refined represent conservation of an important resource and protection of both US waterways and groundwater from improper disposal.

Re-refiners, who necessarily operate on a smaller scale than the major oil companies, are directly affected by the price of crude oil without the economies of scale of the major oil companies. Additionally, re-refiners must compete for used oil in the marketplace with used oil processors, or those organizations which convert used oil into fuels of various types. These oil processors naturally have lower levels of capital investment at a lower cost structure.

Thus the extra costs associated with collecting and re-refining used oil are conceptually comparable to the costs associated with extracting crude oil from difficult-to-access deposits, or "non-conventional sources" and should be afforded comparable tax incentives.

In summary, we believe that a tax incentive as discussed here would have significant multiple benefits for the country; including helping America's increasingly important small business community, helping to keep the environment clean for us and future generations, and assisting an industry that can play an important role in helping America achieve true energy independence.

STATEMENT OF K. MARTIN WORTHY
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
JULY 11-13, 1995

My name is K. Martin Worthy. I am a lawyer in the firm of Hopkins & Sutter in Washington, D.C. and have practiced tax law for more than 35 years. I was Chief Counsel for the IRS for three years and have been Chairman of the Tax Section of the American Bar Association.

I am presenting this statement in support of legislation which would correct a serious inequity which has resulted in the *retroactive* application of federal gift tax. The amendment relates to disclaimers of property interests originally created before 1958.

It has been accepted for over fifty years that a disclaimer or renunciation refusing to accept a gift or transfer by will is not itself a transfer subject to gift tax if the disclaimer is valid and properly made. Although until 1976 the Internal Revenue Code ("Code") contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a Regulation recognizing this court-established principle. Section 2518 of the Code (the disclaimer provision first adopted in 1976) applies only to disclaimers of interests created after 1976, so that disclaimers of earlier interests, including all the interests covered by the proposed amendment, are governed solely by the 1958 Regulation and case law.

I represent the Estate of Mrs. Helen W. Halbach, who died while a resident of New Jersey in 1972. Mrs. Halbach's disclaimer is one that would be covered by the proposed amendment. I believe the following chronology of our case will demonstrate the unfairness of the situation both for Mrs. Halbach's estate specifically and generally, for other disclaimants who meet the requirements of the proposed legislation.

Mrs. Halbach's father died in 1937, and by his will established a trust with the income to be paid to Mrs. Halbach's mother for life, with the remainder to be divided later equally between Mrs. Halbach and her sister in the event of their survival of their mother. Thus, Mrs. Halbach's interest was wholly contingent and would not vest or become possessory in any sense until after her mother's death.

Mrs. Halbach's mother died on April 14, 1970, and Mrs. Halbach, four days later, executed a document in which she irrevocably renounced and disclaimed all her right, title and interest in the one-half share of the trust to which she would otherwise have been entitled. The bank administering the trust thereupon brought an action in the New Jersey courts to determine the effect of the disclaimer, and the Chancery court of New Jersey, in a carefully developed opinion (274 A.2d 614), held in late 1970 that the disclaimer, having been executed promptly after the death of the life tenant, was effective to prevent any passage of title to Mrs. Halbach. The Court thus required distribution of the half interest in the trust, to which Mrs. Halbach would otherwise have been entitled, just as if Mrs. Halbach had not survived. Significantly, the Court noted not only that this was the accepted law of New Jersey, but also that the Court had been unable to turn up any court decision anywhere that to be effective a remainderman's renunciation must occur (as the Internal Revenue Service would later contend) within a reasonable time after learning that a remainder interest had been *created*. Thus, the Court concluded that it was sufficient if renunciation occurred within a reasonable time after ***termination*** of any preceding life interest.

As I will discuss, Mrs. Halbach had no reason to believe, when she executed her disclaimer in 1970, that she had in any way made a transfer of property subject to gift tax. However, by reason of the Supreme Court's 1982 decision in Jewett v. Commissioner and the failure of Congress in enacting section 2518 to deal specifically with disclaimers of interests created before 1976, Mrs. Halbach's estate is faced with a gift tax on the value of the trust interest which she disclaimed in 1970, just as if she had accepted it and then later voluntarily transferred it to persons of her own choosing.

Before the 1958 Regulation the U.S. Courts of Appeals had made it clear that a disclaimer which was valid and effective under state law did not result in a taxable gift. (These and other authorities are discussed more fully in the attached "Technical Analysis.") Although there was some variance in state disclaimer statutes and some states had no disclaimer statutes at all, it was clear from the authorities (such as Page on Wills) that as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without prior acceptance, and made within a reasonable time. Furthermore -- just as later held by the New Jersey court in connection with Mrs. Halbach's disclaimer -- in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

In the Jewett case, however, the Supreme Court held that, under the 1958 Regulation, a disclaimer after 1958 of a pre-1976 interest (*i.e.*, one created before the effective date of section 2518 of the Code) will be recognized as free from gift tax only if the disclaimer is made shortly after the disclaimant obtains knowledge of the ***creation of such interest*** rather than after knowledge of ***its vesting***, as the courts had previously held. Under this interpretation future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. This interpretation of the 1958 Regulation is clearly contrary to accepted case law before 1958 (and contrary to what many justifiably understood the law still to be even after the Regulation was promulgated in 1958 and until well after Mrs. Halbach executed her disclaimer in 1970). Accordingly, application of the Supreme Court's decision to Mrs. Halbach and other holders of pre-1958 contingent interests is very unfair. Under existing case law before the Jewett decision in 1982, they had no reason to disclaim a pre-1958 contingent interest until after they obtained knowledge that the interest had vested, even if they had knowledge of the existence of the interest from its creation. Yet the 1958 Regulation, as interpreted by the Supreme Court in Jewett, gave such holders no opportunity to disclaim their pre-1958 interests without gift tax, since it ***was already too late to do so when the Regulation was promulgated.***

It should be emphasized that Mrs. Halbach had no reason to know at the time of her disclaimer in 1970 that the IRS would claim that such disclaimer was subject to gift tax. The Supreme Court acknowledged in its opinion in Jewett that it was not entirely clear even after 1958 whether the Regulation required that the disclaimer be made upon creation of a contingent remainder interest or upon subsequent vesting on death of the life tenant.

(1) In fact, the position taken by the IRS in the Jewett litigation with respect to the meaning of the 1958 Regulation is specifically inconsistent with the Service's interpretation of such Regulation in Private Letter Ruling 6612201590A, which was issued by the Service prior to Mrs. Halbach's disclaimer ***in 1970***. We have been unable to find why this ruling was not called to the Supreme Court's attention in Jewett, and the Court, in making its conclusion, mistakenly found that "the Commissioner's interpretation of the regulation has been consistent over the years" and concluded that it was therefore "entitled to respect."

(2) In truth, as acknowledged by counsel for the Commissioner of Internal Revenue in oral argument on December 1, 1981, it was not until litigation in the Tax Court in ***1972*** that the Service first publicly stated that it interpreted the Regulation as it now does, as requiring the holder of a future contingent interest to disclaim shortly after knowledge of its creation rather than after knowledge of the termination of the preceding interest.

(3) That the taxpayer knew or should have known that the Regulation meant what the Service now claims it means was certainly not obvious to the United States Court of Appeals for the Eighth Circuit as late as ***1973***, when it held that the interpretation now claimed by the Internal Revenue Service and the Treasury Department was incorrect. Keinath v. Commissioner, 480 F.2d 57.

> The Eighth Circuit reaffirmed this view in 1980 in Cottrell v. Commissioner, 628 F.2d 1127, holding that Mrs. Halbach's sister's disclaimer of her identical interest in the same trust at the same time was not subject to gift tax. Mrs. Halbach and other disclaimants were simply operating within the law in effect at the time of their disclaimers -- the law as interpreted in the Keinath and Cottrell cases.

The proposed amendment would correct the injustice of the Supreme Court decision in the Jewett case, for both estate and gift tax purposes, by providing that a disclaimer of a pre-1958 interest will be treated as satisfying all requirements of the Regulation if made before May 22, 1972 and within a reasonable time after the preceding interest terminates and the disclaimant's interest vests. The May 22, 1972 date is the date of the Tax Court's decision in Keinath, the case in which the Service first publicly stated its contention that, when the Regulation was issued in 1958, it was already too late to disclaim an existing contingent interest. Thus, the proposed amendment is limited to those who were treated most unfairly by the effect of the Jewett decision -- holders of such interests who disclaimed before the IRS first made its interpretation public in May 1972.

The amendment would allow a grace period of one year after enactment of the provision for making a refund claim with respect to each of the specified disclaimers, regardless of the statute of limitations or finality of any prior decision.

In the past the Treasury Department has opposed a similar legislative proposal because it was to be "retroactive." It is ironic that they put so much emphasis on retroactivity of the proposed legislation and do not express the same concern about the retroactivity of the Government's interpretation of the 1958 Regulation, first announced in 1972, saying that Mrs. Halbach, whose contingent remainder interest was created in 1937, should have ***made her disclaimer 21 years before the 1958 Regulation imposing the new test was issued.*** Surely, the *ex post facto* nature of this Regulation, retroactively changing the rules, without any grace period, as to when a pre-1958 contingent interest may be disclaimed without gift tax, cries out for Congressional redress.

Treasury has also opposed a similar amendment on the ground that the rule for disclaimer of post-1975 interests under section 2518 is consistent with the Jewett interpretation of the 1958 Regulation for pre-1976 interests, that timeliness for both is gauged from the time the interest is created. However, the legislative history of the 1976 Act (which adopted section 2518) indicates to the contrary that Congress believed that the Court of Appeals in the Keinath case stated the proper interpretation of the rule for pre-1976 interests. *See*, H. Rept. 94-1380, 66, 1976-3 C.B. 800.

In conclusion, it is our contention that it is only fair and equitable for this Congress to provide relief to taxpayers who in good faith relied on existing case law and never had an opportunity to make a timely disclaimer of their pre-1958 contingent interests, as the Supreme Court has interpreted the requirements of the 1958 Regulation.

Congressional relief from the imposition of the Federal gift tax on the disclaimer of pre-1958 interests is particularly appealing in the instant case under a "basic fairness" test, since my client made the identical disclaimer at the same time as her sister who has been relieved from such gift tax by the Eighth Circuit.

TECHNICAL ANALYSIS AND BACKGROUND CONCERNING PROPOSAL ON THE TAX TREATMENT OF DISCLAIMERS OF CERTAIN REMAINDER INTERESTS

I. BACKGROUND

As noted above, although until 1976 the Internal Revenue Code of 1954 ("the Code") contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a Regulation recognizing this court-established principle. However, even under the Regulation, the effectiveness of a disclaimer for federal tax purposes varied according to applicable state law. By the 1970's it had become apparent to members of the tax bar and others that a uniform definition of disclaimers would be desirable for federal tax purposes. *See*, H. Rept. No. 94-1380, 66, 1976-3 C.B. 735, 800.

In response to the movement for a uniform disclaimer rule, Congress enacted new section 2518 of the Code in the Tax Reform Act of 1976. That section generally requires that a "qualified disclaimer" for federal estate and gift tax purposes, i.e., a disclaimer that does net constitute a taxable gift, be made (a) in writing, (b) before acceptance of the interest being disclaimed or any of its benefits, and (c) within 9 months after the later of the date on which the transfer creating the interest is made or the day on which the disclaimant attains age 21. Section 2518 was subsequently amended in 1978 and 1981 to perfect and clarify the uniform rule.

Under present law section 2518 applies only to disclaimers of interests created after December 31, 1976. Thus, the broad class of disclaimants of interests in trusts created before 1958 remains subject to the law in effect before section 2518 was enacted, irrespective of when the interests become possessory and when the disclaimers are made -- even 40 or 50 or more years from now.

II. REASONS FOR PROPOSED AMENDMENT

In Jewett v. Commissioner, 102 S. Ct. 1082 (1982), the Supreme Court of the United States, interpreting section 25.2511-1(c), Gift Tax Regs., held that a disclaimer after 1958 of an interest created before 1977 will be recognized as free from federal gift tax only if it is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged. Under this interpretation, future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Such an approach is contrary to the view, widely held before the Supreme Court decided Jewett, that the 1958 Regulation permits a tax-free disclaimer within a reasonable time after the death of the preceding life tenant, i.e. after the disclaimed interest becomes present and possessory. Moreover, as interpreted by the Supreme Court, the Regulation represents a sharp departure from the law in effect prior to 1958 under which the effect of such a disclaimer was generally governed solely by State law. Thus, the application of the Supreme Court's decision to holders of interests created before 1958 is very unfair; they had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax -- even "within a reasonable time" -- after the Regulation was promulgated.

Law Before 1958

Prior to the 1958 Regulation there were few cases involving the federal estate and gift tax effect of disclaimers. Nevertheless those few cases made clear that disclaimers which were valid and effective under state law did not result in a taxable gift.

In 1933, the Sixth Circuit decided Brown v. Routzahn, 63 F.2d 914, cert. den. 290 U.S. 641 (1933). In Brown decedent's wife died in 1912 and left decedent one-third of all her property. An April 1920, before any distribution was made, decedent filed with the

proper probate court a renunciation of his right to the third of the estate, and the court, ordering distribution to the remaining heirs, recognized the renunciation. However, at decedent's death the Commissioner contended that the value of the renounced property should be included in decedent's estate for federal estate tax purposes as a transfer made in contemplation of death.

In analyzing the issue, the Court of Appeals began from the "obvious" premise that unless the decedent accepted the gift of one-third of his wife's estate or became owner of such interest before April 1920, there could be no transfer of such interest in contemplation of death within the meaning of the tax statute. The court looked to state law and found that under Ohio law a rejection of a gift by will made any time before distribution would be valid and that decedent therefore had never become owner of the property involved. Accordingly, the court concluded that his renunciation of the property could not be a taxable transfer for federal tax purposes.

There was no indication by the Internal Revenue Service of its intent not to follow the Brown decision. No other decision bearing significantly upon the issue arose until 1952, when the Eighth Circuit decided Hardenbergh v. Commissioner, 198 F.2d 63, cert. den. 344 U.S. 836 (1952). In Hardenbergh the taxpayers attempted to renounce their interest in the estate of a decedent who had died intestate, and the Internal Revenue Service claimed that the disclaimer constituted a taxable gift. The Eighth Circuit found that immediately upon the death of the decedent title to the disclaimants' interests had vested in them by operation of Minnesota law which neither disclaimant had the power to prevent, with the result that their subsequent disclaimers constituted transfers of such interests for federal gift tax purposes. Thus Hardenbergh reinforced the principle that validity of a disclaimer under state law controlled for federal estate and gift tax purposes. Indeed, Hardenbergh cited Brown with approval with respect to disclaimers of testamentary gifts, carefully distinguishing Brown on the basis of the testate/intestate law difference. 198 F.2d at 66.

A number of commentators during this period recognized the principle that state law controlled in determining the tax effect of disclaimers. *See, e.g.*, Ekman, "Can A Transferee Avoid Gift or Estate Tax Liability by Renouncing A 'Transfer By Operation of Law,'" 11 N.Y.U. Inst. on Fed. Tax'n 527, 532-534 (1953); Sayles, "Renunciations -- Estate and Gift Tax Problems," 1953 S. Cal. Tax Inst. 531, 536-539. There was some variance in state disclaimer statutes, and some states, in fact, had no disclaimer statute at all. Nevertheless, as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without previous acceptance, and made within a reasonable time. 6 Bowe-Parker, Page on Wills § 49.9, 49.1, 49.8 (1962); 96 C.J.S. § 1151(b), 1151(a) (1957). In the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement. See 6 Bowe-Parker, Page on Wills § 49.8 (1962). *Also see*, Estate of Page, 74 A.2d 614, 615-616 (N.J. Super. 1970).

A review of these cases and commentary reveals that prior to 1958 nothing in federal estate or gift tax law would require the holder of a remainder interest created by will to disclaim immediately upon the creation of the interest. Generally under state law the holder could wait until a reasonable time after the termination of the preceding interest, and the decided cases indicated that federal tax consequences of the disclaimer were controlled by state law. Against this historical background, section 25.2511-1(c), Gift Tax Regs., was issued in final form on November 15, 1958.

The 1958 Regulation

Section 25.2511-1(c), Gift Tax Regs., which has not been changed since it was promulgated in final form in 1958, provides in pertinent part as follows:

"Where the law governing the administration of the decedent's estate gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly

refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property), ***a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. The refusal must be unequivocable*** [sic] ***and effective under the local law. There can be no refusal of ownership of property after its acceptance.*** Where the local law does not permit such a refusal, any disposition by the beneficiary, heir or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by the beneficiary, heir or next-of-kin. In any case where a refusal is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under the local law. In the absence of facts to the contrary, if a person fails to refuse to accept a transfer to him of ownership of a decedent's property within a reasonable time after learning of the existence of the transfer, he will be presumed to have accepted the property. In illustration, if Blackacre was devised to A under the decedent's will (which also provided that all lapsed legacies and devises shall go to B, the residuary beneficiary), and under the local law A could refuse to accept ownership in which case title would be considered as never having passed to A, A's refusal to accept Blackacre within a reasonable time of learning of the devise will not constitute the making of a gift by A to B. However, if a decedent who owned Greenacre died intestate with C and D as his only heirs, and under local law the heir of an intestate cannot by refusal to accept, prevent himself from becoming an owner of intestate property, any gratuitous disposition by C (by whatever term it is known) whereby he gives up his ownership of a portion of Greenacre and D acquires the whole thereof constitutes the making of a gift by C to D." Emphasis added.

This version of the Regulation is somewhat different from a draft initially proposed on January 3, 1957, which required a renunciation to be made "within a reasonable time after knowledge of the existence of the ***interest***" (emphasis added), rather than after knowledge of the existence of the "***transfer***," as provided in the final Regulation. The word "interest" would clearly include a contingent remainder even though the creation of that remainder by will did not effect a "transfer" to the disclaimant. Thus, under the Regulation as originally proposed, the holder of a future interest would only have had a reasonable time after the creation of the interest in which to disclaim and would not have been permitted to wait until the interest became present and possessory by transfer of the property to him.

On its face, this difference between the proposed and final regulations suggests that the final Regulation was a rejection of the requirement of the proposed regulation that a disclaimer of a contingent interest be made within a reasonable time after its creation rather than a reasonable time after it became possessory. However, in its Jewett opinion the Supreme Court considered the change in language and concluded, based on a Memorandum from the Commissioner of Internal Revenue to the Secretary of the Treasury, dated October 1, 1958, that the reason for the change was unrelated to the issue of when a future interest must be disclaimed. With respect to the disclaimer Regulation, the Memorandum provides in part as follows:

"In what was intended to be the application of the rules in Brown v. Routzahn (1933) 63 F.2d 914, cert. denied 290 U.S. 641, and Hardenbergh v. Commissioner (1952) 198 F.2d 63, cert. denied 344 U.S. 836, it was stated that where title to the property did not vest in the beneficiary or heir immediately upon the decedent's death, the renunciation of the property did not constitute the making of a gift, but that, where title vested in the beneficiary or heir immediately upon the decedent's death, the act of the beneficiary or heir in giving up what passed to him from the decedent

> constituted the making of a gift. . . . Protests on these provisions were received. After reviewing these protests, we have reconsidered our position and now believe that the proper distinction between these two court cases turns on the question of whether under the applicable State law a beneficiary of heir can or cannot refuse to accept ownership of the property which passed from the decedent. Accordingly, we have revised paragraph (c) of section 25.2511-1 to reflect this change of position." XIII Tax Notes 203, July 27, 1981.

Two things are apparent: (1) Even if it is assumed that the drafters of the final Regulation were not intentionally trying to state a different rule for contingent interests than set forth in the proposed regulation, this would not have been apparent to holders of contingent interests at the time, since the Memorandum was not made public until June 15, 1981. (2) The Memorandum clearly indicates that the drafters were trying to soften the inflexibility of the proposed rules and to provide, instead, that state law would apply in every situation. And, as previously noted, under the law applicable in most states, in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

It was not immediately apparent that the 1958 Regulation was intended to make a change in the Treasury position as to when a valid disclaimer must occur. Although it specified three requirements not mentioned in Brown -- that a disclaimer be unequivocal, that it be made before acceptance of the interest, and that it be made within a reasonable time of knowledge of the existence of the transfer, the Eighth Circuit subsequently observed that the conditions in the Regulation were "but a codification of common law principles applicable to the doctrine of disclaimers." Keinath v. Commissioner, 480 F.2d 57, 61 (1973).

What taxpayers and the tax bar did not then know was that the IRS would eventually introduce a new concept by contending that when it said a taxpayer must disclaim within a reasonable time after "the transfer," it meant in the case of a contingent interest, a reasonable time after creation of the interest rather than a reasonable time after the interest became possessory. It was in litigation of Keinath v. Commissioner in the Tax Court in 1972, that the Service first publicly took the position that the Regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest. *See* statement of counsel for the Commissioner of Internal Revenue in oral argument before the U.S. Supreme Court in Jewett v. Commissioner, No. 80-1614, 44-45 (December 1, 1981). This position of the Service was inconsistent with the Brown case, which the Memorandum indicates was intended to be embodied in the Regulation, and contrary to the general principle of state law that disclaimers could be made after termination of the preceding life interest.

It now further appears that the position the IRS took in Keinath was also inconsistent with its own position in an earlier private letter ruling (6612201590A) dated December 20, 1966. (Although private rulings were confidential at that time, since 1976 they have been released to the public, and this particular ruling was made open to public inspection on August 28, 1978.) In that ruling the IRS held that a taxpayer's proposed disclaimer of a contingent interest in a trust created 33 years earlier would not be taxable as a gift. The taxpayer had a present possessory interest in a portion of the trust from its creation, and on the death of other life tenants without "issue" the taxpayer became eligible for additional fractional income interests. The Service ruled that if the taxpayer executed a disclaimer "within a 'reasonable time' from the time that she first received notice [by reason of a court decision that the income interest had vested in her] of her right to the additional income interest," the requirements of the Regulation would be satisfied and no gift tax would be due. Because the taxpayer already held another interest in the trust from which she had received income for nearly 30 years, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent interests in the additional shares in the event of survivorship. Thus, the above quoted language of the ruling means that she had a

However, what is important here is that the interests to which the proposed legislation would apply were created before 1958, not that it was disclaimed after 1958. The Regulation did not provide a grace period for disclaimers after it was promulgated, and as Jewett reads the Regulation, at that point it was already too late. Thus, holders of pre-1958 interests were unfairly and unjustifiably prevented from ever disclaiming without incurring a gift tax. Congress recognized this very transition problem when it made the rules of section 2518 applicable only to disclaimers of interests created after 1976. *See*, section 2009(e) of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520.

The proposed amendment would correct the unfair effect of Jewett on holders of pre-1958 future interests by providing that their disclaimers will be treated as meeting all requirements of the Regulation if made before May 22, 1972 and within a reasonable time of vesting of the interest. As the discussion above shows, the equities weigh heavily in favor of such relief.

PROPOSED STATUTORY LANGUAGE

SEC. ________ Transitional Rule for Pre-May 22, 1972* Disclaimers of Property Interests Created by Gifts, Devises or Bequests Made before Promulgation of Regulations on November 15, 1958.

With respect to an interest in property created by a gift, devise, or bequest made before November 15, 1958, a disclaimer by a person of such interest (in whole or in part) shall not be treated as a transfer for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code and shall be deemed to satisfy all the requirements set forth in Treasury Regulation Section 25.2511-1(c) as in effect at the time the disclaimer was made, if such disclaimer was made in writing before May 22, 1972, and no later than a reasonable time after the termination of all interests in such property prior to the disclaimed interest. This section shall apply notwithstanding any law or rule of law (including but not limited to section 7481 of the Internal Revenue Code of 1986 as amended) concerning the finality of court decisions or other determinations, barring multiple suits on one cause of action, or limiting the time when a claim or suit for refund of tax may be brought, provided that the benefit of this section is claimed within one year of the date of enactment of this Act.

(...continued)
is difficult to understand if, in fact, the Regulation required disclaimer in 1939 when the disclaimed interest was created.

*[This is the date the Tax Court decided Keinath v. Commissioner, 58 T.C. 352, in which the Internal Revenue Service for the first time publicly took the position that the 1958 Regulation required a disclaimer of a contingent interest to be made shortly after creation of the interest, rather than vesting.]

reasonable period from the time she received notice that her additional contingent income interest had vested or become possessory, even though that interest had been created 33 years earlier.

Although this private letter ruling was public when the Jewett case was briefed and argued before the Supreme Court, the Court was apparently not made aware of the inconsistent interpretation of the Regulation made by the IRS In fact, the Court expressly noted in upholding the Commissioner's interpretation of the Regulation that the Service had been consistent in its interpretations over the years (102 S.Ct 1090) -- which is simply not so.[1]

Conclusion

This examination of the federal gift tax law on disclaimers before and after 1958 demonstrates that under the Brown and Hardenbergh cases the validity of the disclaimer under state law determined the federal gift tax result. Thus, before 1958 the holder of a contingent remainder had no reason to disclaim prior to the death of the preceding life tenant.

After the promulgation of the 1958 Regulation it was not apparent that there had been any change in the law. First of all, the deletion of language from the proposed regulation which required disclaimer "within a reasonable time after knowledge of the existence of the ***interest***" suggested that a disclaimer could be delayed until indefeasible vesting. Furthermore, the October 1, 1958, Memorandum from the Commissioner to the Secretary of the Treasury shows that the drafters of the Regulation were trying to follow the existing law of the Brown and Hardenbergh cases. In addition, the IRS itself, in Private Ruling 6612201590A, issued December 20, 1966, ruled that a disclaimer of a contingent future interest would satisfy the Regulation if made after notice that the interest had vested and become possessory. Indeed, it was not until litigation of the Keinath case in the Tax Court in 1972, after Mrs. Halbach's 1970 disclaimer, that the IRS first publicly took the position that a defeasible future interest must be disclaimed shortly after its creation.

Despite these indications of the meaning of the Regulation, the Supreme Court in Jewett adopted the Commissioner's current contrary interpretation.[2] Thus, under the Supreme Court's interpretation, the IRS, by promulgating the 1958 Regulation, changed the rules for a taxpayer owning an interest created before 1958 in the middle of the game, contrary to any reasonable notion of justice or fair play.

In rejecting a similar unfairness argument by the taxpayer in Jewett, the Court noted that the 1958 Regulation was made well in advance of the disclaimers in that case.[3]

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[1]Even though section 6110(j) (3) of the Code provides that private rulings ordinarily "may not be used or cited as precedent," the Supreme Court -- in refusing to accept the government's interpretation of a long-standing regulation in Rowan Companies, Inc. v. United States, 101 S. Ct. 2288, 2296, n. 17 (1981) -- has said that private rulings may be cited as evidence that the Internal Revenue Service has taken a position inconsistent with its present contentions as to the meaning of the law and regulations.

[2]One commentator has criticized the Court's construction of the Regulation as "visibly flawed." Jewett v. Commissioner: Unforseen Crisis of Disclaimers, 14 Loy. L. Rev. 167, 186 (1982). *See also*, M. Wolfson, "Disclaimers -- A Device Whose Time Has Come?," 41 N.Y.U. Inst. on Fed. Tax'n 43-1, 43-23 to 43-27 (1983).

[3]The Court made the puzzling comment that the taxpayer's argument would have more appeal if the disclaimer had been made immediately after the adoption of the 1958 Regulation, rather than 14 years later. 102 S.Ct. 1090, n. 20. The logic of this statement

(continued...)

STATEMENT BY
SENATOR JOHN H. CHAFEE
AT THE HOUSE COMMITTEE ON WAYS AND MEANS HEARING ON MISCELLANEOUS TAX REFORMS
ON S. 910, A PROPOSAL TO EXEMPT CERTAIN LAND SUBJECT TO A PERMANENT LAND CONSERVATION EASEMENT FROM THE ESTATE TAX
July 11 and 12, 1995

Mr. Chairman:

I am pleased to have this opportunity to provide my views on S. 910, the American Farm and Ranch Protection Act of 1995, which I introduced along with Senator Baucus earlier this year. This is companion legislation to H.R. 864, introduced in the House by Congressmen Houghton and Payne and cosponsored by 12 other Members of the Committee on Ways and Means.

A serious environmental problem facing the country today is the loss of open space to development. All across the country, farms, ranches, forests and wetlands are forced to give way to the pressures for new office buildings, shopping malls and housing developments.

America is losing over four square miles of land to development every day. In Rhode Island, over eleven thousand acres of farmland have been lost to development since 1974. In many instances, this is simply the natural outgrowth of urbanization of our society. Other times it is the direct result of improper planning at the state and local levels.

But frequently, the pressure comes from the need to raise funds to pay estate taxes. For those families where undeveloped land represents a significant portion of the estate's total value, the need to pay the tax creates powerful pressure to develop or sell off part or all of the land or to liquidate the timber resources on the land. Because land is appraised by the Internal Revenue Service according to its "highest and best use," which is often its development value, the effect of the tax is to make retention of undeveloped land difficult.

In addition, our current estate tax results in complicated valuation disputes between the donor's estate and the Internal Revenue Service. In many cases, the additional costs incurred as a result of these disagreements may cause a potential donor of a conservation easement to decide not to make the contribution.

Open spaces improve the quality of life for Americans throughout this great nation and provide important habitat for fish and wildlife. The question we face as policy makers is how to conserve this valuable resource during a time of significant budget constraints.

Mr. Chairman, I think we need to restructure the nation's estate tax laws to encourage private property owners to conserve environmentally significant land. The American Farm and Ranch Protection Act does this by providing an estate tax exemption for the value of land subject to a permanent conservation easement.

CTRC

CANCER THERAPY & RESEARCH CENTER

July 10, 1995

Committee on Ways & Means
Hearings on Miscellaneous Revenue Issues
July 11-13, 1995

Statement of Robert D. Mitchell, III
Chief Development Officer
Cancer Therapy & Research Center
San Antonio, TX 78229

Re: H.R. 1099, Generation-Skipping Tax Amendment

Mr. Chairman:

Congressman Houghton, Brewster, Jacobs & Shaw, joined by a bi-partisan coalition comprising 19 members of the Ways & Means Committee and a total of 26 overall have introduced a Bill of great importance to our organization and all charities throughout the U.S. The measure, H.R. 1099, seeks to correct an anomaly in the predeceased parent exclusion to the generation skipping transfer tax which currently results in the unintended over-taxation of assets placed in charitable trusts. It corrects an unintended tax on collateral descendants, as well.

Due to the oversight in current law, a grandparent may bestow a gift upon his or her parentless grandchild and eliminate the generation skipping transfer tax on the gift through the predeceased parent exclusion. However, should such a grandparent wish to create a charitable lead trust (which makes annual payments to a charity for a term of years and subsequently distributes the remaining property to members of the donor's family, thus benefiting charitable organizations as well as the parentless grandchild) distribution of the assets to the same grandchild would be fully subject to generation skipping transfer tax.

H.R. 1099 would correct this oversight, affording charitable trusts in these circumstances, the same tax treatment which the predeceased parent exclusion already provides for a direct, outright gift from the donor to the deceased children's children. The Treasury Department has taken a "do not oppose" position on this noncontroversial change, clear recognition that the policy goals which led Congress to enact the predeceased parent exclusion, apply equally to direct gifts and distributions from charitable lead trusts.

We have joined the ranks of over 200 charities throughout the U.S. who feel that enactment of H.R. 1099 would encourage charitable giving and improve a current tax regimen which unintentionally frustrates the reasonable expectations of those Americans who sought to support worthy charities in addition to providing for their families.

We are very pleased to see the issues presented by H.R. 1099 listed among the subjects which would be considered in these hearings. These issues are very important to us and we urge the Committee to approve these changes. We request that this letter be accepted as our Statement and be made a part of the record of these hearings.

Sincerely,

Robert D. Mitchell, III
Chief Development Officer

This bill is similar to legislation that was introduced last year in both the House and Senate. The principles involved in this bill have been endorsed by the Piedmont Environmental Council, The National Audubon Society, the American Farm Bureau, the Land Trust Alliance, and the National Trust for Historic Preservation.

In order to target the incentives provided in this legislation to those areas that are truly at risk for development, the bill is limited to land that falls within a 50-mile radius of a metropolitan area, a national park or a national wilderness area.

Conservation easements, which are entirely voluntary, are agreements negotiated by landowners in which a restriction upon the future use of land is imposed in order to conserve those aspects of the land that are publicly significant. To qualify for the estate tax exemption under this bill, such easements must be perpetual and must be made to preserve open space, to protect the natural habitat of fish, wildlife or plants, to meet a governmental conservation policy, or to preserve an historically important land area.

Mr. Chairman, thank you for the opportunity to offer my views on this legislation to the Ways and Means Committee.

Indiana University Foundation

Bloomington

Committee on Ways and Means
Hearings on Miscellaneous Revenue Issues
July 11-13, 1995

Statement of Leslie E. Vidra
General Counsel
Indiana University Foundation
Bloomington, Indiana

Re: H. R. 1099, Generation Skipping Tax

July 10, 1995

Mr. Chairman:

We at the Indiana University Foundation are charged with supplementing the public financial support of Indiana University with private contributions from friends of the University to see the University maintain the highest possible level of excellence in public education. As you may know, our reliance on these private contributions increases from year to year.

H.R. 1099, introduced by Congressmen Houghton, Brewster, Jacobs and Shaw, seeks to correct some apparent oversights in the structure of a small portion of the Generation Skipping Transfer Tax. One of the flaws penalizes donors who set up charitable trusts in situations where a child of theirs has predeceased them. This, of course, acts as a disincentive for setting up these trusts in those situations. Furthermore, donors who are survived only by grandnieces and grandnephews, a situation which often leads to generous charitable contributions, are also penalized, we think unintentionally. This situation is corrected by H.R. 1099, as well.

Because it is so important to us not to have unintentional hindrances to the University's private financial support, we were pleased to learn that the Committee has included this measure among the issues to be considered in its current hearings. We ask that this letter be accepted as a Statement in support of this measure and that it be made apart of the record of these hearings.

Sincerely,

Leslie Vidra

Leslie E. Vidra
General Counsel

c: Curtis R. Simic
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Committee on Ways and Means
Hearings on Miscellaneous Revenue Issues
July 11-13, 1995

Statement of Bernard N. Frank
Member
Lewis, Rice & Fingersh
St. Louis, Missouri

Re: H. R. 1099; Generation-Skipping Tax Amendment

Mr. Chairman:

I am Bernard N. Frank, member of the law firm Lewis, Rice & Fingersh, St. Louis, Missouri. I am also a member of the National Committee on Planned Giving (NCPG), an organization of some 7,500 members mostly consisting of persons who are employees of charitable organizations across the country working in assistance to their organizations in securing gifts from private individuals. I submit this statement on behalf of myself, the NCPG and certain clients of our firm. I note that over 200 universities, hospitals, museums, religious organizations, social service agencies and the like have expressed their support for the adoption of the measure now being considered.

I am grateful for the opportunity to join the support of this measure making two minor amendments to the Generation-Skipping Transfer (GST) tax; these changes are currently contained in H.R. 1099. The amendments would further the stated policy of the GST tax and improve the consistency and equity of the application of the tax by correcting unintended impact.

Provision is made in the current law for a person with a deceased parent to be "moved-up" to that parent's generation level for the purpose of determining whether a generation skipping transfer is made. Because this "move-up" feature is limited to <u>direct</u> gifts to <u>lineal</u> descendants only, several anomalies creating death tax rates of up to 80% can occur which are not necessary to carry out the policy of the GST tax.

For example, no move-up is allowed for distributions to a grandchild from certain types of trusts.

Trusts including charitable beneficiaries are one type of trust that gets no move-up.

Certain trusts which might be used to prevent the ownership fragmentation of family owned businesses or farms also get no move-up. An example here might be a transferor who puts his or her farm into a revocable trust for the benefit of his descendants, per stirpes, until such time as the youngest beneficiary reaches 35 years of age. Suppose at the time of the transferor's death he had 1 son surviving and 1 daughter deceased. Suppose further that the deceased daughter had 2 children age 30 and 28 who worked on the farm with their uncle. When the trust terminates under current law there will be a GST tax approximating 55% of the value of their inheritance due immediately upon distribution of the farm interests to the deceased daughter's 2 children. There will be no GST tax due on the share distributed to the son. Keep in mind that the regular

estate tax would have been paid on the value of the whole farm when the transferor died, perhaps at the top 55% rate. The GST tax is due from the daughter's 2 children in addition, approximating a total tax as high as 80% on this illiquid asset--a typically impossible tax burden forcing the sale of all or part of the farm. The illiquidity of the situation is nothing new to estate taxes, but the problem is magnified by the extra GST tax in a situation not necessary to carry out the policies of the GST tax. This example assumes, of course, that the transferor has already used up his lifetime GST exemption.

Another inequity under current law is that childless individuals who by virtue of the order of death of their siblings and their siblings' offspring leave their property to a grandniece or grandnephew, who might be their only living relative, also do not get the benefit of move-up.

I refer to the document called "Correction of Certain Minor Defects in the Generation Skipping Transfer (GST) Tax" (July 26, 1995 revision) attached for a more complete explanation of this measure. In addition, reference is made to the testimony of Jeffrey N. Pennell, Richard H. Clarke Professor of Law, Director, Graduate LL.M. Program in Taxation, Emory University School of Law, and James H. Lockhart, Vice President and General Counsel, The Baptist Foundation of Oklahoma, given on September 23, 1993, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means.

Assistant Secretary of the Treasury Samuels testified at the same hearing before the Subcommittee on Select Revenue Measures that the Department of the Treasury was not opposed to the measure inasmuch as the amendments are consistent with the policy of the GST law.

The description of H. R. 1099 by the Joint Committee on Taxation for purposes of this hearing contains an example which says that under this bill a grandchild who receives a trust distribution will be moved up if his or her parent died prior to the death of the transferor's spouse in certain situations. This would be the case if the spouse were the beneficiary of what is known as a QTIP trust whereby the spouse would be treated as the transferor, under other parts of the tax law, upon the spouse's death. However, H. R. 1099 requires, for move-up, that the parent be deceased at the time when the final estate or gift tax is assessed against the transferor by reason of his or her making the trust transfers. For the sake of clarity, in what I think is the typical siuation, contrary to the Joint Committee on Taxation explanation, H. R. 1099 would require, for move-up, that the child die prior to the death of the transferor, not the transferor's spouse.

H.R. 1099, filed on March 1, 1995, is currently co-sponsored by a bipartisan group of 19 Members of the Ways and Means Committee along with several other Members. You may recall, Mr. Chairman, that you were among the cosponsors of this measure as contained in H.R. 4326 in the last session.

The revenue impact of the measure has been estimated by the Joint Tax Committee to be the loss of a modest $19 million over the next five years.

Again, I appreciate the opportunity to share my views with the Committee.

Correction of Certain Minor Defects in the Generation Skipping Transfer (GST) Tax (H.R. 1099)

• **Purpose of the GST tax** - To prevent avoidance of estate or gift tax by means of a transfer that "skips" a generation, that is, by a gift or bequest of property to a beneficiary who is more than one generation below (younger than) the transferor. If the GST tax applies, the combined transfer tax rate (GST tax plus the estate or gift tax) can reach almost 80 percent

• H.R 1099 corrects two minor defects in the GST tax.[1] Although the tax (Code §§ 2601-2663) is complicated, the two changes proposed by H.R. 1099 are very straight forward.

• The first proposed change would **extend the present law "predeceased parent exception" to collateral heirs.**

> **Present law** - An outright gift or bequest by a grandparent to a grandchild will not trigger the GST tax (even though the transfer "skips" the predeceased parent's generation), if the grandchild's parent (the grandparent's child) is deceased. (Section 2612(c)(2) permits the grandchild to "move up" a generational level.) This relief provision in present law is known as the "predeceased parent exception" or the "move-up exception." Presumably, it is based on the absence of any estate or gift tax avoidance motive when the parent is predeceased.
>
> The predeceased parent exception is not available in the case of a collateral heir (grandniece or grandnephew) in analogous circumstances. It appears that relief for collateral heirs simply was overlooked in 1986, when the predeceased parent exception was adopted.
>
> **Proposed change** - Extend the present law "predeceased parent exception" to a transfer to a collateral heir (a grandniece or grandnephew) if (a) the grandniece's or grandnephew's parent (the transferor's niece or nephew) is deceased and (b) the transferor has no living lineal descendant (child, grandchild, etc.).[2]
>
> **Rationale** - Just as in the case of a grandchild whose parent is deceased, the transfer to a collateral heir could not have been intended to "skip" a generation in order to avoid estate or gift tax when the grandniece's or grandnephew's parent is deceased.

• The second proposed change would **extend the new predeceased parent exception to distributions from trusts.**

> **Present law** - The predeceased parent exception applies to an outright transfer of property to a grandchild, but not to a distribution to the grandchild from a trust. Since Congress specifically decided in 1986 to make the application of the GST tax uniform regardless of how property is transferred

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[1] Predecessor bills (H.R. 4326 and S. 2445) were introduced in the 103d Congress during 1994.

[2] See Code § 2651(e)(1)(B) as proposed to be added by H.R. 1099, § 1(a) (predeceased collateral heirs are covered by the reference to "such individual's parent who is a lineal descendant of the parent of the transferor" and Code § 2651(e)(2) (limitation on application of subsection to collateral heirs).

(outright or in trust),[3] it appears that in drafting the predeceased parent exception, the distinction between outright gifts or bequests and distributions from trusts was overlooked.

Proposed change - Apply the new predeceased parent exception (which under H.R. 1099 will cover both lineal and collateral heirs) to trust distributions,[4] provided the parent was deceased at the time the trust assets were last subject to estate or gift tax (generally, at the time the trust becomes irrevocable).

Rationale - Treat trust distributions in the same manner as outright transfers. By treating them differently, present law limits the legitimate use of trusts in estate planning, including trusts that are established to distribute income to one or more tax-exempt charitable organizations.[5]

• Present law discourages donors with predeceased heirs from establishing charitable lead trusts, and certain other charitable trusts, because of a potential GST tax liability calculated at a 55 percent rate at the time trust assets are distributed to the donor's family members plus a prior estate or gift tax liability imposed at the time of the original transfer to the trust.[6] For this reason, H.R. 1099 is supported by more than 150 charities located throughout the United States.

• Present law also jeopardizes the use of trusts in other situations when they otherwise might be advisable. For example, when a trust might appropriately be used to avoid fragmenting the ownership of a farm or small business, its use imposes an undue risk of a needless GST tax. Worse yet, the tax may be imposed accidentally in the case of a revocable trust that is not properly monitored during the grantor's life before it becomes irrevocable just because the grantor's descendants happen to die in an unusual order before the grantor's death.

• In 1993, the Treasury Department testified that it did not oppose this legislation. The Treasury stated "The policies that underlie * * * [the predeceased parent exception] generally would support the proposed expansions to cover collateral heirs and to apply the rule to taxable terminations and taxable distributions [from trusts] as well as direct skips [outright transfers]."[7]

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[3] See H.R. Rep. No. 426, relating to the Tax Reform Act of 1985 (the House predecessor to the Tax Reform Act of 1986), 99th Cong., 1st Sess. at 824 (1985).

[4] The reference in proposed Code § 2651(e)(1)(B) to "the transfer from which such interest is established or derived" covers trust distributions, or using GST tax terminology, "taxable distributions" and "taxable terminations."

[5] For example, in a so-called charitable lead trust, the donor requires the income of the trust to be paid to one or more charitable organizations for a specific period of time and, thereafter, provides that the trust principal is to be distributed to a noncharitable beneficiary -- typically a family member.

[6] A typical case might involve a donor whose child has died leaving a grandchild, or a donor with no lineal descendants (children or grandchildren), whose nieces and nephews have died and who wishes to benefit grandnieces or grandnephews. In either case, if the donor establishes a trust to provide an interim income interest to a charity, under present law, a GST tax will be due upon termination of the trust.

[7] Statement of Assistant Secretary Samuels before the Ways and Means Select Revenue Measures Subcommittee, pp. 6-7 (September 21, 1993).

• The problems which H.R. 1099 seeks to correct also have been raised by the Real Property, Probate, and Trust Law Section of the American Bar Association and The American College of Trust and Estate Counsel.

• Revenue effect - The Joint Committee on Taxation has estimated the revenue loss attributable to the changes to the GST tax that are contained in H.R. 1099 at $4 million per year or $19 million over 5 years (1996-2000).

UNIVERSITY OF
ROCHESTER

Vice President
Administration

14 July 1995

Committee on Ways and Means
Hearings on Miscellaneous Revenue Issues
July 11-13, 1995

Statement of D. K. Hess
Vice President, Administration
University of Rochester
Rochester, New York 14627-0024

The Honorable Bill Archer
Chairman, Committee on Ways & Means
1236 Longworth House Office Bldg.
Washington, DC 20515-4307

Dear Congressman Archer:

The bill filed in the current session by Congressmen Houghton, Brewster, Jacobs and Shaw as H.R. 1099 contains an important, noncontroversial amendment to the predeceased parent exclusion (sometimes called the "move-up") in the generation skipping tax laws. It is critical because it removes an unintentional obstacle to charitable giving in certain trust situations and other situations involving childless individuals.

It is realized that this is a small issue compared to the major matters which occupy the concerns of Congress and the country at this time. Yet this issue is significant to the charities and individual family members who fall into the scenario which could generate up to an 80 percent death tax in those particular situations. Fortunately, this would appear not to be an everyday occurrence.

This matter is important to us and we are pleased that your Committee has included it among the issues being considered at these hearings. Thank you for the opportunity to comment and request that this letter be accepted for inclusion in the record of these hearings.

Sincerely,

D.K. Hess

DKH:mgk

University of Rochester
Rochester, New York 14627-0024
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WRITTEN STATEMENT OF GENE BRACEWELL

REGARDING REQUIRED NOTICES TO CHARITABLE BENEFICIARIES OF CHARITABLE REMAINDER TRUSTS

I. CORPORATE INTEREST OF WITNESS AND DESCRIPTION OF ITS PUBLIC SERVICE

Shriners Hospitals for Crippled Children is a public charity providing wholly free hospital and medical treatment for children in twenty specialty hospitals located in the United States, including three burn units and 17 orthopaedic hospitals. All of our facilities are available to any child whose parents cannot meet the costs of treatment without substantial hardship, regardless of the child's race, color, creed or sex. There is never a charge to a patient, a parent of a patient or a third party (such as government, or private insurance or a public welfare plan) for any inpatient or outpatient care. Shriners Hospitals meets its operating, research and capital expenditures budget from earnings on its substantial endowment and from charitable contributions from the general public. Shriners Hospitals' budget is $320,000,000 for 1995.

Shriners Hospitals is the beneficiary of over 1800 new estates per year. Almost ninety percent are outright bequests with the remainder being partial interest bequests. In 1994, about $135 million was received from decedents' estates as partial or final distributions, or as distributions from fully matured charitable remainder trusts. Income from investments (including capital gains) in 1994 was $310 million. Administrative costs (including fund-raising costs) approximate 2% of contributions; they are less than 1% of our total revenue.

II. SUMMARY OF SHRINERS HOSPITALS PROPOSAL

In the Committee's press release (FC-8), reference was simply made to proposed legislation which authorized notice to charitable remainder beneficiaries. In the Joint Committee's descriptions of the proposal,[1] an earlier draft of the notice proposal is described, which after our careful review and evaluation, is more cumbersome than H.R. 32. The earliest version (H.R. 5636 102d Cong.) was later pared down (H.R. 771, 103d Cong.) and is now H.R. 32 (104th Cong.). Part of the refinement was to take into account concerns expressed during debate on the measure in 1992. See, Cong. Rec. July 27, 1992 (H 6630-31, daily ed.). If the Committee chooses to go forward on this salutary legislation, we strongly urge that H.R. 32 be used as the starting point because it is a simpler, more expedient approach to the problem the legislation needs to address.

The principal purpose of the notice legislation is to ensure that charitable beneficiaries of charitable remainder trusts are made aware of their financial stake in these trusts on a timely and sufficient basis. The proposal has a notice requirement imposed on a fiduciary of an estate funding such a trust and an annual reporting requirement imposed on the trustee of a funded charitable remainder trust.

We have been party to numerous deferred gifts where we were not timely notified of our stake in an estate which passed to a charitable remainder trust, and funds were lost due to negligence or maladministration. Other charitable institutions have similar stories of comparable losses. It all comes down to the plain fact that all too often a charity is informed of its interest in a remainder trust only after the last life beneficiary dies, years after its funding. Absent any timely notice of current financial condition a charitable remainderman cannot hold a fiduciary accountable for non-feasance, misfeasance or malfeasance during the years of secrecy.

III. REASONS FOR ENACTMENT OF A SIMPLIFIED NOTICE AND REPORTING RULE

Charitable remainder trusts and other "split-interest" gifts represent an important source of funding for all charities. The National Audubon Society estimates that charitable remainder and other deferred gifts represent about 25% of the total contributions it receives. Many of Independent Sector's members -- especially universities, hospitals, social welfare organizations and religious groups -- derive a substantial part of their endowments from split interest gifts. Shriners Hospitals is a beneficiary of about 1000 pre- and post 1969 charitable remainder trusts.

Charitable remainder trusts ("CRTs") owe their popularity to their convenience and tax advantages. It enables a donor, in a single instrument, to make a sizeable charitable contribution, and at the same time, provide for the support of family members during their lifetimes.

The Internal Revenue Service recently disclosed that more than 47,000 CRTs filed federal tax returns on IRS Form 5227 during 1992. IRS data show that about 3,000 new CRTs are created and funded annually. Although the aggregate value of assets held in all funded trusts cannot be readily determined from IRS records, Shriners Hospitals believes that more than $10 billion is held in such trusts, excluding pooled income funds. One sampling of 15 bank and trust companies revealed that they serve as trustee for 3,125 CRTs with aggregate assets in excess of $725 million.[2] The Council for Aid to Education estimates that the amount of deferred gifts (principally CRTs) to some 1,100 private educational institutions totaled $670 million -- more than 10% of all gifts by individuals to such institutions during 1992.[3] A recent sample of newly created lifetime gifts to charitable remainder trusts indicates that for 1992, the average CRT gift was about $260,000 per trust.[4] This same report indicates that the total value (deductible and non-deductible) of the gifts to these trusts exceeded $150,000,000 for the charitable institutions surveyed. Ibid. Lastly, and of importance here, is that less than 20 percent of all funded trusts have professionals as fiduciaries, meaning that the donor, family members, or third parties, controlled the bulk of these split interest trusts. Ibid.

Despite the importance of CRTs to charities, 48 states do not require the charitable remaindermen to be notified of the commencement of probate proceedings or of trust transactions (such as asset sales) that may vitally affect charities' interests.

Two states have statutes specifically requiring notice to charities in circumstances where the executor and trustee are the same person: California and New York.[5] Several states have no relevant notice provision or provide expressly that notice is either not required or must only be given to the trustee of the charitable remainder trust, and not the individual beneficiary.[6] Thus, most state laws do not specifically address the question of notice to CRT beneficiaries. Rather, they provide generally that the executor or probate court must furnish notice of probate proceedings to "devisees" or "devisees and legatees,"[7] to beneficiaries "named in the will,"[8] or to "interested persons."[9] As is clear from a decision of the Wyoming Supreme Court,[10] it is anybody's guess whether a state court would construe the latter terms to include charitable remaindermen. Some states require that the attorney general[11] or other governmental agency[12] be notified of transactions affecting CRTs, but such officials, in practice, rarely communicate notice to charities directly.

Shriners Hospitals for Crippled Children, and other charitable institutions, believe that providing notice to charitable remainder beneficiaries of their interests in trusts, and in decedent's estates -- particularly at the commencement of probate proceedings -- would materially increase the value of property that charities ultimately receive from CRTs. In their experience, it is common for trustees of CRTs also to serve as executors of the corresponding estates, making potential conflicts of interest more likely. Under the current patchwork of state-law notice provisions, such CRTs are often administered for years -- even decades -- without the charitable remainderman even knowing of the trust's existence. Only after all income beneficiaries die, do trustees of CRTs typically inform charitable remaindermen of their vested remainder interest. By then, the passage of time will often have made it impracticable for a charity to

challenge trustee investment actions or certain discretionary payments made, or trustee, attorney or agency fee payments taken or other transactions that may have affected it adversely.[13]

The failure of states to prescribe any notice under its law affects the United States in its regulatory capacity. Prior to 1969, there were opportunities for abuse in making split-interest gifts to charity, enabling donors to unjustly claim tax deductions vastly in excess of the amounts charities ultimately realized. Congress responded by enacting Code sections 664 and 2055(e)(2), restricting charitable deductions for remainder interests to statutorily-defined types of trusts: annuity trusts and unitrusts.

These two provisions were designed to ensure a direct relationship between the contribution deduction claimed and the charitable benefit eventually received by the donee. It precludes a charitable deduction where "it is not probable that the gift will be ultimately received by the charity," for example, where the charity "has only a contingent remainder interest." H.R. Rep. 91-413 (Pt. 1), 91st Cong., 1st Sess., 58-59 (1969). It also prevents donors from "obtain[ing] a charitable contribution deduction for a gift of a remainder interest in trust to a charity . . . substantially in excess of the amount the charity may ultimately receive," e.g., where the trustee has discretionary power to invade corpus for the life tenant's benefit. S. Rep. 91-552, 91st Cong., 1st Sess., at 87 (1969).

Besides mandating changes to the form of governing instruments, Congress in 1969 enacted new penalty taxes aimed at deterring misfeasance by (among others) fiduciaries of CRTs. Under Code Section 4947(a)(2), the actuarial share of a charitable remainderman is subject to the same protections against self-dealing (IRC Section 4941), jeopardizing investments (IRC Section 4944), and taxable expenditures (IRC Section 4945) that apply to private foundations. Transactions in an estate destined for charity are also subject to penalty taxes if the fiduciary fails to comply with the Code's regulatory requirements. Rockefeller v. United States, 718 F.2d 290 (8th Cir. 1983) cert. den., 466 U.S. 962 (1984).

IRC Chapter 42 reflects Congress' strong policy that gifts destined to charity through CRTs not be frittered away through improper actions by fiduciaries. Wholly apart from cases of fiduciary malfeasance, moreover, Congress' objectives will be frustrated whenever the value of a CRT's assets is needlessly reduced below its value when the trust was created. The donor's estate tax deduction is keyed to the value of property transferred to the CRT. If the value of a CRT's property subsequently declines -- e.g., because trust assets are sold at improvidently low prices -- the amount ultimately received by charity will be reduced, and the legislative subsidy represented by the tax deduction is wasted.

The resources of the IRS are limited, and charitable remainder trusts (or private foundations) are at the very bottom of the Commissioner's list of enforcement priorities. There are no IRS audits planned in FY 95 for charitable remainder trusts (about 47,000), an audit coverage of zero percent (0%). Even if it was able to do so, the IRS could not possibly detect all cases of abuse or maladministration. Given these facts, the best prophylactic against devaluation of a charity's interest is oversight by the charity itself. If interested charities are immediately and constantly involved in monitoring monies held for them in trust - the enforcement burden of the IRS will be lightened and the objectives of Congress more fully realized.

IV. COMMON LAW REQUIRES FULL FINANCIAL DISCLOSURE; NO INVASION OF DONOR'S RIGHT TO OR EXPECTATION OF PRIVACY

We have found no common law right of privacy in trusts, especially charitable trusts. The opposite is true. Shriners Hospitals surveyed the common law of trusts and found no authority which prevents a vested remainderman from demanding, and receiving, an accounting from a fiduciary respecting assets under its care.

> ". . . prevailing American jurisprudence holds that a vested remainderman has

> standing to compel a trustee to account for his management of trust assets " Shriners Hospitals for Crippled Children v. Smith, 385 S.E.2d 617, at 618 (Va. 1989)

In support for its conclusion, the Virginia Supreme Court cited Restatement (Second) of Trusts Sec. 172; Bogert, Trusts and Trustees, (2d Ed.) §142 Scott and Fratcher, Law of Trusts, §143 (4th Ed. 1987).

Giving a donor his or her federal tax benefits implicitly gives the charitable remainderman an interest in assuring that the qualified trust is operated consistent with the subsidies derived by the private parties from the status of the remainderman. A trustee which attempts secrecy violates his trust; a donor that demands secrecy disserves the very person he sought to benefit:

> "That the settlor has created a trust and thus required that the beneficiary enjoy his property interest indirectly does not imply that the beneficiary is to be kept in ignorance of the trust, the nature of the trust property and the details of its administration. If the beneficiary is to hold the trustee to proper standards of care and honesty and to obtain the benefits to which the instrument and doctrines of equity entitle him, he must know of what the trust property consists and how it is being managed." Bogert, Trusts and Trustees, 2d Ed., §961.

What does the common law already require the trustee to disclose to the beneficiaries? Case law requires disclosure of -

1. Opinions of counsel (Scott, §173).
2. Papers relating to any possible self dealing by the fiduciaries or entities under their control before, during or after funding of the trust (Scott, §170); In Re Green Charitable Trust, 431 N.W. 2d 492 (Mich. 1988).
3. Papers relating to all amounts and sources of trust earnings, and allocation of income, expenditures, asset gains, asset losses, to individual beneficiaries and remaindermen (Bogert, §961).
4. Papers relating to tracing title to property administered by the Trustee (Bogert, §961).
5. Papers relating to the source and status of all trust investments (Marcellus v. First Trust and Deposit Co., 52 N.E.2d 907 (NY 1943).
6. Papers relating to compensation paid the fiduciaries, their lawyers and their agents (Cosden v. Mercantile Safe Deposit, 398 A.2d 460 (Md. 1979), cert. den., 444 U.S. 941 (1979). Shriners Hospitals v. Robbins, 450 So.2d 798 (Ala. 1984).
7. The visitation and touching of the physical property (tangible or intangible, real or personal) (Bogert, §961).
8. All books of account (Bogert, §961, Scott, §173, Restatement (Second) Law of Trust, §173).

Except for contingent beneficiaries, there is simply no case law approving a fiduciary keeping any secrets from a beneficiary, even in the face of a trust clause which relieves a trustee of disclosure, since it may be contrary to public policy to allow enforcement of a non-disclosure clause absent

very special circumstances. Matter of Estate of Hearst, 67 Cal. App. 3d 777 (Calif. 1977). Under existing law, a charitable remainderman, if it knows of its interest in an estate or charitable remainder trust, is authorized to obtain the federal tax return and tax return information from the Internal Revenue Service. See, IRC Section 6103(e)(1)(E)(ii) and (F). Despite this authorization, IRS has no published procedures explaining how affected persons should attempt access to otherwise confidential information.

The governing instrument of a qualified remainder trust contains numerous duties owed by the fiduciary to the remainderman, implicitly granting the remainderman the right to ascertain the fiduciary's faithful discharge of his duties. Parenthetically, the use of the charitable deduction, the income tax exemption, and the implicit shield from the grantor trust rules create a substantial debt owed by the donor to the charity. For these tax opportunities, donors must pay for their tax benefits by giving remaindermen options for oversight (of course, the income beneficiaries have that already).

Existing regulations require the trustee to pay out the correct annuity or unitrust amounts to the income beneficiary and underpayments and overpayments must be corrected.[14] The regulations require catch-up payments to be paid arising out of deferrals of the payment of a testamentary unitrust or annuity amount; payments must be made at fixed intervals; valuation of assets must be made; and, a governing instrument must impose limits on transactions with donors, fiduciaries and other disqualified persons. (Id). In addition, there may be contingencies which, if certain acts or events occur, accelerate the remainder, and cause the income beneficiary to forfeit its interest. Cf. IRC Section 664(f). If a fiduciary fails to adhere to the various governing instrument rules, the exempt status of the trust is jeopardized, putting all income and assets at risk.[15]

We would be remiss in not recognizing the role of state courts in authorizing and enhancing the rights of trust beneficiaries. However, a beneficiary needs to know about a trust before it can begin to use its state statutory or common law rights and a federal law giving notice is an inexpensive enforcement opportunity justified by the initial and continuing federal tax subsidies. The proposed legislation grants no new rights; provides no new rules on what is due a trust beneficiary; and burdens the trustee in only a de minimis, but compensable, way to accomplish a salutary result. We find no weight of state law, nor any well articulated reason, to preclude timely and complete disclosure of the information called for by H.R. 32.

V. CONFORMITY OF H.R. 32 TO SIMPLIFICATION CRITERIA

1. H.R. 32 satisfies the Ways and Means Committee test for simplification. The proposal would reduce, and not increase, compliance and administrative costs of the Internal Revenue Service. The proposed legislation will make available to charitable remainder beneficiaries, on a timely basis, the information they need to monitor and audit the administration of such trusts for charitable purposes. As a result, audit and review by the Internal Revenue Service will only be required to find Chapter 42 violations usually reported on IRS Form 4720, a confidential tax return.

2. The proposal would preserve under lying policy objectives of current law and not create or reopen opportunities for abusive tax planning. The proposed legislation would dramatically further the basic purpose of the charitable remainder regulatory provisions of IRC Sec. 4947(a)(2), viz, to ensure that charities receive the full financial benefits of the subsidized charitable remainder gift.

3. The proposal avoids significant shifting of tax burdens among taxpayers. It would not cause any dislocations whatsoever because no new burden is involved. The fiduciary of a CRT must now prepare tax returns and information returns for the IRS and by furnishing notice, or even a copy of a tax return, to the remainderman is a de minimis, and compensable, chore.

4. The simplification our proposal would achieve outweighs the instability resulting from making any statutory changes, as opposed to permitting statutory repose. The proposed legislation is necessary to maintain the basic integrity of the charitable remainder deduction scheme in the federal tax code. Without the legislation, a portion of the over $10 billion in assets in such trusts may never be received by the beneficiaries because of fiduciary misfeasance or nonfeasance, acting without any oversight or accountability whatsoever.

5. Revenue effects of the proposal would comport with current revenue and budgetary constraints. The proposed legislation would not decrease federal tax revenues but may increase revenues.

Shriners Hospitals for Crippled Children earnestly supports tax simplification and provisions directly affecting charitable institutions. H.R. 32, either as written, or as modified, furthers the Ways and Means Committee's simplification desires and authorizes charitable institutions to be watchdogs of gifts and bequests held by fiduciaries for them. Mr. Gibbons' bill is efficient, since it costs Government nothing; it is simple because it reduces paperwork; and, it is an effective way for beneficiaries to patrol and protect tax subsidized monies.

ENDNOTES

1. JCS 19-95, Department of Miscellaneous Tax Proposals Scheduled for Hearings Before House Committee on Ways and Means on July 11-13, 1995, at 106-108.

2. Estes, Managing Charitable Assets Fund Raising Management 26-36 (February 1990).

3. Council for Aid to Education, Voluntary Support of Education 1994 (Table 11), at 7 (June 1995).

4. "Charitable Remainder Trusts: Characteristics of Selected CRTs Established in 1992," National Committee on Planned Giving, 1994, pp. 5, 8

5. See Cal. Prob. Code Section 1208 (1990) (requiring notice to trust beneficiaries where trustee also serves as executor); N.Y. Surr. Ct. Prac. Act Section 1904 (1967) (requiring notice to remainderman concerning disposition of trust property). See also, Ohio Rev. Code Ann. Section 5303.22 (1989) (requiring notice to "persons interested" in sale of an estate's property).

6. E.g., Fla. Stat. Ann. Section 733.613 (1976) (executor not required to provide notice of sale of trust property); Ind. Code Ann. Section 29-1-15-15 (1989) (same); Ill. Ann. Stat. ch. 110 1/2, 6-10 (1989) (executor not required to notify trust beneficiaries that probate has commenced). Cf. Utah Code Ann. Section 57-1-25 (1989) (requiring notice by publication of proposed sale of trust property).

7. E.g., Ariz. Rev. Stat. Ann. Section 14-3705 (1989); Kan. Stat. Ann. Sections 59-2209, 59-222 (1983); Mass. Gen. Laws Ann. ch. 192, Section 12 (1958); Nev. Rev. Stat. Ann. Section 136.100 (1986); Or. Rev. Stat. Ann. Section 113.145 (1984); S.C. Code Ann. Section 62-403 (1987); S.D. Codified Laws Ann. Section 30-6-8 (1984); Wash. Rev. Code Ann. Section 11.28.237 (1987). Cf. Tex. Prob. Code Ann. Section 128A (1990) (notice inter alia to a "charitable organization . named as devisee").

8. E.g., Wyo. Stat. Ann. Section 2-7-205 (1989)

9. E.g., Neb. Rev. Stat. Section 30-222 (1985); Va. Code Ann. Section 64-1-82 (1986); W.Va. Code Section 41-5-5 (1982); Wis. Stat Ann. Section 879.03 (1989).

10. Shriners Hospitals for Crippled Children v. First Security Bank of Utah, et. al., 770 P.2d 1100 (Wyo 1989), cert. den 496 U.S. 905 (1990).

11. E.g., N.J. Civ. Prac. Rul. 4:80-8 (1989); Or. Rev. Stat. Ann. Section 128.720 (1984); R.I. Gen. Laws Section 18-9-13 (1988); Tex. Prob. Code Ann. Section 123.001 (1987).

12. E.g., Va. Code Ann. Section 55-29 (1986) (trustee of CRT must make annual accounting to county or city commissioner); Va. Stat Ann Tit 14, Section 2501 (1974) (same to probate court). But see, Shriners Hospitals for Crippled Children v. Smith, 385 S.E 2d 617 (Va. 1989) where the Shriners (as a remainderman) had to sue a trustee for accounting information, incurring the fiduciary's own substantial legal fees to defend his improvident acts.

13. On March 31, 1982, the Tax Court decided Boeshore v. Comm'r, 78 T.C. 523 (1982). Until our tax counsel read the decision in a commercial tax service, we had no idea that we were a remainder beneficiary of the decedent's estate or that estate (and trust) funds were being expended in tax litigation. Although the decedent died May 28, 1976, we learned of our financial interest from a person other than the fiduciary (our lawyer) six years later.

14. See, Rev. Rul. 72-395, 1972-2 C.B. 340 and Rev. Rul. 88-81, 1988-2 C.B. 127.

15. Because Congress allows reformation of unqualified transfers, early notice to charity by an estate may assist it in achieving certain tax savings. See, IRC Sec. 2055(e)(3).

TESTIMONY OF W. GENE BURDEN
STATE OF ALASKA DEPARTMENT OF ENVIRONMENTAL CONSERVATION

Introduction

My name is Gene Burden. I am the Commissioner of Environmental Conservation for the State of Alaska. Prior to my appointment by Governor Knowles in December 1994 I served as Senior Vice President of Marketing and Operations for Tesoro Alaska Petroleum Company, Anchorage, Alaska. I thank you for the opportunity to describe the affects in Alaska of a current IRS requirement to add dye to tax exempt diesel fuel.

My testimony is based on my ten plus years of experience with Tesoro and my familiarity with the Alaska petroleum refining, marketing, and distribution businesses.

The Origin of the Problem

The Omnibus Reconciliation Act of 1993 included provisions requiring segregation of diesel fuel used for taxable purposes (generally "on road" use by vehicles) and nontaxable purposes such as power generation, home heating, commercial fishing, and other stationary uses.

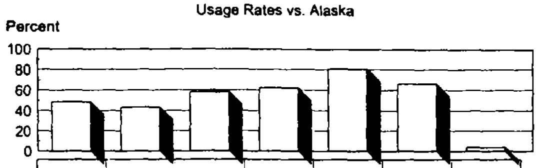
Alaska's reliance on diesel for nontaxable uses is unique

Alaska has four refineries that produce and market diesel fuel. Alaska's sparse population, enormous geography, limited distribution channels, and lack of demand for taxable diesel fuel present challenges that have been compounded by the requirement for diesel dyeing.

Road systems do not link the entire state. Approximately 65% of the state's communities are served solely by barge lines with only 35% served by the federal aid highway system. Alaskans rely on diesel fuel for home heating, power generation, commercial fishing, operation of construction equipment, and for on road vehicles; however, contrary to the rest of the country less than 4% of the diesel consumed in Alaska is used for taxable purposes. (The state's largest refiner indicates that less than 2.5% of its diesel is used for taxable purposes.) One distributor who supplies fuel to predominantly marine customers estimates that less than 1% of its sales go for taxable purposes. This means that Alaska distributors and refiners are dyeing from 96% to 99+% of their diesel fuel to satisfy IRS requirements to segregate the remainder.

The significance of Alaska's usage rate versus the rest of the country is illustrated in the following table which describes U.S. "on road" use and then a projection of taxable use by petroleum districts.

Comparison of U.S. and Regional Taxable Diesel
Usage Rates vs. Alaska



U.S. (Note 1)	PAD 1 (Note 2)	PAD 2	PAD 3	PAD 4	PAD 5 (Note 3)	Alaska
48.8	43.5	58.4	62.3	80.7	66.5	4.0

Note 1: U.S. data obtained for "on-road" use only. Source: National Petroleum News, June 1995 page 64.
Note 2: Petroleum District data ("PAD") derived from Petroleum Supply Monthly, April 1995. The fuel reported for non-road use was subtracted from total diesel sales generating a slightly different projection but still illustrating the range of the relationships between use in Alaska.
Note 3: PAD 5 includes Alaska, Arizona, California, Hawaii, Nevada, Oregon, and Washington.

Note: The 4% rate in Alaska is probably high as the state's largest refiner indicated sales of around 2% and a smaller refiner indicated less than 1%. Some suppliers dye over 99% of their fuel to comply with the requirements aimed at the less than 1 % that is taxable.

<u>IRS'S Objective is to Eliminate Illegal Sale of Nontaxed Diesel</u>

The opportunity to divert nontaxed diesel for taxable on-road uses has been recognized as a problem in a number of areas in the U.S. I recall that during the initial effort to obtain an exemption, a calculation was made of the tax increase expected from these requirements. I recall that the figure was reached by taking the quantity of illegal sales assumed by IRS to occur in the U.S. and make a similar assumption for Alaska. This generated a projected $500,000 in federal revenues that could be expected to be recouped; however there are a number of factors to suggest that the actual loss in Alaska is probably substantially below the national average. These factors include:

☑ Alaska's diesel fuel is exempted from the low sulfur requirements of the Clean Air Act because such a small percentage of vehicles use diesel and because of the significant costs associated with converting existing refineries to produce the fuel. As a result, the diesel produced in Alaska is not a candidate to enter the trade in other states.

☑ Transportation costs and storage limitations further insulate Alaska from organized schemes to avoid the federal tax for on-road diesel use.

☑ In addition, Alaska fuel distributors collected the federal tax for on-road diesel for many years prior to the dye requirement and there has been no indication of any significant abuses. The taxes will continue to be collected whether the dye is used or not thanks, in part to

an already existing compliance program for the taxable fuel facilitated by a Certificate of Use form that each distributor must obtain from each customer.

The Costs to Alaska Far Exceed Increased Revenues From Dyeing the Fuel

I conducted a telephone poll of the three largest Alaska refiners (Mapco, Tesoro, and Petro Star) on July 10-11, 1995 to obtain an update on costs associated with this requirement. One of the companies has installed injection systems at a cost of $125,000 and annual operating costs of over $100,000 plus the cost of dye which was not immediately available. One of the refiners indicated annual expenditures for the dye alone exceed $750,000 and that there are costs associated with personnel for the mixing procedures and associated accounting which were characterized as substantial.[1] Another refiner that presently splash blends the dye indicated concerns that new IRS regulations were going to mandate installation of expensive injection systems. Based on these discussions, a conservative estimate of annual costs to administer this program exceed $ 1 Million. In areas where only clear "taxable diesel" is available, purchasers intending to use the fuel for nontaxable purposes must file for a refund. This has prompted concern about the costs of floating these dollars.

There are reports that the added cost of dyeing diesel fuel is less than 1/2 cent per gallon. This may be true in the rest of the United States; however, one refiner/distributor indicates the cost should be based on the gallons sold as taxable that are not dyed. If that is done in Alaska there is a cost of as high as 11 cents for every gallon of taxable diesel sold. The end result is that the Alaska consumer pays those costs. The magnitude of the issue is illustrated by the Alaskan based Petro Marine services which sold over 75,000,000 gallons last year with only 600,000 gallons taxable -- well less than 1%. In Petro Marine's case approximately 74.4 Million gallons had to be dyed so they could sell 0.6 million clear taxable diesel.

There are other "costs" to Alaskans in addition to the imbalance of dollar costs versus tax revenues expected. There are inadequate storage tanks in Alaska to accommodate both taxable and nontaxable diesel fuel. In many rural locations, the communities rely on annual barge deliveries of diesel fuel.

The present regulations do not require, and the refineries do not inject dye into barges. This leaves the distributors with the choice of injecting dye at remote transfer points or charging tax on all sales. The splash dyeing of barge loads of diesel present unique Alaska challenges to the distributors and actually pose potential health and safety threats to their employees. The addition of the dye occurs on the vessel's deck and exposes employees to risk during the process, particularly in the range of weather extremes that occur in the areas served. There have also been concerns expressed about the safety of employees from exposure to the caustic dye handled during these blending exercises.

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[1] This figure is consistent with Mapco's projections of expenses in an April 18, 1994 letter to Senator Murkowski that included a prediction that the dye expenses alone would cost three times as much as any increase in tax income.

One small refiner reported storage problems arising when volumes are inadvertently dyed. This again points to the lack of justification for construction of duplicate storage tanks when 96% to 98+% of the diesel is sold for tax-exempt purposes.

Diesel fuel for pleasure boats is taxed but not for fishing vessels. Virtually every marina in Alaska relies on common tankage, making segregation impossible absent significant investments for injection systems at every marina.

The current requirements for dyeing 96% to 99% of the diesel fuel in Alaska seems to fly in the face of reason. The irony was noted by an article in the Anchorage Daily News that quoted a local Alaska IRS agent. The gentleman, responding to the issue of the lack of storage tanks for both taxable and nontaxable diesel, said one component of the diesel tax funds the removal of leaking underground fuel tanks around the country. The agent said, "It serves one purpose, but defeats another (increasing demand for more tanks)." [2]

Thank you for the opportunity to provide my comments to the committee.

Anchorage Daily News, January 7, 1994

STATEMENT OF THE

AMERICAN BUS ASSOCIATION

ON H.R. 1947,

MISCELLANEOUS FUEL TAX CORRECTIONS ACT OF 1995

JULY 12, 1995

The American Bus Association appreciates this opportunity to submit a statement in support of H.R. 1947, the Miscellaneous Fuel Tax Corrections Act of 1995, and wishes to express its thanks to the Ways and Means Committee for looking at these and other excise tax issues. We are particularly interested in Section 4 of H.R. 1947 which is meant to correct what we understand are unintended problems for the intercity bus industry.

ABA is the trade association of the intercity bus industry with more than 700 bus and tour company members in the United States and Canada. Most of these companies are small businesses, many of which are family-owned. They operate regular route, charter and tour, airport express, special operations, and contract services. The ABA membership also includes another 2,300 travel and tourism organizations and suppliers of bus products and services who work in partnership with the North American

motorcoach industry.

Intercity bus companies are liable for only a portion of the federal diesel fuel tax. Prior to 1988, they paid the entire amount of the tax and had to file for a rebate for the amount for which they were not liable. Congress recognized the cash flow problem this was causing these small businesses and rectified it, effective in 1988, by collecting only the portion of the tax that was owed, affording the bus companies an exemption from the rest of it.

This system worked well for the bus companies until the Omnibus Budget and Reconciliation Act of 1993 made all of its changes relative to diesel fuel. Such actions were necessary, we were told, in order to "fix" an estimated billion dollar a year evasion of taxes from the Highway Trust Fund. Ironically, although the intercity bus industry never was accused of being any part of the evasion, it is this industry that is suffering from the solution to the problem.

Two provisions of the "fix"--changing the collection point of the tax and requiring tax-free, low sulfur diesel fuel to be dyed red--have resulted in a tremendous burden on the intercity bus

industry. The situation as it now exists in the industry is as follows:

The point of collection of the tax is at the terminal rack. Clear diesel carries the full 24.4 cents per gallon tax when it is dispensed at that point; red-dyed fuel carries no tax. OBRA '93 provides that fuel vendors may purchase clear diesel for farmers and state and local governments (who are totally exempt from federal diesel fuel tax), pay the full tax at the rack, sell it to their customers with no tax, and collect their refund (for the tax they paid) from the Internal Revenue Service expeditiously.

Vendors, who are willing to help, are not allowed to do this for intercity bus operators. Where does that leave these bus operators now?

By removing the need for state and local governments to use red-dyed diesel, Congress inadvertently removed the incentive for petroleum manufacturers to make it. The amount that intercity bus operators use is very small compared to that used by state and local governments, which include the nation's public transit systems and all other government vehicles powered by diesel fuel.

Because the bulk of the market has been eliminated from the purchase of dyed fuel, this fuel is a very rare commodity. Most of the petroleum companies are not offering it, and the bus industry understands and accepts that. However, it causes a major problem.

In lieu of red-dyed diesel fuel, the bus operators buy the clear diesel. Because the tax comes with the fuel, so to speak, they must pay the full 24.4 cents per gallon federal diesel fuel tax and then apply quarterly to the IRS for their refund, usually 17.4 cents per gallon, but in some cases all 24.4 cents. There is no expedited rate of return for the intercity bus operators and, in some cases, companies are owed thousands of dollars for months on end. At the very least, since the filings only are made quarterly, the bus companies are floating a permanent, interest-free loan to the government. This is causing them to encounter large cash flow problems because their operating capital is not being returned to them in a timely fashion. Many of ABA's members have told us of their difficulties and we have tried to relate them to the Congress and the IRS. Several months ago, we were notified by one company that it had received no refunds at all, not even from the first quarter of 1994, and it was owed a total of $350,000. This is a huge amount of money for

one independent, privately-owned bus company to be owed by the government.

In order to fix these problems, the intercity bus operators need to be treated like state and local governments and farmers for the purpose of purchasing diesel fuel. Section 4 of H.R. 1947, which modifies the IRS code, is intended to do this, and we applaud this effort. Vendors (otherwise known as marketers, jobbers, distributors) would buy the clear fuel, pay the full tax, get their refund from the government, and the intercity operators would pay the government the tax that they owe--which is what they were doing prior to OBRA '93. When a vendor does not do this for the operators and when the operators buy fuel on the road at the fully-taxed rate, they would continue to file with the IRS for their return.

For all of the reasons stated above, the American Bus Association supports the enactment of H.R. 1947, introduced by Congressman Jim McCrery and cosponsored by Congressmen Wally Herger and Andy Jacobs, in order to solve the problems and inequities now in place.

TESTIMONY OF MICHAEL SCIULLA
BOAT OWNERS ASSOCIATION OF THE UNITED STATES
BOAT/U.S.

I am Michael Sciulla, Vice President of Boat Owners Association of The United States. With over 500,000 members, BOAT/U.S. is the nation's largest organization of recreational boat owners in the country. I appreciate the opportunity to provide testimony for the record regarding the fuel problems now being experienced by recreational boat owners due to the Omnibus Budget Reconciliation Act of 1993 and the diesel fuel regulations issued by the Treasury Department on November 30, 1993.

As you know, the 1993 Act levied a 24.4 cents per gallon tax on diesel fuel used only by recreational boat owners. To collect this tax, the Treasury Department issued regulations mandating that diesel fuel be dyed - red for non-taxed commercial marine use and clear for taxed recreational use. An unintended consequence of these regulations is that fuel availability problems have arisen throughout the country where many "mom and pop" fuel retailers - who only have one diesel tank and pump - have been forced to choose between selling to commercial or to recreational boats.

We have received reports from recreational boaters over the past 18 months that clear "taxed" diesel fuel is now either difficult to obtain or entirely unavailable for miles along major stretches of our waterways. This is especially true in those areas where recreational boating and commercial fishing co-exist. Since fishing vessels generally purchase hundreds, if not thousands of gallons at a time every day, in comparison to the occasional 10 to 300 gallons for a recreational boat, the market has simply dried up for clear diesel fuel in these areas.

For example, there is no clear diesel fuel available along the entire 300-mile

stretch of the Intracoastal Canal, a major transit route, between Gulfport, Mississippi and Galveston, Texas. Clear fuel may be obtained at Vermillion Bay and Lake Charles, but these locations require side trips of at least a two-hour duration. Further south in Venice, La. there is only one marina carrying clear fuel. "This has created a monopoly on this fuel and the marina can charge any price it wants for taxed fuel," reports a diesel boat owner.

In New England, Taylor Marine Corp. reports that they sell the only diesel fuel in a 20-mile stretch between Plymouth Harbor and Scituate Harbor, Massachusetts. Since 80% of their business is commercial, they will no longer sell to recreational boats. In Rhode Island, O'Neill Oil Service of Peace Dale reports that since they sell most of their fuel to commercial boats they no longer serve recreational vessels. Along Maine's coast, many fuel docks, except those near major urban areas, cater solely to the commercial fishing trade.

On Florida's Gulf Coast, Yankeetown Boat Company no longer sells diesel fuel to recreational boaters forcing customers to travel 75 miles to Tampa Bay. In Crystal River, all fuel retailers have chosen to service the commercial trade. Recreational boaters must travel 50 miles to Tarpon Springs for clear fuel.

On the West Coast, the fuel docks at Santa Cruz and Port San Luis, California no longer sell clear fuel and in Monterey, Breakwater Cove Marina, which used to sell fuel to boats cruising south, reports that recreational boats must now travel 90 miles to obtain clear diesel fuel.

In Astoria, Oregon, the owner of a 32-foot powerboat reports that he must now travel one and one-half hours up the Columbia River to Cathlamet in Washington

state in order to obtain clear diesel fuel. There were five facilities in Astoria where he could purchase diesel fuel prior to the imposition of this federal dyeing scheme. "Cruisers come to our marina for extended visits each summer. They will avoid our city now that they can't get fuel for their boats. Furthermore, if I wanted to sell my boat in the area, who would buy it now," he asks.

It is not, however, simply a matter of inconvenience when a recreational boat owner is turned away by a diesel fuel retailer. It can be a serious safety issue. Unlike the highways where there is diesel fuel on almost every other corner, diesel fuel docks on our waterways may be located hours, if not days apart. The owner of a truck or automobile running out of diesel fuel may lose some time. The skipper of a boat running out of fuel in bad weather conditions or at night can lose his life.

Not only are these regulations making it difficult or impossible for recreational boaters to find fuel, but many family-owned marina's have suffered significant business losses. For example, a marina in New Bern, North Carolina has one tank and pump. The operator reports that by choosing to sell clear fuel to recreational boaters he is, in effect, being forced by the government to give up all of his commercial fuel customers. The reverse holds true for the Holiday Harbor Marina in Pensacola, Florida which used to sell nearly 40% of their fuel to recreational customers and now only sells to commercial boats.

Installing an additional fuel tank and pump is just not a viable option for

most small marine fuel retailers due to prohibitive costs and environmental regulations.

According to J.R. Wynne of PetroPac, Ft. Lauderdale, Florida, the cost of installing a second fuel tank and dispensing equipment, including the monitoring devices and alarms which are required for environmental protection, could cost a marine fuel retailer from $12,000 to $100,000 depending largely on whether an above ground or inground tank is installed.

Given these costs, it is highly unlikely that a marine fuel retailer, whose primary business is serving commercial vessels, will make the added investment necessary to provide clear "taxed" diesel fuel to recreational boats. Simply put, it would just take too long to recoup the expense.

It is clear to us that it was never the intent of Congress to cause this potential safety problem and to create this hardship for consumers, many of whom have considerable investments in their diesel-powered boats, or to force small "family" businesses to lose business. Since the Treasury Department maintains that existing law affords it very little flexibility in interpreting how the diesel tax should be collected from recreational boats, we urge you to include the provisions of H.R. 1956, sponsored by Congressman Clay Shaw, in the next tax bill considered by this committee.

H.R. 1956 would 1) require the Treasury Department to assess the effectiveness of various procedures for collecting excise taxes on diesel fuel used by recreational boaters and report to Congress within 18 months the results of

the study, including any recommendations; 2) suspend collection of the tax for two years while the Treasury Department conducts this study and; 3) re-institute the tax and the current collection procedure at the end of this two-year moratorium if Congress has not enacted legislation to create a new collection procedure.

The other option would be to simply eliminate the tax on recreational diesel fuel. As you know, this tax is due to expire in four years - at the end of this decade. It was initially conceived of as a temporary retail tax by Congress in order to raise revenues to offset the repeal of the infamous "luxury" tax on boats. As you may recall, that tax did not hurt the so-called "rich". They simply stopped buying boats. Instead, hundreds of thousands of boat builders and their employees lost their jobs before the tax was repealed.

The elimination of the tax would involve very modest revenues. According to a 1992 report by Price Waterhouse for the U.S. Fish and Wildlife Service, recreational boats consume less than one percent of all fuel sold and diesel fuel used by the nation's 400,000 diesel boat owners amounts to only five percent of this amount, or about 46.6 million gallons. A tax of 24.4 cents per gallon should be generating about $11,370,000 per year. I am at a total loss to understand how "offsets" as high as $40 million per year have been estimated by the Joint Committee on Taxation.

On behalf of the thousands of BOAT/U.S. members who own diesel-powered boats, I would like to thank you for the opportunity to present our concerns.

Delta Western
ALASKA'S PETROLEUM DISTRIBUTOR

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July 27, 1995

Via Telecopier

The Honorable Bill Archer
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515 - 6348

Dear Mr. Chairman:

We are writing to provide you testimony upon two of the miscellaneous tax proposals for which public hearings were held on July 11-13, 1995[1]. Although we understand that at the present time oral testimony on these proposals has not been scheduled, we would welcome the chance to testify in person should that opportunity become available. In making this submission, it is our intent that this material be included in the written record of the hearing.

Western Pioneer, Inc. ("Western Pioneer") is a Washington corporation providing bulk fuel sales and delivery to various locations throughout the Alaska bush. We operate under the trade name of "Delta Western Fuels", and accordingly, we refer to ourselves in this letter as "Delta Western". Delta Western is keenly interested in the proposal set forth at page 111 of the *Description of Miscellaneous Tax Proposals* relative to exempting diesel fuel sold in Alaska from the requirement that non taxable fuel be dyed. It is for this reason that we today submit this testimony.

The locations at which Delta Western sells diesel fuel throughout the Alaska bush are remote and have relatively few inhabitants. Most of the diesel fuel we sell is non taxable because it is used for heating rather than highway transportantion. The volume of

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[1] These proposals were described in the pamphlet issued by the Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995. For simplicity, we refer to this in the text simply as the "*Description of Miscellaneous Tax Proposals*".

diesel fuel (as well as other fuels) which are sold at any one bush location is usually quite small. Often, there is inadequate infrastructure (primarily tanks and piping) to keep non taxable (i.e., dyed diesel) fuel physically segregated from the taxable (i.e., undyed fuel). While means do exist to try to deal with these problems (such as a dye injector system), the capital costs of such improvements are relatively large in relation to the margin on our sales. This makes it unfeasible to use the dye injector system. In some cases, the remote village or other customer itself will own the tank and infrastructure, not Delta Western, again making it unfeasible to add the system since their finances are usually precarious.

Moreover, even if the costs of the capital improvement could ultimately be justified, those costs would have to then be recovered from the ultimate end users of the diesel fuel. Since many of the bush residents exist on a subsistence basis off the land, these customers could not bear the added costs.

We do not wish to belabor the point, Mr. Chairman. The Alaska bush is a unique and beautiful place which cannot be fully comprehended unless one has spent time there. For this reason, Delta Western supports the proposal to exempt diesel fuel being sold in Alaska for non taxable uses from the dyeing requirement.

Thank you, Mr. Chairman, for the opportunity to provide you this testimony. Again, Delta Western would very much appreciate the opportunity to present oral testimony upon the diesel dyeing issue. Delta Western's designated contact persons upon this legislation is Thomas A. Crandall, Chief Financial Officer. His address and telephone number are 4601 Shilshole Avenue N.W., P.O. Box 70438, Seattle, WA 98107-0438 and (206) 781-4714. Please do not hesitate to contact us if we can provide further information.

Sincerely,

WESTERN PIONEER, INC.
d/b/a Delta Western Fuels

Thomas A. Crandall
Chief Financial Officer

SAM FARR
17TH DISTRICT, CALIFORNIA

COMMITTEE ON AGRICULTURE
SUBCOMMITTEES
DEPARTMENT OPERATIONS, NUTRITION, AND FOREIGN AGRICULTURE
RISK MANAGEMENT AND SPECIALTY CROPS

COMMITTEE ON RESOURCES
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The Honorable Bill Archer
Chairman
Committee on Ways and Means
1104 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

We are writing to ask you to include the provisions of **H.R. 1821, The 1995 Marine Diesel Tax Reform Act** in the miscellaneous tax bill the House Committee on Ways and Means is preparing to markup later this summer.

As you know, Section 13242 of the 1993 Omnibus Reconciliation Act requires that diesel fuel which is sold for use in a recreational boat must be non-dyed, clear diesel fuel, and that a Federal excise tax be added at the refinery level.

Clear, taxable fuel may be offered for sale to recreational boaters, while dyed non-taxable diesel fuel is offered for sale to commercial boaters. In effect, this provision forces commercial vendors of marine diesel fuel to either dispense two types of diesel fuel which must be stored in separate tanks, often at the unnecessary and excessively burdensome cost of building an additional tank, or to offer only one type of diesel fuel, usually the dyed, which is not available for sale to recreational boaters.

While this tax provision was meant to ensure that recreational boaters paid their fair share of marine diesel fuel taxes, it has instead created a disastrous situation where many recreational boaters cannot find clear, non-dyed taxable fuel for their use. This provision often forces boaters to travel long, often perilous distances at sea, in the search for diesel fuel.

H.R. 1821 would amend this marine diesel fuel tax provision to allow all boaters, both commercial and recreational, to purchase dyed diesel fuel and pay applicable taxes at the pump. H.R. 1821 would make it easier for fuel vendors to offer taxable fuel for sale while making it easier and safer for recreational boaters to purchase this fuel. The greater availability of dyed diesel fuel could even lead to an increase in revenues to the Treasury. Commercial boaters would remain exempted from this tax.

This problem is not specific to one particular district or state. Boaters nationwide are suffering from the unavailability of diesel fuel at local marinas. By supporting this legislation as a provision of your tax bill you will be ensuring safe and fair access to diesel fuel for all boaters. Thank you for your consideration of this important matter. We look forward to hearing from you.

Sincerely,

Sam Farr

SAM FARR, MC

Wayne T. Gilchrest

WAYNE GILCHREST, MC

JIM MORAN, MC	RANDY "DUKE" CUNNINGHAM, MC
SAM GEJDENSON, MC	GERRY STUDDS, MC
FRANK PALLONE, MC	ZOE LOFGREN, MC
JACK REED, MC	DOUGLAS "PETE" PETERSON, MC

Greyhound Lines, Inc.
1001 G. Street, N.W., Suite 400 East
Washington, DC 20001

July 13, 1995

The Honorable Bill Archer
Chairman
Ways and Means Committee
1102 Longworth House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing to express the support of Greyhound Lines, Inc. for H.R. 1947, the "Miscellaneous Fuel Tax Corrections Act of 1995", sponsored by Congressman McCrery and cosponsored by Congressmen Herger and Jacobs. Section 4 of H.R. 1947 is intended to put intercity buses in the same category as transit buses for purposes of payment procedures for fuel used in a "nontaxable use". This would remove a serious cash flow problem for intercity buses that was inadvertently created by the red dyed fuel requirements imposed by the Omnibus Budget and Reconciliation Act of 1993.

Intercity bus companies are partially exempt from the federal fuel tax. Prior to 1988, intercity bus companies had to pay the entire federal fuel tax and then seek a refund. Recognizing the cash flow burden that this represented to private operators trying to provide a public service without operating subsidies, Congress in 1988 specifically provided that "no tax shall be imposed" on intercity bus operators except to the extent that the tax is not refundable because of the nonapplicability of the exemption. 26 U.S.C. sec. 4093. Given the months long refund procedures of the IRS, this provision provided a cash flow lifeline for many intercity bus companies.

In the Omnibus Budget and Reconciliation Act of 1993, Congress enacted a set of fuel tax dyeing provisions that have had the unintended effect of negating that provision and putting intercity bus operators back where they were prior to 1988, that is, having to pay the full tax and then file for a refund.

Specifically, Congress crafted a new section 4082, which required that all diesel fuel destined for a nontaxable use be dyed pursuant to IRS regulations. Only such dyed fuel could be purchased at the terminal rack without payment of the full tax. In new section 4082(b)(3), Congress defined intercity bus usage as a "nontaxable use", thus clearly recognizing that intercity bus companies should continue to be able to pay only that part of the tax from which they were not exempt.

Congress intended that dyed fuel would be available to nontaxable users; however, it is now clear that red dyed fuel, which intercity bus operators must use, is not available and is not likely to become available. This has caused a serious cash flow problem for Greyhound. Greyhound's quarterly refunds since the enactment of OBRA 93 have averaged approximately $1.5 million. The last refund that Greyhound received was for the second quarter of 1994. Greyhound gets no interest during the period that the refund requests are being processed.

Thus, assuming that the IRS continues to take 9-12 months to process refunds, OBRA 93 is causing Greyhound to make a continuous interest free loan to the IRS of between $4.5 and $6 million. Greyhound simply cannot afford this. We, along with other intercity bus companies, are providing the only form of low cost, intercity public transportation to over 5000 communities nationwide and are doing so without operating subsidies. Greyhound emerged from Chapter XI reorganization in late 1991 and at the end of 1994 went through an economic restructuring that narrowly averted another bankruptcy filing. If Greyhound is to continue to provide the nationwide public service that it now provides, it must avoid financial penalties such as that inadvertently imposed by OBRA 93.

There are several reasons for the unavailability of red dyed fuel, the most important being another provision in OBRA 93. That provision, new section 6427(l)(5)(A), empowers vendors to sell farmers and state and local governments clear fuel tax free and then to file for an expedited refund for the tax that the vendor paid at the terminal rack.

In light of this provision and the fact that state and local governments are the main potential users of red dyed fuel, producers and vendors are simply not going to the expense of purchasing the equipment to supply red dyed fuel. Thus, intercity bus operators cannot get red dyed fuel from their suppliers and are left in the unintended position of having to buy clear fuel, pay the full amount of the tax and then file for a refund.

Another development that has prevented intercity bus companies from using red dyed fuel is that a number of states including Montana, Indiana, Wisconsin, Nebraska, and North Carolina have adopted laws or regulations prohibiting any entity but state and local governments from using red dyed fuel. Thus, even if red dyed fuel were widely available, Greyhound and other intercity bus companies could not use it in these states without being in violation of state law.

To cure this anomaly and to put intercity bus operators back in the position that Congress intended them to have, section 6427 should be modified to include intercity bus operators in the group entitled to use clear fuel without paying fuel tax to the extent that they are exempt. Section 4 of H.R. 1947 is intended to accomplish that result. Pursuant to that provision, vendors would file for an expedited refund for the tax that they paid on fuel

sold to intercity bus operators following the same procedure that they use for state and local governments. Intercity bus operators would remain responsible for separately paying the 7.4¢ per gallon fuel tax, which is the portion of the fuel tax from which they are not exempt. Of course, intercity bus companies must retain the right to file for a refund when purchasing from a vendor who is unable or unwilling to use the vendor refund procedures.

There should not be any revenue effect from such an amendment since the rate of tax owed by intercity bus operators is not changed and the amendment simply provides a mechanism to accomplish what Congress intended in OBRA 93, that is, to enable intercity bus operators to continue to pay only that part of the federal fuel tax from which they are not exempt.

For these reasons, Greyhound respectfully urges the adoption of H.R. 1947. Thank you for your consideration of this request. We would greatly appreciate it if this letter could be included in the record of the hearings that the Committee has been conducting this week on miscellaneous matters.

Sincerely yours,

Theodore Knappen

cc: The Honorable Jim McCrery
The Honorable Wally Herger
The Honorable Andy Jacobs
Norah Moseley

July 27, 1995

STATEMENT BY JACQUE JOHNSON, DIRECTOR
FEDERAL GOVERNMENT RELATIONS
NATIONAL MARINE MANUFACTURERS ASSOCIATION

SUBMITTED TO THE COMMITTEE ON WAYS AND MEANS
OF THE U.S. HOUSE OF REPRESENTATIVES
REGARDING THE CURRENT SCHEME FOR COLLECTING
THE EXCISE TAX ON DIESEL FUEL
USED IN RECREATIONAL BOATS

On behalf of the members of the National Marine Manufacturers Association (NMMA), I want to bring to the Committee's attention the significant unintended problems created for marina operators and recreational boaters by the current diesel fuel tax scheme. These problems are national in scope and affect every area of the country with significant boating activity. The Chairman and Members of the Committee deserve much credit for considering ways to improve the federal diesel fuel excise tax law, and we are grateful for the opportunity to present our views on this serious and continuing problem.

NMMA is the nation's leading trade association representing over 1600 members that manufacture recreational boats, engines, and related products. Many members also own and operate marinas that sell diesel fuel. Our members range from small proprietorships to Fortune 500 companies.

We offer the following comments regarding the current scheme for collecting the excise tax on diesel fuel used in recreational boats and the legislative solutions proposed to address the problems created by the current scheme:

DESCRIPTION OF THE CURRENT SCHEME

The current scheme for the collection of the excise tax on diesel fuel used by recreational boaters resulted from provisions of the Omnibus Reconciliation Act of 1993. These provisions (1) moved the point of collection of the diesel fuel excise tax to the point at which the diesel fuel is removed from registered terminal facilities, (2) repealed the exemption from the federal excise tax on diesel fuel for recreational motorboat use, and (3) prohibited a fuel retailer from selling or holding for sale dyed (untaxed) diesel fuel for a taxable use, even if the retailer intended to collect the tax from taxable customers, such as recreational boaters, and remit it to the Internal Revenue Service.

PROBLEMS CAUSED BY THE CURRENT SCHEME

The current scheme for the collection of the excise tax on diesel fuel used by recreational boaters has created very serious unintended consequences for marine fuel retailers, such as marina operators, and recreational boat users. Marina operators have been forced to choose either (1) to incur the significant costs and regulatory burdens of having separate fuel storage tanks from which to pump untaxed (dyed) and taxed (undyed) diesel fuel or (2) to pump only one type of diesel fuel (either dyed or undyed). Many marina operators can only afford to maintain one fuel storage tank and have chosen to sell only untaxed (dyed) diesel fuel to commercial boaters.

Under the current scheme, recreational boaters are not allowed to purchase the untaxed (dyed) diesel fuel carried as the only diesel fuel by many marina operators; therefore, diesel fuel has become unavailable to recreational boaters along major stretches of the nation's waterways. With fuel unavailable, there is a serious threat that boaters may run out of fuel and become stranded before they are able to find a marina that sells taxed (undyed) diesel fuel. Indeed, the Committee has received testimony that many recreational boaters have had to travel for hours and longer to find a marina selling taxed (undyed) diesel fuel.

In addition to the loss of revenue which results from not being able to sell fuel to the recreational boaters, there is another significant unintended consequence of the dyeing scheme to marina operators, who are mostly small business people. It also affects their non-fuel sales activities.

Often when recreational boaters stop to purchase fuel at a marina, they will also purchase incidental items, such as groceries and boating and fishing related products. Additionally, recreational boaters on longer voyages may rent transient slips from marinas. According to our member operators this aspect of their business can contribute up to a third of their revenue. When recreational boaters bypass marinas who can not accommodate their fuel needs, those marinas are denied the opportunity to engage in essential activities often critical to their continued profitability and even commercial existence.

LEGISLATIVE SOLUTIONS PROPOSED

We support H.R. 1956 introduced by Representative Clay Shaw earlier this month. This bill addresses the problems created by the current scheme in a practical manner by:

- Having the Treasury Department, in consultation with the affected industries, assess the effectiveness of various procedures for collecting excise taxes on diesel fuel sold for use, or used, in recreational boats and report to Congress within 18 months the results of the study, including any recommendations.

- Suspending collection of the tax for two years while the Treasury Department conducts this study.

- Re-instituting the current collection procedure at the end of the two-year suspension period if Congress has not enacted legislation to create a new collection procedure.

There are other legislative proposals that have been introduced that are intended to address the problems with the current collection scheme. These proposals would require marina operators to ascertain the taxable status of each diesel fuel purchaser. For a number of reasons, we believe that solution could unintentionally create as many problems as it seeks to eliminate. That type of collection scheme, along with others, is included within the scope of the study which would be required under H.R. 1956.

NMMA believes that the only way to completely address this issue and avoid adopting a solution fraught with unintended problems is to suspend the collection of the tax while the Treasury studies the issue. This approach would make diesel fuel available once again to recreational boaters while at the same time requiring a complete study of the problem before adopting a solution.

CONCLUSION

We believe that legislation is necessary immediately to ensure that diesel fuel is available to recreational boaters across the country. H.R. 1956 would ultimately lead to improved collection of the diesel fuel tax, prevent a potentially serious safety hazard to recreational boaters, and improve the economic viability of many marina operators. Therefore, we respectfully ask that the Committee move H.R. 1956 forward as expeditiously as possible so that it can be enacted into law prior to the end of the 1995 boating season.

NEW ENGLAND FUEL INSTITUTE

Phone: (617) 924-1000 ▪ Fax: (617) 924-1022

The New England Fuel Institute ("NEFI") hereby submits these comments and proposals to the House Committee on Ways and Means as it considers the Miscellaneous Tax Provisions. NEFI is an association of more than 1300 home heating oil marketers located throughout the six New England states. Most of NEFI's members are small businesses operated by the same family for three or four generations.

NEFI supports the current diesel fuel excise tax structure that places the point of collection at the terminal rack (loading platform) adopted as part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66). The program has clearly resulted in a reduction in tax evasion. However, because on-highway diesel fuel and home heating oil are essentially the same product, the Internal Revenue Service ("IRS") regulations implementing the Act have created unintended problems for legitimate businesses trying to comply with the law. NEFI respectfully requests that Congress seek a greater balance between the benefits of measures designed to minimize evasion and the undue burden such measures often impose on small home heating oil marketers.

I. Current Law

As indicated, diesel fuel and home heating oil are essentially the same refined petroleum product. Tax is imposed based on the use of the product. In general, diesel fuel sold for on-highway use is sold undyed and is subject to tax at the rate of 24.4 cents per gallon. Diesel fuel sold for such off-highway uses as heating, farming or construction, or for use by a state or local government must be dyed red at a precise specified concentration; failure to comply with the dye concentration, even if the dye is plainly visible, can subject marketers to substantial penalties. Dyed diesel fuel is sold without the imposition of tax.

II. Discussion and Proposals

A. Operational Problems

The 1993 Act has created new operation problems for home heating oil marketers that they never faced before. First, if a marketer accidentally adds dyed fuel to a tank of undyed, tax-paid fuel, the marketer is forced to sell the entire mixture only for tax-exempt purposes. He is not able to obtain a refund or credit for the tax paid as part of his purchase price from his supplier at the terminal rack. Second, if a marketer spills tax-paid diesel fuel, even though he can document the amount of fuel lost, he cannot obtain a refund or credit.

Such problems did not occur before 1993. At that time there was no color distinction between diesel fuel used for different purposes; therefore, there was no such thing as an accidental mixture; all of the fuel was the same. In addition, home heating oil marketers purchased diesel fuel at the terminal without the imposition of tax; the tax was imposed farther down the distribution chain, when the fuel was delivered and its purpose could be determined. Prior to 1993, if a marketer spilled oil, he could not recover for the lost product, but because no tax had yet been imposed, he experienced no loss of the taxes paid.

Such operational problems create serious financial losses, which significantly reduce the ability of small businesses to obtain adequate supplies of heating oil to meet customer demand during the winter season. Thus, customers are often lost to much larger companies, and they are difficult to get back.

Recommendation:

Accordingly, NEFI urges Congress to provide home heating oil marketers with a refund or credit for these operational losses.

B. Ultimate Vendor

At times a home heating oil marketer will purchase a truckload of undyed, tax-paid diesel fuel for sale to a customer using the fuel on-highway. Unfortunately, the customer may not take all of the truck load, and the marketer, who has no storage, may have nowhere to put the fuel oil. Thus, he may be forced to sell the remaining tax-paid fuel to homeowners located near his on-highway customer.

Homeowners are tax-exempt users, they do not want to buy tax-paid fuel and seek their own refunds, as permitted under current law. The process is too complicated and the amounts are too small. Therefore, the marketer must sell the product without passing along the tax and absorb the loss. Under the Internal Revenue Code, only the homeowner is entitled to the refund.

Recommendation:

Thus, to minimize this type of operating loss, the marketer should be able to sell the fuel without passing along the tax and seek an expedited refund as the "ultimate vendor." Marketers are already permitted to follow this procedure for sales of tax-paid diesel fuel sold to other tax-exempt users -- farmers and state and local governments. There is no justification for distinguishing between different tax-exempt consumers.

C. Kerosene

1. Current Law

Under current law, kerosene is classified as an "aviation fuel" and is taxed accordingly. This classification is based on the fact that more than 90 percent of all kerosene in the United States is used for aviation purposes. If kerosene is blended into diesel fuel/home heating oil to prevent the fuel from congealing, it becomes either diesel fuel subject to tax or home heating oil which is tax-exempt and must be dyed.

NEFI strongly believes that kerosene should remain classified as "aviation fuel." The Department of the Treasury believes that the classification of kerosene as an "aviation fuel" creates an opportunity for tax evasion. NEFI questions whether there is evidence of significant evasion resulting from the current classification. Many of the same opportunities for evasion have existed for years, and it has never been a problem.

2. Treasury Proposal

Treasury has proposed reclassifying kerosene as "diesel fuel" and subjecting it to the tax and dye requirements. If kerosene is sold undyed, the tax is imposed when it leaves the terminal rack. If kerosene is dyed red when it leaves the terminal, it is exempt from tax. The Treasury proposal would also address (1) kerosene destined for aviation use, and (2) sales of undyed kerosene to a consumer for use as heating oil. In the latter case, the marketer would buy the undyed fuel tax-paid, sell the fuel without passing on the tax and as the "ultimate vendor" would obtain a 20 day refund for the tax paid as part of his purchase price from the terminal.

3. Limited Storage

Storage space is severely limited at most terminal facilities. Facilities in the Northeast and elsewhere typically handle diesel fuel, kerosene/jet fuel and gasoline. With the numerous segregation requirements resulting from the rules for reformulated gasoline and high and low sulfur fuel oil, there is little tankage available. Thus, a terminal that sells kerosene will most likely keep only one tank for this product. It will be undyed to provide flexibility. If the kerosene is sold undyed it will be taxed. If it is purchased for heating, it most likely would be splash blended with dye (the dye is added manually) and no tax would be imposed. However, the marketer buying from the terminal may buy undyed, tax-paid kerosene and use it in two ways:

1. He may sell the undyed fuel directly to a trailer park consumer or other end-user; or

2. He may blend the undyed, tax-paid kerosene into dyed diesel fuel to prevent congealing.

In either instance, the marketer should be able to obtain the 20 day refund.

Recommendation:

NEFI believes that Congress should maintain the current classification of kerosene as an "aviation fuel." However, if Congress adopts the Treasury proposal, it is essential that a home heating oil marketer be able to obtain the expedited 20-day refund in either instance -- when the marketer sells the undyed fuel directly or when it is blended into dyed home heating oil.

D. Dye Concentration

Section 6714 of the Internal Revenue Codes provides that, if a person willfully alters the strength or composition of the dye in diesel fuel, he is subject to a penalty of $10 per gallon. This provision may not be limited to a marketer who dilutes the dye concentration with the intent of evading the tax. Indeed, it may also apply to a marketer who adds kerosene (a less viscous product) to dyed diesel fuel to keep the diesel from gelling at very low temperatures (i.e. minus 20 or 30 degrees Fahrenheit). By adding the kerosene, the marketer dilutes the dye; however, even if the dilution is not significant, it is blended intentionally.

IRS Notice 94-21 permits the blending of kerosene into dyed diesel fuel so long as the dye concentration is not diminished. As a practical matter, small independent home heating oil marketers do not have the capability to add more of the costly dye to the diesel-kerosene mixture. This procedure can only be performed at the more sophisticated terminal facilities. Therefore, it is inappropriate to expose small home heating oil marketers to the potential liability of $10 per gallon when they have no intent of evading the excise tax, and they do not do so.

Many assume that this problem will be alleviated if kerosene is reclassified as "diesel fuel;" they believe that only dyed kerosene would be added to dyed diesel fuel and thus, there would be no dilution of the dye concentration. However, that is not the case. As explained above, storage tank space is very limited at terminals; thus, it would be unlikely for terminals to store both dyed and undyed kerosene at their facilities. In all probability, they would maintain only one tank -- containing undyed kerosene. Thus, marketers buying from a terminal are

still likely to be forced to add undyed kerosene (tax-paid) to dyed home heating oil (diesel fuel). Under these circumstances, the marketer should be able to (1) obtain a refund for the tax included in the purchase price of the kerosene, and (2) market the diesel fuel with dye concentration that ensures simply that the dye is visible.

Recommendation:

Accordingly, NEFI recommends that the dye concentration level be the same as that established by the regulations of the Environmental Protection Agency -- the dye must be visible within the fuel.

III. Conclusion

The New England Fuel Institute commends the Congress for its consideration of changes to the diesel fuel excise tax structure. In sum, NEFI recommends:

(1) providing refunds for limited types of operational problems;

(2) providing expedited refunds for home heating oil marketers selling undyed, tax-paid diesel fuel to homeowners and other tax-exempt users;

(3) retention of the current classification of kerosene as an "aviation fuel;" and

(4) modification of the standard applicable to the dye concentration in tax-exempt diesel fuel.

Adoption of these recommendations would permit legitimate businesses to continue to operate and maintain economic viability; and moreover, would not diminish current efforts to minimize evasion.

Thank you.

Statement of
Mayor George Ahmaogak
North Slope Borough, Alaska
Before the
United States House of Representatives
Committee on Ways & Means

July 27, 1995

I am George N. Ahmaogak, Sr., Mayor of the North Slope Borough in the State of Alaska. The Borough is a political subdivision of Alaska, and encompasses approximately 89,000 square miles of the northernmost region of the State. The vast majority of our Borough's population are Inupiat whose ancestors have inhabited the area for generations, surviving the harsh climate primarily through subsistence hunting. The combination of the Inupiat lifestyle, harsh climate, and extremely remote situation of the villages make the Borough's infrastructure quite unique.

I submit this testimony in support of an exemption for Alaska from the diesel fuel dyeing requirements set forth by the IRS under the Omnibus Budget Reconciliation Act of 1993. The requirements are designed to help the Department of Treasury recapture millions of dollars in taxes which have been evaded nationwide by failing to distinguish taxable diesel from non-taxable diesel. However, more than 96% of the diesel used in Alaska is non-taxable, and State regulations are already in place to deter fraud with respect to the remaining taxable diesel. The IRS requirements, therefore, not only fall short of fulfilling their purpose on the North Slope -- they place an incredible and unnecessary monetary burden on consumers and business men and women who provide diesel to the Slope.

Both the storage and dyeing requirements of the IRS regulations are incompatible with the conditions and infrastructure on the North Slope. In many of the diesel facilities that currently provide for small communities, taxable and nontaxable diesel share storage space, enabling consumers to obtain fuel for all of their needs. These facilities can not afford separate storage facilities, and ultimately consumer choices would be severely limited.

The dye requirements, in addition to being prohibitively expensive, would pose an unecessary occupational hazard to workers. I am particularly concerned about a practice used to dye fuel in barges that involves the use of hazardous chemicals, called "splash dyeing." Splash dyeing would threaten the health and safety of workers when applied under the often-harsh maritime conditions off Alaska's North Slope.

The State of Alaska, because such a small percentage of its vehicles use diesel, has already been exempted from the low sulfur diesel dying rule required by the Clean Air Act. We ask Congress to recognize a similar situation here and grant the State of Alaska an exemption.

In closing, let me thank you for this opportunity to present the views of the people on the North Slope who rely on diesel fuel for many day-to-day activities. Our community, like the rest of Alaska, needs this exemption very much.

NKHA
NATIONAL KEROSENE
HEATER ASSOCIATION, INC.

March 21, 1994

CC:DOM:CORP:T:R (PS-52-93)
Internal Revenue Service
Room 528 HAND DELIVERED
Washington, D.C. 20024

Re: Diesel Fuel Excise Tax Proposed Regulations - Comments in Opposition to Dyeing Kerosene Blue

Dear Sir or Madam:

These comments by the National Kerosene Heater Association ("NKHA") are submitted in response to the notice published in the Federal Register on November 30, 1993 by which the Internal Revenue Service ("IRS") issued temporary regulations governing the diesel fuel excise tax and attendant registration requirements. The NKHA wishes to respond specifically to the IRS request for comments concerning the treatment of kerosene after June 30, 1994.

The NKHA is a not-for-profit association of manufacturers and national marketers of the "new generation" of portable kerosene heaters complying with the 647 standard of Underwriters Laboratories (hereinafter "UL-647") in the United States. These portable kerosene heaters use 1-K kerosene, which represents a significant volume in the home heating market. NKHA serves as a central clearing house and information resource for its members and the public concerning kerosene heaters. The purposes of the NKHA are to encourage maximum safety and efficiency for kerosene heaters marketed and used in the United States through product safety standards, regulatory requirements, and public education promoting safe use.

I. PORTABLE KEROSENE HEATER USAGE

Since 1976 nearly 22 million portable kerosene heaters have been sold in the United States and NKHA estimates that 15 million of these units are still in use. By turning back the thermostat of their oil, gas, or electric central heating system and heating only an occupied room, consumers save an estimated 4.5% for each degree of thermostat set back. For a 10 degree setback from 70 to 60 degrees, consumers save up to 40% on their annual heating bill. **An average savings of $500 each winter for 15 million kerosene heater owners results in total annual consumer savings of approximately $7 billion.** For most consumers this $500 savings is not generating additional income which could be taxed, but is essential to make ends meet.

Perhaps even more importantly, during the winter of 1994, many millions of Americans were totally without power for periods exceeding thirty (30) days, and would not have had any heat but for the portable kerosene heaters. In winters such as these, and in the increasing number of natural disasters, portable kerosene heaters may have actually saved the lives of many Americans.

II. PRODUCT SAFETY CONCERNS RELATED TO DYEING KEROSENE BLUE

The principal concerns of NKHA concerning the treatment of kerosene after June 30, 1994 are focused on the impact a requirement that kerosene be dyed blue might have on the safe use of portable kerosene heaters. NKHA contends that any proposal to dye kerosene blue will have a major negative impact endangering the lives and health of consumers in the following ways:

A. **The costs of the dyeing and fuel segregation requirements may cause fuel suppliers to abandon the distribution of 1-k kerosene, reduce its availability in the marketplace, and cause consumers to use gasoline jeopardizing their lives and safety.**

In 1982, the U.S. Consumer Product Safety Commission (hereinafter CPSC) initiated a major "priority project" investigating the safety of new generation kerosene heaters. The stated purpose of that project was to "comprehensively address" any risk of injury which might be associated with the product. Investigations of fire safety and air quality issues costing CPSC over $900,000 and parallel studies by the industry placed the total cost of the cooperative effort in the millions of dollars. Product design changes were voluntarily implemented industry-wide under an NKHA Board Resolution within a 9 month period, followed by an upgrade in the U.L. 647 standard. In its final 2500 page report, however, the CPSC staff concluded **"the single most important element in the safety of modern portable kerosene heaters is the pattern of consumer use."**

As one of the first investigations, CPSC asked the Department of Energy to conduct a nationwide survey on the availability of 1-K kerosene. That report concluded that there was an adequate supply of 1-K kerosene in the marketplace. The report was requested, however, because the CPSC was concerned about the safety consequences of fuel with a high sulfur content or a total absence of kerosene in any one area of the marketplace. If there had been any areas of the country where there was a shortage, there was a safety concern that consumers would turn to gasoline or some other volatile fuel exposing them to a fatal risk of injury.

Unlike kerosene, which has a flash point of +130 degrees F, gasoline produces flammable vapors at room temperature (it vaporizes at -45 degrees F) and creates a serious fire hazard and explosion risk to any consumer using the product. Tragically, gasoline fires often result in multiple fatalities. The depth of the concern about this issue by both the NKHA and the CPSC is best illustrated in the 1994 joint press release issued to warn consumers about the dangers of gasoline usage attached hereto as Exhibit A. Note that the very first message urges consumers to look for a "water-clear" 1-K kerosene. Also attached hereto as Exhibit B is a letter from CPSC to the IRS submitted previously documenting the safety concerns associated with a dyeing requirement.

Although much of the kerosene distribution is dedicated to 1-K kerosene, a portion of the market is supplied by jobbers who carry a high quality Jet-A which also meets the 1-K specification. As discussed later in these comments this amount of fuel is significant nationwide, but for some jobbers it represents relatively low volume and low profitability. This low return on the small volume is not sufficient for some suppliers to justify separate storage if it must be dyed blue. Our discussions with some of these fuel suppliers have led NKHA to believe that a number of them may abandon the distribution of 1-K kerosene. **For this reason, it is critical to consumer safety that 1-K kerosene continue to be classified as an aviation fuel consistent with current FAA requirements, which require that aviation fuel be sold undyed.**

In time it is possible that the fuel jobbers dedicated to a larger volumes of the 1-K kerosene will expand their distribution to meet the market need. In the short run NKHA is concerned that there may be markets this winter in which consumers could resort to gasoline usage, despite the warnings because of their dire need to heat their homes with scant economic resources, and no other alternatives.

B. **Dyeing kerosene blue could cause jobber or retailer confusion with blue "aviation gas" in the distribution channel.**

Unlike Jet-A sold for use in most commercial jets, which is kerosene, aviation gas for propeller driven aircraft is a volatile

fuel with a very low flash point. Aviation gas presents all the same risks of fire and explosion to portable kerosene heater users as gasoline used in highway vehicles. NKHA conversations with jobbers have led us to believe that there is a possibility that a kerosene dyed blue could lead to confusion at the terminal rack with aviation gas which is also dyed blue. We do not know the extent of distribution of this fuel nationwide, but every jobber with whom NKHA spoke acknowledged this risk. Unless there are adequate safeguards in place, the possibility of a grave risk to the lives of consumers from such confusion is very real.

C. **Dyeing kerosene blue could also cause confusion in fuel distribution channels and misfueling by consumers who have been told for over a decade to purchase only "water clear 1-K" kerosene.**

To prevent consumer misuse of kerosene heaters and misfueling with volatile fuels, the NKHA has over the last decade produced and distributed an ongoing consumer educational effort which has involved media tours in major markets, radio and television public service announcements, point of sale posters and literature to product and fuel retailers, a consumer education slide tape developed for the fire service, product labelling and "Important Safety Information" brochures packaged with each product, and other public relations initiatives. In 1983, these NKHA efforts won an "Award for Achievements in Product Safety" from the National Safety Council, and we believe these programs reached millions of Americans and educated them to look for a "water clear" 1-K kerosene.

A central message in every facet of this educational effort was that the consumer should purchase only "water clear 1-K kerosene." Changing the message would not only be costly, there will be no clear message to send to consumers. As stated later in these comments, we have reason to believe that some refiners will continue to distribute a "taxable" water clear 1-K, while others might distribute a kerosene dyed blue. The requirements of the Environmental Protection Agency are designed to convey to the consumer that a "blue" fuel is a "high sulfur" and undesirable fuel. This situation will contribute greatly to the possibility of consumer confusion and misfueling, especially when aggravated by the desperation often imposed by a very cold winter.

D. **Inadvertent or intentional blending of high sulfur heating fuel dyed blue with a blue dyed kerosene in the fuel distribution channels may produce indoor air emissions harmful to consumers using kerosene heaters.**

For almost a decade the NKHA has continued its work with the CPSC to establish an indoor air quality standard for heater emissions as a part of the UL-647 standard. Most of the work is being done through a task force of Underwriters Laboratories composed of industry, consumer and environmental representatives. Quality fuel adhering to very tight specifications is essential to the success of this effort.

The 1-K standard promulgated by the American Society for Testing and Materials (hereinafter "ASTM") requires that kerosene contain a sulfur content of no more than .04%. See Exhibit C attached hereto. The ASTM standard is set at this level to keep the indoor emission of sulfur dioxide from a kerosene heater within acceptable levels. To meet this specification, most refiners must produce sulfur levels well below .04% because of the possibility that the fuel will be contaminated during its transportation and storage through the jobber network. Often this requires segregated transportation and storage.

NKHA conversations with fuel suppliers seem to indicate that most will seek to put all "blue" fuels in segregated storage. This situation could easily lead to a contamination of any 1-K kerosene with some of the higher sulfur heating oils. When used in a kerosene heater these fuels also emit unacceptable and harmful levels of carbon monoxide and sulphur dioxide. The consumer would have no way of knowing whether the fuel purchased was acceptable from an indoor air quality standpoint.

NKHA contends that requiring all kerosene to be dyed blue would pose a significantly increased risk of consumer exposure to unsafe indoor air quality. In addition to avoiding any dyeing requirement for kerosene, NKHA urges the IRS to take whatever steps are necessary to prevent such fuel contamination or confusion by proposing a certification program for kerosene marketers.

E. A dyeing requirement would be contrary to the "water clear" requirement imposed by law in twenty three (23) states, and in the absence of clear preemption of the IRS regulations, further reduce the supply of safe 1-K kerosene in many of these states.

The ASTM standard D 3699-90 setting forth the kerosene standard specification imposes a "water clear" standard in its D 156 requirement for a sabolt color of +16. See Exhibit C. The National Conference of Weights & Measures of the National Institute of Standards & Technology has issued a "Model Method of Sale" incorporating this requirement and have sent it to their affiliated offices in each of the states. According to a study conducted by NKHA in 1986, this "water clear" standard has been adopted as a state law requirement by twenty three (23) states. The sale of a kerosene dyed blue would be prohibited in these states unless the proposed IRS regulations were to clearly preempt these state law requirements. In the absence of clear preemption, which might be achieved only by further Congressional action, the availability of a safe 1-K kerosene could be jeopardized in many of these states.

III. NKHA ESTIMATES OF THE ANNUAL VOLUME OF KEROSENE USAGE FOR PORTABLE KEROSENE HEATERS DEMONSTRATES THAT ANY POTENTIAL EVASION OF TAX BY BLENDING 1-K KEROSENE WITH TAXABLE ON-ROAD DIESEL IS MINIMAL AND CANNOT JUSTIFY DYEING KEROSENE BLUE IN THE FACE OF PRODUCT SAFETY CONCERNS.

The NKHA estimates that since 1980, approximately twenty two million (22,000,000) portable kerosene heaters have been sold in the United States. Of these heaters sold, approximately fifteen million (15,000,000) are still in use. In 1981, NKHA conducted a survey of actual consumer usage patterns in connection with the air quality study conducted by the CPSC. This study determined that consumers use portable kerosene heaters approximately eight hours each day. To reach a national average usage, we can conservatively assume an average heating season of four (4) months and that heaters are used only twenty (20) days out of the month. Since one gallon of kerosene will burn in the average kerosene heater approximately ten (10) hours, the total number of gallons of kerosene used is fifteen million (15,000,000) X sixty four (64) gallons per consumer household per season or nine hundred million (900,000,000) gallons per season.

Even if the assumptions about the number of portable heaters in use were high, the usage rate is low for winters such as that experienced in 1994 where consumers were without power in some areas continuously for over a month. Further, these projections do not include the vented kerosene systems being sold in ever increasing numbers.

This annual gallonage projection exceeds the estimates of kerosene fuel usage for home heating for 1991 of four hundred ninety one million (491,000,000) gallons by the Department of Energy, but reflects a reasonable estimate of consumer usage. The discrepancy in the numbers can be explained we believe by the volume of 1-K kerosene which is refined for aviation use, and reported as such, but significant portions of which are sold into the open jobber market for portable heater usage.

The Department of Energy estimated home heating usage of kerosene at six hundred eighteen million (618,000,000) gallons in 1989, and seven hundred seventy million (770,000,000) gallons in 1988. Subtracting these numbers from the NKHA average of nine hundred million (900,000,000) gallons suggests that the amount of aviation fuel sold for kerosene heater usage is approximately one hundred thirty million (130,000,000) gallons to four hundred eight million (408,000,000) gallons annually.

This volume of estimated annual usage should be even higher during the winter of 1994, because of the widespread power outages which lasted for extensive periods of time in many parts of the country. This estimate also demonstrates that the extent of blending of 1-K kerosene and taxable on-road diesel is minimal in the marketplace. There is no justifiable reason therefore to impose a dyeing requirement in the face of the grave product safety risk which such a requirement poses to consumers.

IV. COSTS ASSOCIATED WITH ANY REQUIREMENT THAT KEROSENE BE DYED BLUE WOULD BE PROHIBITIVE TO CONSUMERS

The NKHA contends that the protection against tax evasion afforded by a requirement that kerosene be dyed blue is outweighed by the grave risks to the health and safety of consumers. Even if the IRS were to determine to the contrary, however, the costs to consumers associated with such a requirement would be prohibitive.

A. Fuel dyeing of kerosene and its costly segregation requirements may cause certain refiners or fuel jobbers to keep the kerosene "clear," treat it as taxable increasing its price, and pass the LUST Trust Fund Taxes on to consumers despite the legislative exemption.

NKHA discussions with fuel suppliers have led us to be concerned that the low volume and profitability of 1-K kerosene for some refiners and suppliers will compel them to use any number of methods to avoid segregated storage, even if it means treating the fuel as taxable. Consequently, despite the exemption, the dyeing requirement could cause a price increase of 24.4 cents per gallon to consumers. Such a tax would eliminate the utility of portable kerosene heaters for those consumers who need them most.

For many consumers at lower income levels these heaters are the only source of heat, and the imposition of any additional cost would put the use of the product out of economic reach. The stark reality of this situation is that many families will not be able to afford to heat their homes. Other consumers who use the heaters during power outages and the increasing number of natural disasters will be unable to afford the additional costs of keeping an emergency kerosene supply and lose this potentially lifesaving source of heat.

B. The increased product safety risk imposed by a kerosene dyeing requirement may require a reassessment of the certification and standards of Underwriters Laboratories and the NKHA at an astronomical cost to consumers and could result in a prohibition of all kerosene heaters under the laws of at least thirteen (13) states.

If the IRS were to impose a dyeing requirement on 1-K kerosene, the NKHA and perhaps Underwriters Laboratories ("UL") would be forced to perform an extensive review of the product safety concerns set forth herein. A fuel availability study to ascertain the volumes of 1-K kerosene being sold in the marketplace, and the consumer surveys to ascertain the potential indoor air quality risk of confusion with other blue fuels would be prohibitive.

If for any reason either NKHA or UL were to determine that they could no longer certify the portable kerosene heaters, the model legislation promoted by the NKHA in effect in thirteen (13) states which requires compliance with UL and in some states NKHA standards would ban the sale of the products. Although it is theoretically possible to hire another independent testing laboratory to certify to U.L. Standards, the standard itself might have to be reevaluated and perhaps withdrawn in the face of the unavailability of 1-K kerosene in major portions of the marketplace. The product safety risk would continue for those fifteen million (15,000,000) consumers who still have the heaters and would use them when needed in a cold winter, but could not obtain safe 1-K kerosene fuel.

C. **<u>If the certification standards were not withdrawn, the costs of modifying the standards, and altering the instruction manuals, advertising and all associated materials, and product warning labels to reflect a blue kerosene would require major price increases to consumers.</u>**

If the IRS were to impose a requirement that kerosene be dyed blue and certifications were not withdrawn, all product labelling, instruction manuals, advertising and promotional materials would have to be changed to eliminate the "water clear" terminology. Studies would have to be made to determine the extent of 1-K kerosene fuel in the marketplace, and the appropriate warnings which might be required to deal with the increased risks. The costs of such an effort would be passed on to consumers, most of whom use portable kerosene heaters because they cannot afford central heat or other alternatives. It is possible that such price increases could place the product out of reach for the very Americans who need it most.

V. **<u>THE IRS SHOULD CONSIDER IMPOSING REGISTRATION AND CERTIFICATION REQUIREMENTS FOR MARKETERS OF KEROSENE FOR HOME HEATING USE.</u>**

The discussions NKHA has held with fuel suppliers nationwide has given us concern about the number of additional storage requirements being imposed as a result of these and other regulations. Even if the dyeing requirement is not imposed, there are other requirements placing at its limits the ability of refiners and jobbers to provide segregated storage. Consequently, NKHA urges the IRS to consider proposing and adopting a registration and certification of kerosene marketers for home heating use. Such a program could provide some protection against future blending of 1-K kerosene if the IRS continues to believe tax evasion in that manner may be a concern. The program could also require certain other contractual obligations concerning the transportation and segregation and storage of kerosene similar to those required in the certification conducted by the NKHA for a number of years.

These contractual obligations could help to prevent contamination as well as prevent or minimize dispensing of the fuel into on-road use. By imposing these contractual requirements at all points in the distribution system down to the level of retail sale as a condition of certification, the IRS will also be helping to assure the safety of consumers using 1-K kerosene. If the IRS is unable to provide this more extensive certification, the NKHA offers its services and a willingness to initiate such a program as a loss prevention program working cooperatively with the IRS.

<u>V. CONCLUSION</u>

The NKHA contends that the IRS should continue the exclusion of kerosene from the definition of diesel fuel in the temporary regulations or any final regulations which may be adopted after June 30, 1994. To avoid critical shortages of safe fuel in the marketplace, 1-K kerosene must continue to be treated as an aviation fuel, which consistent with FAA requirements is undyed. This action would enhance the safety of consumers using portable kerosene heaters by exempting kerosene from the diesel excise tax and dyeing program and permit the continued sale and distribution of 1-K kerosene as "water clear" tax exempt fuel.

Respectfully Submitted,

Harold Smith

Harold F. Smith, Ph. D.

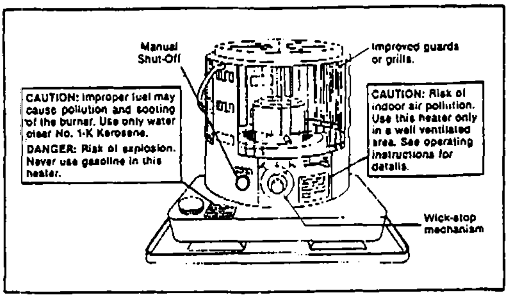
J. Thomas Smith
General Counsel

EXHIBIT A

Consumer Product SAFETY ALERT

From the U.S. Consumer Product Safety Commission, Washington, D.C. 20207

CPSC and NKHA Stress Kerosene Heater Safety



If you are using a kerosene heater, the U.S. Consumer Product Safety Commission and the National Kerosene Heater Association advise you to follow these suggestions in order to minimize the risk of fire and potential health effects from indoor air pollution.

--Use only water-clear 1-K grade kerosene. **Never use gasoline.** Gasoline is not the same as kerosene. Even small amounts of gasoline or other volatile fuels or solvents mixed with kerosene can substantially increase the risk of a fire or an explosion.

--Always store kerosene in a separate container intended for kerosene, not in a gasoline can or a can that has contained gasoline. This helps you avoid using contaminated fuel or the wrong fuel by mistake. Kerosene containers are usually blue; gasoline containers are usually red.

--When purchasing kerosene at the pump, make sure to use the kerosene pump, not the gasoline pump. Some service stations have separate islands for kerosene. Some oil companies have also established quality control programs to minimize the chances of gasoline contamination of kerosene.

--1-K grade kerosene should be purchased from a dealer who can certify that what is being sold is 1-K. State-operated and private sector certification programs that ensure the quality of kerosene are established in some states. Grades other than 1-K can lead to a release of more pollutants in your home, posing a possible health risk. Different grades of kerosene can look the

same so it is important that the dealer certify that the product sold is 1-K grade kerosene.

--Never refuel the heater inside the home. Fill the tank outdoors, away from combustible materials, and only after the heater has been turned off and allowed to cool down. Do not refuel the heater when it is hot or is in operation. Do not fill the fuel tank above the "full" mark. The space above the "full" mark is to allow the fuel room to expand without causing leakage when the heater is operating.

--In case of flare-up or if uncontrolled flaming occurs, do not attempt to move or carry the heater. This can make the fire worse. If the heater is equipped with a manual shut-off switch, activate the switch to turn off the heater. If this does not extinguish the fire, leave the house immediately and call the fire department. As an added reminder and precaution, install at least one smoke detector near each sleeping area or on each level of the house.

--Reduce your exposure to indoor air pollutants by properly operating and maintaining your portable kerosene heater. Although portable kerosene heaters are very efficient in the burning of fuel to produce heat, low levels of certain pollutants such as carbon monoxide and nitrogen dioxide are produced. Exposure to low levels of these pollutants may be harmful, especially to individuals with chronic respiratory or circulatory health problems. To assure that you and family members are not exposed to significant levels of these pollutants, you should follow carefully the following rules of safe operation:

--Operate your heater in a room with a door open to the rest of the house.

--If you must operate your heater in a room with the door closed to the rest of the house, open an outside window approximately an inch to permit fresh air to effectively dilute the pollutants below a level of concern.

--Always operate your heater according to the manufacturer's instructions, making sure that the wick is set at the proper level as instructed by the manufacturer.

--Keep the wick in your heater clean and in good operating condition by following the cleaning and maintenance procedures recommended by the manufacturer.

--Keep an outside window opened approximately an inch to insure adequate fresh air infiltration. This is true regardless of whether you use a kerosene heater or some other conventional method of heating, if your home is relatively new and tight, or if it is older but has been winterized to reduce air infiltration from the outside.

EXHIBIT B

U.S. CONSUMER PRODUCT SAFETY COMMISSION
WASHINGTON, D.C. 20207

Frank Boland
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Room 5228
CC:DOM:CORP:T:R (PS-52-93)
Washington, D.C. 20044

OCT 15 1993

Dear Mr. Boland:

The U.S. Consumer Product Safety Commission (CPSC) is an independent regulatory agency whose mission is to protect the public against unreasonable risks of injury associated with consumer products, provide consumers with information on the safe use of products, assist consumers in evaluating the comparative safety of consumer products, develop uniform safety standards for consumer products, and promote research and investigation into the causes and prevention of product-related deaths, illnesses, and injuries. The CPSC has jurisdiction over residential combustion appliances that utilize various fuels.

The CPSC staff offers the following comments on the Advance Notice of Proposed Rulemaking concerning the dyeing of diesel fuel destined for a nontaxable use ("Diesel Fuel Excise Tax", Federal Register, August 26, 1993, Vol 58, No. 164, page 45081).

For over a decade, the CPSC staff has strongly encouraged the use of water-clear, 1-K kerosene for residential kerosene heaters in order to avoid the release of more indoor air pollutants into a home or prevent the possiblity of fire or explosion from the use of improper fuel. The staff urges the Internal Revenue Service to take the necessary steps to ensure the continued availability of water-clear, 1-K kerosene to consumers for use in their heaters.

The staff raises the general concern about the use of dyes or markers in fuels without prior testing to determine the effect on emissions. Burning dyed fuels or fuels with markers may result in emissions that are detrimental to the health of the public.

The CPSC staff urges the Internal Revenue Service to consider all possible ramifications to the use of dyes or markers in fuels that are tax exempt.

Sincerely,

Lori E. Saltzman
Project Manager for
Indoor Air Quality

EXHIBIT C

Designation: D 3699 – 90

Standard Specification for Kerosine[1]

This standard is issued under the fixed designation D 3699; the number immediately following the designation indicates the year of original adoption or, in the case of revision, the year of last revision. A number in parentheses indicates the year of last reapproval. A superscript epsilon (ε) indicates an editorial change since the last revision or reapproval.

This standard has been approved for use by agencies of the Department of Defense. Consult the DoD Index of Specifications and Standards for the specific year of issue which has been adopted by the Department of Defense.

1. Scope

1.1 This specification covers two grades of kerosine suitable for use in critical kerosine burner applications:

1.1.1 *No. 1-K*—A special low-sulfur grade kerosine suitable for use in nonflue-connected kerosine burner appliances and for use in wick-fed illuminating lamps.

1.1.2 *No. 2-K*—A regular grade kerosine suitable for use in flue-connected burner appliances and for use in wick-fed illuminating lamps.

1.2 This specification is intended for use in purchasing, as a reference for industry and governmental standardization, and as a source of technical information.

1.3 This specification, unless otherwise provided by agreement between the purchaser and the supplier, prescribes the required properties of kerosine at the time and place of custody transfer.

1.4 The values stated in SI units are to be regarded as the standard. The values stated in inch-pounds units are for information only.

NOTE 1—Nothing in this specification shall preclude observance of federal, state, or local regulations which may be more restrictive.

NOTE 2—The generation and dissipation of static electricity can create problems in the handling of kerosines. For more information on the subject, see Guide D 4865.

TABLE 1 Detailed Requirements for Kerosine

Property	ASTM Test[A] Method	Limit[B]
Flash Point °C (°F), min	D 56	38 (100)
Distillation temperature °C (°F)	D 86	
10 % volume recovered, max		205 (401)
Final boiling point, max		300 (572)
Kinematic viscosity, mm²/s[C] at 40°C (104°F)	D 445	
min		1.0
max		1.9
Sulfur, % mass	D 1266	
No. 1-K, max		0.04
No. 2-K, max		0.30
Mercaptan sulfur, % mass, max[D]	D 3227	0.003
Copper strip corrosion rating max., 3 h at 100°C (212°F)	D 130	No. 3
Freezing point, °C (°F), max	D 2386	−30 (−22)
Burning quality, min	D 187	pass (see 4.2)
Saybolt color, min	D 156	+16

[A] The test methods indicated are the approved referee methods. Other acceptable methods are indicated in Section 2. The table values stated in SI units are to regarded as standard. Values in parentheses are for information only.

[B] To meet special operating conditions, modifications of individual limiting requirements, except sulfur, may be agreed upon among purchaser, seller and manufacturer.

[C] 1 mm²/s = 1 cSt.

[D] The mercaptan sulfur determination may be waived if the fuel is considered sweet by the Doctor Test described in section 6.1.10 of Specification D 235.

2. Referenced Documents

2.1 *ASTM Standards:*

D 56 Test Method for Flash Point by Tag Closed Tester[2]

D 86 Test Method for Distillation of Petroleum Products[2]

D 130 Test Method for Detection of Copper Corrosion from Petroleum Products by the Copper Strip Tarnish Test[2]

D 156 Test Method for Saybolt Color of Petroleum Products (Saybolt Chromometer Method)[2]

D 187 Test Method for Burning Quality of Kerosine[2]

D 235 Specification for Mineral Spirits (Petroleum Spirits) (Hydrocarbon Dry Cleaning Solvent)[2]

D 445 Test Method for Kinematic Viscosity of Transparent and Opaque Liquids (and the Calculation of Dynamic Viscosity)[2]

D 1266 Test Method for Sulfur in Petroleum Products (Lamp Method)[2]

D 2386 Test Method for Freezing Point of Aviation Fuels[3]

D 2622 Test Method for Sulfur in Petroleum Products by X-Ray Spectrometry Method[3]

D 3227 Test Method for Mercaptan Sulfur in Gasoline, Kerosine, Aviation Turbine, and Distillate Fuels (Potentiometric Method)[3]

D 3243 Test Method for Flash-Point of Aviation Turbine Fuels by Setaflash Closed Tester[3]

D 3828 Test Methods for Flash Point by Setaflash Closed Tester[4]

D 4294 Test Method for Sulfur in Petroleum Products by Nondispersive X-Ray Fluorescence Spectrometry[4]

D 4865 Guide for Generation and Dissipation of Static Electricity in Petroleum Fuel Systems[4]

3. General Requirements

3.1 Kerosine shall be a refined petroleum distillate consisting of a homogeneous mixture of hydrocarbons essentially free of water, inorganic acidic or basic compounds, and excessive amounts of particulate contaminants. Additive

[1] This specification is under the jurisdiction of ASTM Committee D-2 on Petroleum Products and Lubricants and is the direct responsibility of Subcommittee D02.E on Burner, Diesel, Gas, and Turbine Fuel Oils.

Current edition approved April 27, 1990. Published June 1990. Originally published as D 3699 – 78. Last previous edition D 3699 – 88.

[2] *Annual Book of ASTM Standards*, Vol 05.01.

[3] *Annual Book of ASTM Standards*, Vol 05.02.

[4] *Annual Book of ASTM Standards*, Vol 05.03.

STATEMENT BY EDWIN L. HARPER
ASSOCIATION OF AMERICAN RAILROADS
ELIMINATION OF THE 1.25 CENT-PER-GALLON DEFICIT REDUCTION FUELS TAX
before the
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
July 11, 1995

Mr. Chairman and members of the committee, I am Edwin L. Harper, president and chief executive officer of the Association of American Railroads. I appreciate this opportunity to address a threatened tax inequity against the nation's freight railroads. Unless Congress acts before October 1, 1995, the railroads will be singled out as the only transportation mode paying the 1.25 cents-per-gallon deficit reduction fuel tax. It is simply discriminatory to require railroads to pay 1.25 cents more per gallon towards deficit reduction than their major competitors. To avoid putting the railroads at a competitive disadvantage, the Association of American Railroads respectfully urges that all modes of transportation contribute equally to deficit reduction. This can be done fairly and with no revenue impact.

I. UNDER CURRENT LAW BOTH RAILROADS AND THEIR MAJOR COMPETITORS CONTRIBUTE EQUALLY TO DEFICIT REDUCTION.

Prior to 1990, the sole purpose of the transportation fuels tax was to finance the Highway Trust Fund. Therefore, railroads (like other non-highway users) did not pay this tax. The 1990 Reconciliation Act extended the fuel tax beyond its historical role as a highway user fee, by introducing a 2.5 cents-per-gallon deficit reduction tax on transportation fuels.

The original 2.5 cent tax was payable by most transportation modes into the general fund of the Treasury. The 1993 Reconciliation Act imposed an additional 4.3 cents-per gallon deficit reduction rate on all transportation modes. At present and until October 1, 1995, both railroads and trucks pay a combined deficit reduction rate of 6.8 (4.3 plus 2.5) cents-per-gallon of transportation fuel.

II. UNLESS CONGRESS ACTS BEFORE OCTOBER 1, 1995, RAILROADS WILL BE PLACED AT A DISADVANTAGE, BECAUSE THEY WILL BE REQUIRED TO PAY MORE TOWARDS DEFICIT REDUCTION THAN THEIR COMPETITORS.

Under the 1993 Reconciliation Act, the 2.5-cents tax paid by highway users will be redirected into the Highway Trust Fund instead of being dedicated to deficit reduction. Thus, on October 1, 1995, railroads will be left as the only payers of the original deficit reduction tax at a rate of 1.25 cents-per-gallon. Highway users will pay only 4.3 cents-per-gallon into the Treasury's general fund, while railroads will pay 5.55 (4.3 plus 1.25) cents-per-gallon for deficit reduction. Unless the deficit reduction rate levied on the railroads is reduced to the level of its competitors, the railroad industry will be subjected to tax discrimination as shown:

Transport-Mode	Current Tax Per-Gallon	October 1, 1995 Tax Per Gallon
Railroads	6.8 cents	5.55 cents
Trucking	6.8 cents	4.3 cents
Inland Water	4.3 cents	4.3 cents

III. EITHER THE DEFICIT REDUCTION FUEL TAX IMPOSED ON RAILROADS SHOULD BE REPEALED OR ALL MODES SHOULD BE ASSESSED A LOWER TAX RATE TO RESTORE BALANCE.

Tax equity begins with recognition of the differences between railroads and their competitors on infrastructure funding. The Highway Trust Fund, funded by highway user taxes, provides the financing for the construction and maintenance of the public roads used by trucks. The railroad industry operates over its own privately funded rights-of-way, with respect to which the industry pays significant property taxes and interest on debt. Moreover, because the railroads do not enjoy, require, or want a trust fund, the diversion of the excise tax paid by trucks into the Highway Trust Fund should be balanced by the repeal of the fuel tax paid by railroads.

If, on the other hand, a fuel tax is deemed appropriate for deficit reduction, all transporters should be required to make equal contributions. This can be done without creating a revenue shortfall. First, if airlines are excluded from paying fuel taxes, a .028 cent-per-gallon tax on fuel used by the same transporters, including railroads, subject to the 1993 deficit reduction tax would raise enough revenue to eliminate the 1.25-cent discriminatory tax on railroads. This proposal would allow fuel taxes paid by the other modes to be directed into their respective trust funds in a revenue neutral manner, with all modes contributing equally to deficit reduction

Alternatively, if airlines begin to pay the 4.3 cents per-gallon fuel tax effective October 1, 1995, the railroad tax could be decreased from 5.55 cents to 4.3 cents. This reduction would equalize fuel taxes at 4.3 cents for all modes, and bring in revenues of $472 million ($527 million from airlines less the $45 million reduction on railroads).

House Ways and Means Committee
Hearings on Miscellaneous Tax Reforms
July 11-13, 1995

Statement Submitted by:
The National Ready Mixed Concrete Association
Julie Renjilian Luther, Government Affairs Representative
900 Spring Street
Silver Spring, Maryland 20910
(301) 587-1400 ext. 129
(301) 587-9419 fax

THE NATIONAL READY MIXED CONCRETE ASSOCIATION (NRMCA)

The National Ready Mixed Concrete Association (NRMCA) is a national trade association representing producers of ready mixed concrete and those companies that provide materials and support to the industry. Our membership of approximately 1,300 companies is located throughout the United States and is bound by a common goal of increasing growth and professionalism in the ready mixed concrete industry. Ready mixed concrete is one of the premier construction materials of the 20th century used for roads, bridges, and commercial and residential buildings of all kinds.

NRMCA is engaged in a number of activities to advance the interests of our membership and contribute to the quality of the nation's infrastructure and living standards. These include: providing technical support to improve safety, health and environmental control programs; creating engineering, research and marketing programs to improve the quality and use of ready mixed concrete; contributing to the work of technical and professional societies; and representing our industry before all branches of the federal government, as well as public and private organizations whose work affects the ready mixed concrete industry.

ISSUE: EXCISE TAXES, # 5

Exempt from excise tax motor fuels used in highway engines to power non-highway equipment mounted on trucks.

Under current IRS rules, ready mixed concrete producers are paying federal fuel taxes on the fuel they use to turn their concrete mixer drums. This is despite a specified exemption from federal fuel taxes for off-highway use (see Section 6421 of the Internal Revenue Code). Since ready mixed concrete trucks do travel over the road part of the time, but do not have a separate motor to turn the concrete mixer drum, they do not qualify for the "off-road" exemption from federal fuel taxes under current interpretations by the Internal Revenue Service (IRS). The current IRS regulations, which were originally written over thirty years ago, allow a credit for

fuel used in special equipment only when a separate engine powers the equipment. The regulations disallow a credit in cases where only one engine or motor is used to fuel both the propulsion of the highway vehicle and the special equipment. This distinction was made when the regulations were originally written because at that time there was no reliable method of substantiating non-highway consumption. However, modern technology has made this rationale obsolete because the amount of fuel used for propulsion of the vehicle (on-road) versus that used in powering special equipment (off-road) can now be accurately substantiated.

This issue is extremely important to ready mixed concrete producers, as many producers estimate approximately 30 percent of their fuel is used off-road (and they currently receive no rebate for their off-road consumption). Ready mixed concrete producers are being unfairly penalized by the federal government due to their unique circumstance of having to mix and agitate their product while traveling to the site where they dispatch their product. As a matter of fairness and equity, ready mixed concrete producers -- and other taxpayers who use only one engine for both on and off-road fuel use but can substantiate the amount used for each purpose -- should not be treated any differently than taxpayers who have a separate engine to operate their special equipment.

The original statutory framework allows a credit for <u>any</u> properly substantiated non-highway use. Therefore, the revenue impact of correcting this inequity in the current regulations should be minimal, since it is a matter of statutory interpretation rather than a change in the underlying intent of the original statute.

Several states -- including Georgia, Kansas, Kentucky, Michigan, Missouri, Ohio, Oklahoma, Virginia, West Virginia, and Wisconsin (to name a few) -- currently allow some form of rebate for fuel used to turn a concrete mixer drum. NRMCA hopes that the 104th Congress will ensure that such a rebate is secured on the federal level as well. While ready mixed concrete producers are happy to pay their fair share to maintain the roads they travel upon, they deserve the same consideration as farmers and others who are exempt for the fuel they use for off-road purposes.

House Ways and Means Committee
Hearings on Miscellaneous Tax Reforms
July 11-13, 1995

Statement Submitted By:

The National Tank Truck Carriers, Inc.
Clifford J. Harvison, President
2000 Mill Road
Alexandria, VA 22314
(703) 838-1960
fax (703) 684-5753

NATIONAL TANK TRUCK CARRIERS, INC.

Background

The National Tank Truck Carrier Association ("NTTC") represents and promotes the interests of the highway bulk transportation community. The bulk transportation community includes truck companies that convey cargo that is transported in a large tank (e.g., gasoline, diesel fuel, soda, natural gas, etc.). Tank truck carriers are a vital part of the nation's economy and specifically the nation's trucking industry.

Tank trucks, once they have arrived at their destination, generally off-load their cargo in two separate ways. In the first instance, the truck uses gravity to unloads its cargo. There is no mechanical apparatus employed. This is by far the most common form of delivery. In this case, no fuel is expended on special equipment, and no fuel tax credit is claimed for "off-highway" business use in operating special equipment.

The second, less common, method is the use of a pump that would off-load the cargo from the tank and into a storage facility at the destination port. This pump is special equipment that is powered by the tank truck's engine through a device commonly called "power take-off." Fuel is used to power the special equipment and this use is "off-highway" business use that should be available for the off-highway fuel tax credit.

Clarification of the "Off-Highway" Fuel Excise Tax Credit

Section 6421 of the Internal Revenue Code of 1986 provides a fuel tax credit for "off-highway business use." As defined in the statute, this term means "any use" by a person in a trade or business "otherwise than as a fuel in a highway vehicle." This broad statutory grant does not include any artificial impediments that restrict access to the tax credit. However, the Treasury regulations interpreting the statute, which were originally written over 30 years ago, only allow a credit for vehicles that are equipped with two engines -- one engine that is used to power the special equipment and another to power the vehicle itself. This may have been done for administrative convenience years ago because of a lack of technology capable of substantiating off-highway usage. However, technology is now available to accurately reflect fuel used for the dual purposes of propulsion (on-highway) and for powering special equipment (off-highway). Thus, these regulations no longer reflect the original intent of the legislation to provide a credit for "any" off-highway use.

There is no question that if users of special equipment outfitted their highway vehicles with a separate motor, they would qualify for the credit. The only question is whether they should be penalized by being denied a tax credit for having vehicles that contain a single, efficient motor used for dual purposes, especially if the engine is computerized or can otherwise accurately monitor "off-highway" fuel usage. Common sense dictates that there is no practical reason for this single/double motor standard and it should be erased.

Proposal: Excise Taxes #5
Exempt from Excise Tax Motor Fuels Used in Highway Engines to Power Non-Highway Equipment Mounted on Trucks

This proposal would clarify and modify the existing tax statute to allow a tax credit under §6421 of the Internal Revenue Code for fuel used in highway vehicles with a single motor and an accessory unit to power special equipment which is fueled from the same tank used to propel the vehicle.

The policy justifications which disallow the credit to be substantiated in vehicles containing a single engine (i.e., administrative convenience) have been outdated by modern technology. Computerized engines can now determine and accurately substantiate the amount of fuel used for propulsion of the vehicle (on-highway use) or in powering special equipment (off-highway use). As a matter of fairness and equity, taxpayers who use only one engine should not be treated any differently than taxpayers who have two separate engines to operate their special equipment. The original statutory framework allows a credit for "any" properly substantiated non-highway use.

By allowing taxpayers with single engine vehicles to have the same right to reclaim their money as taxpayers with double engines, Congress would ensure that many small businesses across our nation are given the opportunity to get credit for taxes that they have unnecessarily paid to the Treasury. Without this clarification, these regulations will continue to frustrate the many small businesses and other vehicle operators throughout the country for whom this credit was created to accommodate.

COMMENTS FOR THE RECORD REGARDING THE PROPOSAL TO EXEMPT FROM EXCISE TAX MOTOR FUELS USED IN HIGHWAY ENGINES TO POWER NON-HIGHWAY EQUIPMENT MOUNTED TO TRUCKS

House Ways and Means Committee

Statement Submitted by:
Western Waste Industries
Kosti Shirvanian, President & Chairman of the Board
21061 South Western Avenue
Torrance, California 90501
(310) 222-8705
(310) 212-7092 fax

Re: Support for HR 2014

Honorable Members:

Western Waste is a leading solid waste management company providing collection, recycling, compacting and disposal services in six states. We operate various trucks in our operations, some of which operate completely off the nation's highways ("off-road vehicles"), while others operate both on the nation's highways and off of them ("on-road vehicles").

Western Waste's primary customers are small businesses and municipal contracts. We are dedicated to the concept of environmental protection. New technologies are sought which not only benefit the environment, but provide for more efficient and economical collection, recycling and disposal of refuse.

Exempt from excise tax motor fuels used in highway engines to power non-highway equipment mounted to trucks.

Western Waste supports the proposed change to exempt from excise tax motor fuels used in highway engines to power non-highway equipment mounted to trucks included in the Joint Committee on Taxation, description of miscellaneous tax proposals, "JCS-19-95", July 10, 1995, Page 113. In addition, Western Waste supports HR 2014, billed to provide such an exemption, introduced by Representative Wally Herger (R-CA) on July 11, 1995.

Under current Internal Revenue Service (IRS) rules, fuel used in waste management trucks (rubbish trucks) is being charged federal fuel taxes on the portion of the fuel used in the on-road vehicles which is utilized in operating the "power take-off" (PTO) unit mounted on each vehicle; the PTO equipment performs refuse industry tasks, including raising and emptying containers, compacting refuse and ejecting refuse.

Since rubbish trucks travel over the road, but do not have a separate motor to power the non-highway equipment, they do not qualify for the "off-road" exemption from federal fuel taxes under current interpretations by the IRS. The IRS regulations, which were originally written over 30 years ago, allow a credit for fuel used in special equipment only when a separate engine powers the equipment. The regulations disallow a credit in cases where only one engine or motor is used to fuel both the propulsion of the highway vehicle and the special equipment. This distinction was made when the regulations were originally written because at that time there was no reliable method of substantiating non-highway consumption and it would be an administrative inconvenience. Today these regulations are outdated because rubbish trucks cannot operate efficiently with two motors, moreover, on-board computers and other equipment can accurately monitor fuel consumption.

The measurement of the amount of fuel consumed in the non-propulsion operations of a one-motor vehicle is easily handled by modern technology. The technology in a small PC today is as great as the technology the United States was using to send a man to the moon 30 years ago when the regulations were written.

Fairness and equity says that Western Waste -- and any other taxpayer who uses only one engine for both on and off-road fuel use, but can substantiate the amount used for each purpose -- should not be treated any differently than taxpayers who have a separate engine to operate their special equipment to life and compact waste as the trucks go from customer to customer.

Looking as far back as the Revenue Act of 1934, one can see that it has always been Congress' intent to tax only the fuel used for the propulsion of vehicles over the public highway and allow for a credit for <u>any</u> properly substantiated non-highway use. In 1953, the IRS, in a very significant ruling, ruled that the retail diesel fuel tax applied only to fuel utilized in the propulsion of cement mixer trucks, and not to the fuel consumed in operating the power take-off units. A copy of that ruling letter, as published in the 1954 P-H Tax Service, 76,436, is attached hereto for the convenience of Congress. Nine years later the IRS regulations penalized trucks with one motor purely for administrative convenience

Modern technology has been recognized by most states. The principal states that Western Waste does business in: California, Florida and Texas, provide a statutory credit of 22%, 35% and 30%, respectively, with California allowing more than 22% if one can substantiate the usage through testing.

The revenue impact of correcting this inequity in the current regulations should be minimal, since it is a matter of statutory interpretation rather than a charge in the underlying intent of the original statute. The 1993 changes in diesel fuel tax collection point, dyeing and refunds has been estimated to have increased receipts by perhaps as much as $1 billion. This correction would have an impact of less than $50 million and could be fixed at a lesser amount by using a statutory percentage, similar to many states, as a controlling factor.

The main policy argument in favor of this bill is consistency. Excise taxes on diesel fuel are dedicated primarily to the Highway Trust fund which helps sustain our nation's valuable highway network. Fuel taxes serve to support the highway network by collecting highway funds from people who use the highways. In recognition of the purpose of fuel taxes, Congress has generally exempted non-highway uses of diesel fuel. Exemptions are granted to vehicles that do not use public roads, Section 6421(a), farm equipment, Section 4041(f)(1), fishing boats, Section 6421(e)(2)(B), and heating oil, Section 4041(a)(1). HR 2014 is needed to correct an aberration in the law that fails to recognize the non-highway use of diesel fuel to operate power takeoff equipment.

Western Waste hopes that the 104th Congress will ensure that a credit is secured on the federal level. The waste haulers of America have always been willing to pay their fair share to maintain the roads they travel upon, however, it is inequitable and discriminatory to not consider and exempt the fuel they use for off-road purposes.

Therefore, I respectfully request your support of HR 2014. If you have any questions or require further information, please don't hesitate to contact myself or Chuck Jelloian at (310) 222-8705.

Thank you for your consideration of this important matter.

cc: Chuck Jelloian

dated December 20, 1952, which is hereby superseded.

The functions herein transferred may be delegated by the Commissioner to subordinates in the Internal Revenue Service in such manner as he shall from time to time direct. [Treasury Department Order 150-32, Nov. 18, 1953.]

SPECIAL RULING

[¶ 76,436] Diesel fuel tax not applicable to liquid used in separate diesel engine which heats and rotates concrete transit-mix drum [See also ¶ 39,245].—

This is in reply to your letter of May 20, 1953, requesting information with respect to the Federal excise tax imposed on diesel fuel.

It appears that your client is engaged in the manufacture of concrete transit mix. This product is partially manufactured on the client's premises and then transported by a truck equipped with rotating drums which complete the manufacturing of the concrete while en route to the customer. Diesel oil is used as a fuel for the operation of the trucks as well as a fuel for heating and power for rotating the drums on the truck. You request advice with respect to the taxibility of diesel oil used under the following circumstances:

1. Diesel-powered trucks which use diesel oil as a fuel and contain no machinery.

2. Diesel-powered trucks which use diesel oil as power and which carry a transit-mix drum, contents of which are being processed into concrete by use of a diesel-powered engine.

3. Trucks which are powered by gasoline engines, which have a transit-mix drum (as described in 2) which is powered by a diesel engine.

Section 2450 of the Internal Revenue Code [¶ 39,246], effective as of November 1, 1951, imposes a tax of 2 cents a gallon upon any liquid (other than any product taxable under section 3412), sold by any person to an owner, lessee, or other operator of a diesel-powered highway vehicle for use as a fuel in such vehicle, or (2) used by any person as a fuel in a diesel-powered highway vehicle unless there was a taxable sale of such liquid under clause (1).

Under the provision of section 324.21(b) of Regulations 119 [¶ 39,247-D], the sale of a taxable liquid to an owner, lessee, or other operator of a diesel-powered highway vehicle shall be considered a taxable sale of such liquid (1) where the liquid is delivered by the vendor into the supply tank of the vehicle, or (2) where not so delivered, the vendee indicates in writing to the vendor prior to or at the time of the sale that the entire quantity of the liquid covered by the sale is for use by him as a fuel in a diesel-powered highway vehicle. If such a written statement is not furnished by the vendee, he shall be liable for the tax on that quantity of the liquid which is used by him as a fuel in a diesel-powered highway vehicle or which is sold by him in a taxable transaction. In such case he will be required to report and pay such tax liability to the district director of internal revenue for the district in which is located his principal place of business.

In view of the foregoing, tax is applicable to all sales of diesel fuel where the fuel is delivered by the supplier into the supply tanks of diesel-powered highway trucks referred to in question No. 1.

With respect to your question No. 2, all sales of diesel fuel by the supplier to your client for use as fuel for the propulsion of the diesel-powered trucks equipped with transit-mix drums are properly subject to tax. However, if the truck is equipped with one engine which furnishes the power for propelling the truck and rotating the drum, a credit or refund may be obtained for the tax paid on the quantity of diesel fuel used in the operation of the drum. Thus, if your client can establish that a quantity of the liquid was used otherwise than as a fuel in diesel-powered highway vehicles the supplier may under the provisions of section 2452(a) of the Internal Revenue Code [¶ 39,246-B] take a credit for such tax paid by him against the tax shown to be due on a subsequent return or he may file a claim on Form 843. The claim for credit or refund must be supported by evidence showing that the supplier has repaid the amount of the tax to your client or has obtained the latter's consent to the credit or refund of the tax involved to him. If the truck has two engines, one for the propulsion of the truck and one for rotating the drum, tax will be applicable only to the diesel fuel used for the propulsion of the truck.

With respect to question No. 3, no tax will be applicable to diesel fuel used in the diesel engine to operate the transit-mix drum with which trucks powered by gasoline engines are equipped. [Letter dated July 27, 1953, and signed R. J. Bopp, Chief, Excise Tax Ruling Branch.]

TESTIMONY OF ALTERNATIVE TRANSPORTATION FUELS INC.

Alternative Transportation Fuels Inc. ("ATFI") is pleased to submit the following comments regarding a proposal on alternative fuels in the "Miscellaneous Tax Reforms" under consideration by the Committee. ATFI is a new company, established in 1992, to develop a comprehensive alternative transportation fuels business for its parent company, Skelgas, Inc. of Oak Brook, Illinois. Skelgas has been a distributor of propane throughout the U.S. Midwest since the early 1920's. Affiliated companies are leaders in the alternative fuels business in Canada and Mexico, with a current network of more than 2,000 public refueling stations. Although ATFI intends to market a variety of alternative fuels, the Company believes that propane, in particular, has many attractive characteristics as a readily available, clean burning, domestically-sourced transportation fuel. (See Appendix.)

I. Background

ATFI believes that the motor fuels excise tax code for too long unfairly taxed some alternative fuels at a higher rate of tax than gasoline -- the fuel with which they must compete in the marketplace -- and is a significant barrier to the increased use of clean, domestic transportation fuels. This unfair disadvantage and distortion of market economics occurs because tax is charged on fuels such as propane and liquified natural gas ("LNG") at the same rate per gallon as gasoline, although they have a lower energy content per gallon. Therefore, propane, for example, pays an effective rate of 24.9¢/gasoline equivalent gallon or 6.6¢/gasoline equivalent gallon more than gasoline. This situation, which has continued for many years, is described in a Congressional Research Service ("CRS") report issued in March, 1994.[1/] The current effective tax rates, according to CRS are summarized in the following table.

Fuels	Current Rates	
	Tax Rate (cents per gallon)	Effective Rate (Gasoline Equivalent cents per gallon)
Gasoline	18.3[2/]	18.3
Propane	18.3	24.9
CNG	4.3[3/]	5.6
LNG	18.3	28.2
Methanol	11.4	23.0
Ethanol	13.0	19.7

In addition to the obvious market distortions resulting from this tax, it imposes a significant burden on both large and small companies which have already chosen propane as their transportation fuel. For example, Skelgas, a relatively small company, uses propane in 450 of its 461 vehicles and, as a

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1/ CRS Report for Congress, "Impact of Highway Fuel Taxes on Alternative Fuel Vehicle Economics," David E. Gushee, Senior Fellow in Environmental Policy, Environment and Natural Resources Policy Division, March 16, 1994.

2/ Gasoline pays an additional .1 cent per gallon to compensate for leaking underground storage tanks (the "LUST" tax); most alternative fuels do not pay the LUST tax, so it has been excluded from the equivalency calculation.

3/ The tax on compressed natural gas ("CNG") is 48.54 cents/MCF, determined at standard temperature and pressure. *See* note 5.

result, paid an estimated Federal tax penalty of $72,000 on its fuel use during 1994.

II. Proposed Remedy

ATFI recommends that the tax code be amended to establish the maximum rate of tax which can be charged on an alternative transportation fuel at the energy equivalent rate to gasoline. Based on the current gasoline excise tax of 18.3¢/gallon (without payment of the LUST tax), this recommendation would establish the maximum rate of tax on each fuel as outlined in the following table.[4]

Fuel	Maximum Tax Rate Cents/Gallon	Equivalent Tax Rate Cents/Gasoline Gallon
Gasoline	18.3	18.3
Propane	13.56	18.3
CNG	4.3 [5]	5.6
LNG	11.96	18.3
Methanol	9.06	18.3
Ethanol	12.12	18.3

ATFI does not recommend changing the actual rate of tax on CNG, which is lower than the recommended maximum rate for other fuels.

III. Other Comments

ATFI believes that strong arguments can be made that propane, LNG and CNG should all be taxed at the same lower tax rate (5.6 cents). All three are derived primarily from the same source (domestic natural gas production), contain the same constituents (methane, ethane and propane), share the same applications (heat and power), and have the same inherently clean-burning chemical characteristics. All three can play a significant role in the nation's transportation future.

A strong argument can also be made that greater equity should be created in the taxation rates among alternative fuels and that some encouragement should be provided to this young industry for a few years to help it reach a self-sustaining size. For example, the CRS, in its 1994 report, recommended taxing all alternative fuels at 12¢/gasoline gallon, providing a small reduction in the tax rate to permit greater market penetration.[6] In addition, the President's Federal Fleet Conversion Task Force recommended that Congress significantly reduce or eliminate Federal excise taxes on all alternative transportation fuels. The Task Force noted that in some cases excise taxes on alternative fuels are higher than the tax rate on gasoline and recommended that this discrepancy be eliminated as soon as possible to achieve tax parity.[7]

4/ *Supra* note 1.

5/ Compressed natural gas, or CNG was not taxed as a transportation fuel until adoption of the Omnibus Budget Reconciliation Act of 1993. At that time, a tax of 48.54 cents per MCF was established which is equivalent to 5.6¢/gasoline gallon.

6/ *Supra* note 1.

7/ *First Interim Report of the Federal Fleet Conversion Task Force*, August, 1993, at pp. 36 and 37.

The Committee may wish to consider either now, or at some future time, further actions to create greater equity, and offset the significant tax penalties paid in the past.

IV. Conclusion

The Committee should, as a minimum, take action during its consideration of proposed "Miscellaneous Tax Reforms" to ensure permanently that the rate of tax on any alternative fuel never exceeds the gasoline equivalent rate. This action would remove the unfair penalty which now exists and move towards more equitable tax rates among alternative fuels. In so doing, it would remove the single greatest impediment to the increased use of alternative fuels in the United States.

ATFI believes that this action will increase the use of clean, domestic alternative fuels by the nation's business fleets. In particular, ATFI believes that elimination of inequity in the tax code could ultimately result in the use of several million propane vehicles (up from an estimated 350,000 today). The infrastructure and technology already exist. Supply is ample and can be expanded by increasing extraction from domestic natural gas to produce sufficient low-cost propane for these vehicles, as well as all of the nation's other propane requirements.

Thank you.

Attachment

APPENDIX

BENEFITS OF PROPANE

Propane, which is derived primarily from domestic natural gas, has for many years been the nation's most widely used alternative fuel. Unlike gasoline, propane is environmentally friendly and clean burning, with the lowest greenhouse emissions of any currently viable fuel. Propane is used as a safe, reliable energy source throughout the world in homes, farms and businesses, as well as for transportation. For several reasons, propane can most readily be used by fleets and motorists.

First, there is widespread availability of propane through an established infrastructure. There are already at least 3,500 retail refueling outlets across the country, providing drivers with the security that they will be able to obtain fuel wherever they go. Moreover, a propane dispensing pump can be installed at an existing service station inexpensively and quickly.

Second, the cost of converting an automobile to propane is relatively low, about $2,000; in contrast, conversion of an automobile to compressed natural gas ("CNG") is approximately double that amount. Moreover, it is anticipated that the cost for a propane-fueled vehicle could, as more are produced, become only $700 or $800 more than a conventional gasoline-fueled automobile.

Third, propane is an inexpensive fuel. Excluding Federal and State taxes, the retail price of a gallon of propane can be less than 50 cents. Thus, consumer savings from the purchase of propane can be very significant, particularly for vehicles with high fuel consumption.

Fourth, the long driving range provided by propane provides additional convenience and security. In general, a gallon of propane will take an automobile about 75% as far as a gallon of gasoline. To compensate for the lower energy content, propane-fueled vehicles usually have a slightly larger fuel tank. Thus, they provide drivers with the <u>same</u> driving range as a gasoline-fueled car. Automobiles fueled with most other alternative fuels suffer significant reductions in driving range.

Fifth, there is more than adequate supply of propane to meet current and projected demand. Over 90% of the U.S. requirements are met with domestic production, primarily as a co-product of natural gas extraction. Most of the remaining propane supply comes from Canada. Moreover, sufficient volumes of additional propane can be recovered from natural gas production to meet probable new demand in the transportation fuel market. Established pipeline, storage and terminal facilities are used to transport and distribute propane; these facilities would require only incremental expansion to meet the rising demand of the automotive market.

As a result of these factors, approximately 350,000 vehicles operate on propane today in the United States and about 4 million, worldwide.

Liquid Carbonic Industries Corporation
800 Jorie Blvd
Oak Brook, Illinois 60521

July 26, 1995

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: **WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE**

**Hearing on Miscellaneous Tax Reforms, July 13, 1995
Excise Taxes - adjust certain fuels tax rates for Btu equivalency to gasoline, Item 6, pp.114-115**

Dear Mr. Moseley:

In lieu of a personal appearance at the above-referenced hearing, Liquid Carbonic Industries Corporation respectfully submits the following comments on the excise tax proposal before the Committee regarding the change in excise tax rates on liquefied natural gas (LNG) to reflect its Btu equivalence to gasoline.

Introduction

Liquid Carbonic Industries Corporation is the world's largest supplier of carbon dioxide in its various forms. Liquid Carbonic also produces, processes and markets a wide variety of other industrial and specialty gases, including oxygen, nitrogen, argon, hydrogen, acetylene, carbon monoxide, liquefied natural gas, and nitrous oxide. Liquid Carbonic also assembles and sells industrial gas-related equipment. Its customers included commercial manufacturers, research facilities, federal, state and municipal governments, as well as private customers.

In recent years, Liquid Carbonic has intensively focused on the production and development of liquefied natural gas. As you are aware, natural gas has been selected as a clean alternative fuel by the U.S. Department of Energy, and is supported by the Clean Air Act Amendment and the Energy Policy Act. Under these Acts, federal, state and municipal agencies are required to reduce vehicle emissions by shifting to the use of alternative fuels.

Liquefied Natural Gas (LNG)

Natural gas can be stored in a variety of ways. It can be stored in a compressed form or as a liquid. Compressed natural gas is commonly referred to as "CNG," while liquefied natural gas is commonly referred to as "LNG." Both forms have virtually identical chemical compositions, and are composed primarily of methane, CH_4. Due to the large ratio of storage volume of liquid to gas (620:1), storage of natural gas in the liquid state is very efficient, as it allows for the storage of a much greater amount of natural gas in a given volume of storage.

CNG is obtained by compressing pipeline natural gas, or by revaporizing LNG. LNG is obtained by compressing, and also

cooling pipeline natural gas to a cryogenic temperature of approximately -260° Fahrenheit.

Vehicles which utilize natural gas fuels are referred to as natural gas vehicles ("NGV's"). NGV's are not new to the federal arena, and were first addressed by Congress in the Methane Research Development and Demonstration Act of 1980. NGV projects are currently underway in most major modes of transportation, including municipal mass transit systems, over-the-road truck fleets, the rail industry, and maritime tankers and commercial vessels. The natural gas vehicle industry is currently making significant developmental advancements, and is in production today, with users of NGV's increasing daily.

Prior to its use in NGV's, LNG must be revaporized before introduction into the engine via the fuel system. Thus, LNG is simply a temporary storage state for the easy transport and storage of natural gas. When used in an internal combustion engine, natural gas must be utilized in its gaseous form. Consequently, at the time the natural gas fuel is introduced into a combustion chamber of an engine, the natural gas fuel, either LNG or CNG, is in a gaseous state.

Taxation of LNG

As a transportation fuel, methane is subject to the fuel excise taxes of Subchapter B on special fuels. Pursuant to the Omnibus Budget Reconciliation Act of 1993, the Internal Revenue Code (IRC) section 4041 imposes a tax on CNG at a rate of 48.54 cents per MCF (1,000 cubic feet), which is based on the respective Btu content of CNG. This corresponds to approximately 5.89 cents per gallon of gasoline equivalent.

There is no definition or mention of LNG anywhere in the Internal Revenue Code. Due to its storage state as a cryogenic liquid, LNG could fall by default into the language of IRC section 4041(a)(2), which imposes the highway fuel excise taxes on "other liquid fuels" used in motor vehicle transportation. The rate of tax imposed is the sum of the Highway Trust Fund Financing Rate (currently 11.5 cents per gallon, 14 cents per gallon after September 30, 1995), and the Deficit Reduction Rate in effect under IRC section 4081 (4.3 cents per gallon) at the time of such sale or use. In addition, the Revenue Reconciliation Act of 1993 imposes an additional excise tax on transportation fuels that are subject to the Leaking Underground Storage Tank Trust Fund excise tax. Absent clarification, if LNG is found to be taxed as an "other liquid" under IRC section 4041, the effective rate of tax would be as high as 20.1 cents per gallon equivalence, a disparity of 14.21 cents when compared to the tax on CNG, which is the same fuel (methane).

Thus, there exists an inconsistency between the taxation of different forms of methane sold for use in a NGV. If stored on board a vehicle in a compressed state, methane is taxed at a rate of approximately 5.89 cents (for a gasoline gallon equivalent), but if stored on board a vehicle in a liquefied state, methane could be subject to tax at a rate of 20.1

cents per gasoline gallon equivalent. This was not the intention of the drafters of IRC Section 4041(a)(2), as LNG was not a commercially viable fuel at the time this section was passed, and was not contemplated as an "other liquid fuel." LNG has only recently been considered as a serious alternative fuel for motor vehicle use.

Proposal to Adjust Excise Tax Rates to Btu Equivalency to Gasoline

The proposal before you seeks to adjust certain fuels tax rates for Btu equivalency to gasoline. This would provide a uniform method of measurement for these fuels by utilizing the Btu equivalency to gasoline as the base for excise taxation.

Three alternative proposals have been advanced for the taxation of certain special motor fuels. The first would exempt LNG from the Highway Trust Fund component of the special motor fuels excise tax, and adjust the rate of the deficit reduction component of the tax to reflect LNG Btu's equivalence to CNG. This would result in a rate of tax of LNG of approximately 6.23 cents per Btu equivalence to gasoline.

The second alternative would continue to impose tax as under current law, but would reduce the aggregate tax rates on propane, methanol, LNG and CNG to reflect their Btu equivalence to gasoline. This would result in a rate of tax of approximately 13.6 cents per Btu equivalence to gasoline for propane, approximately 9.2 cents per methanol, approximately 12.2 cents per ethanol, approximately 12.0 cents per LNG, and approximately 5.89 cents for CNG.

The third alternative would adjust only the propane tax rate to a rate based on propane's Btu equivalence to gasoline.

We applaud the efforts of the Propane Vehicle Council, and agree that there is an immediate need to provide a uniform standard of measurement among certain special motor fuels, particularly alternative motor fuels which serve the goals of the Clean Air Act. However, we believe that this proposal is incomplete as to its treatment of LNG.

While the first alternative will result in the same rate of tax for LNG as CNG on a Btu basis, there still exists a need for specific recognition of LNG for transportation purposes in the Internal Revenue Code.

From the perspective of competitiveness and equity, LNG should be taxed at the same rate as CNG, as the two fuels have virtually identical chemical compositions, and are utilized by a motor vehicle's engine in a gaseous form. To subject one compressed form of natural gas to a higher rate of taxation simply due to the artificial and temporary storage state of the substance defies logic. As stated earlier, regardless of storage form, all natural gas, when used as a fuel in the engine of a NGV, will be utilized in a gaseous (vapor) state.

In comments submitted for proposed rulemaking project PS-66-93, clarification was requested from the Department of the

Treasury that LNG is compressed natural gas for transportation purposes and therefore should be taxed at the same rate as CNG. As of yet, no guidance has been received, and the industry standard is to collect and remit excise tax on LNG at the CNG rate.

Conclusion

It is illogical to tax LNG at a different rate than CNG when both forms of natural gas are consumed in NGV's. LNG is stored at greater than atmospheric pressure and is simply cooled to reach a condensed state. The state in which natural gas is stored in a vehicle, as either CNG or LNG, is irrelevant to the operation of the vehicle, as all vehicles fueled with natural gas actually utilize it in its gaseous state.

This submission is not requesting a reduction or elimination of federal excise taxes. Rather, a request is made to resolve the tax uncertainty, and possible disparity, that surrounds the use of LNG and CNG for transportation purposes. There are no rational reasons or policy goals to necessitate inconsistent taxation of the same fuel.

The market for LNG is expanding as companies and individuals strive to meet the requirements of the Clean Air Act Amendments of 1990 and the Energy Policy Act of 1992. Natural gas provides a clean, domestically abundant motor fuel, and the expansion of the LNG market would be beneficial to the United States economy with increased jobs and production facilities. LNG is a viable and feasible fuel today, and is currently being used on our roadways.

Our customers and other potential users of LNG need to definitively know the tax liability associated with the use of natural gas fuels.

Respectfully submitted,

LIQUID CARBONIC
INDUSTRIES CORPORATION

By: Lynn A. Kopnick

Lynn A. Kopnick
Tax Counsel

TESTIMONY OF NATIONAL PROPANE GAS ASSOCIATION

Mr. Chairman:

The National Propane Gas Association (NPGA) respectfully submits for your consideration the following testimony in support of a technical proposal to achieve tax equity for propane and other alternative fuels.

NPGA is the national trade association of the LP-Gas industry with a membership of 3,500, including 37 affiliated state and regional associations representing members in all 50 states. Although the single largest group of NPGA members is retail marketers of propane gas, the membership includes propane producers, transporters and wholesalers, as well as manufacturers and distributors of associated equipment, containers and appliances.

Propane gas is used in over 18 million installations nationwide for home and commercial heating and cooking, in agriculture, in industrial processing, and as a clean air alternative engine fuel for both over-the-road vehicles and industrial lift trucks (forklifts). By 1993 estimates, sales of propane gas in the U.S. for motor fuel account for about 3.5% of the 500 million gallons of propane sold in this country.

While it may be considered an "alternative" fuel by some, it is certainly not new. Propane gas has powered motor engines for decades. In fact, over 350,000 vehicles in the U.S. and over 4 million worldwide operate on clean-burning propane gas today. Of all the alternative motor fuels, propane gas has one of the most extensive refueling infrastructures in place today. There are thousands of propane refueling stations in operation; some 3,500 of these are retail operations. So, the current motor fuel tax rate affects many more users of propane gas than users of other alternative fuels.

Unfortunately, these fuel users have borne an undue tax burden for years. The problem is that the fuels are all taxed on a per gallon basis. When you compare all the fuels on a common energy content basis, they very widely. For instance, propane gas has approximately 75% the energy content of gasoline. The current motor fuel tax for both propane gas and gasoline is 18.3 cents per gallon. (Gasoline actually pays another one tenth of a cent per gallon into the leaking underground storage tank fund) On an energy equivalency basis, propane users pay an effective rate of 24.9 cents per gallon. The current propane excise tax rate, then, is actually in excess of the rate imposed on gasoline.

Consumers and fleet operators log thousands of mile per year in their propane powered vehicles. These motorist effectively pay anywhere from $100 to $200 or more per year in excise taxes due to the tax inequity. Congress's tax policy has failed to recognize the energy content differences among the alternative fuels compared to gasoline and imposes a very unfair tax structure on the very same fuels it encourages through its energy policy.

Through the Clean Air Act of 1990, the Energy Policy Act of 1992 and Executive Order 12844, Congress and the Administration have recognized the important role alternative fuels like propane gas can play to clean our nation's air and reduce our oil dependence. The NPGA supports structuring the motor fuels excise tax rate for alternative fuels based on energy content, so no alternative fuel will be taxed at a higher rate than gasoline, as propane is today.

Mr. Chairman, we support the position put forth by the Propane Vehicle Council who has been working with the Committee on this issue and ask you to include this alternative fuels tax equity provision in the miscellaneous tax reform bill. Thank you for your consideration.

STATEMENT OF THE

NATURAL GAS VEHICLE COALITION

The NGV Coalition is a national organization of over 280 members, including vehicle manufacturers; NGV component manufacturers; natural gas distribution, transmission, and production companies; natural gas development organizations; environmental and non-profit advocacy organizations; state and local government agencies; and fleet operators. The NGV Coalition is dedicated to developing long-term markets for NGVs and building an NGV infrastructure, including the installation of fueling stations, manufacturing NGVs, developing consensus industry standards, and providing training.

II. Summary

The Omnibus Budget Reconciliation Act of 1993 required for the first time that natural gas distributors of transportation fuels collect excise taxes. The Committee is currently considering various proposals to modify the collection of excise taxes, along with other miscellaneous revenue issues. Thus, the NGV Coalition and its member companies have a direct and substantial interest in these hearings.

The NGV Coalition supports the Committee's initiative to review the application of excise taxes to alternative fuels. U.S. tax policy should be consistent with the goal of promoting the use of alternative transportation fuels. Congress, therefore, should move to repeal the existing excise taxes on alternative fuels. Repeal would encourage the use of natural gas, an environmentally clean-burning fuel, enhance the national policy of creating a market for alternative fuel vehicles to reduce our reliance on imported oil, and remove the inequities and burden of administering the tax.

III. Comments

Justification for Repeal of Federal Excise Tax on Natural Gas Used As a Vehicular Fuel

The continued dominance of petroleum fuels in the transportation fuels market poses significant economic and environmental consequences.[1] Exempting natural gas (liquefied and compressed) from the current excise taxes will stimulate economic growth, creating new jobs in the energy market, and improve the environment, as the importation and consumption of oil is displaced in the transportation fuels market. Natural gas is a clean, efficient, domestic energy resource that when used as a vehicular fuel significantly reduces emissions of harmful pollutants. Over 90 percent of the natural gas used in the U.S. is produced in America. Government incentives are necessary to overcome the country's entrenched reliance on liquid fuels, such as gasoline and diesel. Incentives, such as tax exemptions, not disincentives, therefore, should be put in place to overcome the institutional impediments that have kept alternative fuels from competing in the transportation fuels market.

Growing reliance on foreign oil imports is a significant drain on the U.S. economy, altering our balance of payments with trading partners and undermining the viability of the domestic oil and gas industry. Last year, payments to overseas oil exporters totaled $49.7 billion. Economic figures released in July indicate that May's record breaking import deficit figures were in large measure due to a 17 percent jump in petroleum imports. Future disruptions in oil supplies could have a devastating impact on our economy if effective measures to offset the growing demand for foreign oil are not put in place. The economic damage caused by the last two oil embargoes is estimated to have cost in the trillions of dollars. The National Petroleum Council's report, entitled "Factors Affecting the U.S. Oil and Gas Outlook" estimates that the previous oil embargoes reduced GNP by 3.5%, increased unemployment by 2%, increased interest rates by 2% to 3%, resulting in over $1.5 trillion dollars of loss to the U.S.

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[1]See Congressional Research Service, Library of Congress, The External Costs of Oil in Transportation (June 1992). A mid-range estimate prepared by the CRS in 1992 concluded that the minimum external cost of continuing to use oil for U.S. transportation is in the range of $10 to $20 billion per year; externalities are costs imposed by the use of a product but not internalized in its price.

economy. See, e.g., Task Force on Strategic Energy Research & Development, "Energy R&D: Shaping Our Nation's Future in a Competitive World" IX (June 1995) ("The cost of U.S. vulnerability to oil price shocks are significant. The cumulative losses to the U.S. economy of the oil price shocks of the 1970's and 1980's, combined with related U.S. economic policies of that period, are now estimated to have been in the trillions of dollars.")

For the first time ever, the U.S. is importing more oil than it produces. The Energy Information Administration projects that U.S. reliance on oil imports will continue to grow with imports accounting for well over 60 percent of U.S. demand by the year 2010. Under low oil price assumptions, that number could grow to as high as 75 percent. The import figures are particularly alarming considering that oil imports today are much higher than at any time preceding the past two oil embargoes; they also highlight the fact that energy policy measures adopted since the 1970's have been unable to alter the trend toward greater reliance on foreign oil.

The surge in oil imports is primarily a result of the transportation sector's increased demand for oil and declining U.S. oil production. The transportation sector is almost entirely dependent on petroleum motor fuels. In 1993, Americans consumed more than 117 billion gallons of gasoline. Each year Americans drive more miles, increasing the demand for gasoline; in 1992, passenger cars in the U.S. alone traveled 1.6 trillion miles. Meanwhile, improvements in fuel efficiency peaked in 1990 and have been flat ever since. Efforts to require further improvements in fuel efficiency are not likely to succeed. In 1992, Congress estimated that U.S. automobiles and trucks "consume[d] a volume of fuel equalling . . . one-seventh of the entire world's oil production." House Report No. 102 - 474(I), 136, 106 Stat. 1959. The Energy Information Administration projects that the transportation sector alone will require 14.1 million barrels of oil per day by 2010. EIA, "Annual Energy Outlook 1994" (Jan. 1994). At that time, the transportation sector will be consuming 7 million more barrels per day of oil than U.S. domestic production is capable of delivering. Id.

Concerns over rising oil imports and the oil embargo of 1973 led congressional leaders to look for avenues to increase alternative fuel use. In 1978, Congress enacted the Energy Tax Act (P.L. No. 95-618) providing alternative fuels with special treatment. The Congressional Research Service (CRS) reports that "[t]he underlying rationale for the [Tax Act] was the perceived failures in the energy markets in allocating resources efficiently and fairly, in coping with the 1973 oil embargo, and in adjusting to the sharp increases in energy prices, the shortages, and the associated adverse economic and social problems." CRS Report for Congress, "Disparate Impacts of Federal and State Highway Taxes on Alternative Motor Fuels," 93-330E (March 1993). Since 1978, numerous congressional measures have increased or altered the tax treatment of alternative fuels.

Efforts to encourage alternative fuel use, unfortunately, have not been uniformly applied, and today, certain alternative fuels are taxed at rates higher than gasoline (on an energy equivalent basis). Measures to stimulate market demand for alternative fuels, even those taxed at lower rates than gasoline, have only been marginally effective due in part to the limited interest of U.S. automakers in producing alternative fuel vehicles and to slumping oil prices during the early 1980's. Passage of the Clean Air Act Amendments of 1990 and the Energy Policy Act of 1992 has renewed much interest in alternative fuels. This year, U.S. automakers are offering a variety of alternative fuel vehicles, including passenger, truck and heavy duty applications. Fleet operators, however, will unlikely be willing to acquire these vehicles, which are priced higher than comparable gasoline vehicles, unless they are assured lower fuel prices. Exempting alternative fuels from the current excise tax could provide an important incentive necessary to encourage fleet operators to buy these vehicles.

Alternative fuels should be exempted from the existing motor fuels excise tax until they are firmly established in the marketplace. Providing alternative fuels with an exemption is a simple, straightforward method of encouraging the use of AFVs. The revenue impact of delaying the imposition of the motor fuels excise tax on natural gas vehicles is minimal. Assuming that eligible NGVs on the road today pay excise tax at the rate of 5.9 cents per gallon

equivalent, the total revenue generated from NGVs is less than $600,000[2] or **0.003 percent** of the total $20 billion in revenues generated by the highway trust funds each year. Continuing to impose the excise tax on alternative fuels, however, will diminish penetration of AFVs into the transportation fuels market. To the individual customer the added cost associated with the excise tax can be significant in determining whether they purchase natural gas.

Impeding growth in the NGV market will also result in foregone revenue from an increase in employment associated with the alternative fuels industry. The number of workers in the domestic oil industry has been steadily declining over the past several decades. While some portion of that job loss is attributable to efficiency improvements, a large portion of the decline is simply a result of decreased production levels. Domestic crude production, for example, has declined nearly 21 percent from 1980 to 1993. The number of workers employed in the petroleum refining industry has declined more than 25 percent over the same period.

In contrast, employment in the natural gas production and distribution industries has not experienced the dramatic declines seen in the oil industry. Employment in the natural gas production and distribution industry was at 162,000 in 1993, compared with 168,000 in 1980. It is reasonable to expect that with measurable increases in natural gas markets, employment will also increase, though not on a one-for-one basis. And unlike oil, the vast majority of the natural gas we consume in the coming decades will continue to come from America.

Regulatory Burden of Collecting the Tax

Exacerbating the barriers that exist to increased market penetration is the burden imposed of collecting the tax. Since the natural gas vehicles industry is still in its infancy, there are no guidelines to follow for collecting the tax. Tracking sales of natural gas for vehicular use is much more complex than tracking sales of gasoline. Unlike gasoline distributors, distributors of natural gas sell their product to a variety of customers for a variety of uses. Furthermore, there is no uniform way of complying with the tax regulations. Currently, different state IRS offices are dictating different methods of collecting and reporting.

Despite the fact that distribution of gasoline and natural gas are not similar, natural gas distributors are expected to collect excise taxes in the same manner as the gasoline industry. With respect to natural gas, the gas distributor must first segment the volume of gas being used as a transportation fuel (since the storage system for gasoline is not available/feasible for natural gas) and then the seller must distinguish exempt from non-exempt users before collecting the taxes. In the end, the cost of administering this burdensome collection process does not just justify the revenues generated.

IV. Conclusion

The NGV Coalition supports repeal of the current federal excise tax on natural gas as a transportation fuel (CNG and LNG). The tax is burdensome for the companies responsible for collection. In addition, it is inequitable to impose higher tax rates on natural gas or any other alternative fuel than imposed on gasoline. Increasing the use of alternative fuels will provide significant economic and environmental advantages. Tax policies, therefore, should encourage their use. We propose that Congress exempt alternative fuels until such time as several alternatives to gasoline become competitive in the transportation fuels market.

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[2]For purposes of computing these figures, 40,000 NGVs are assumed to be in-use; most of these are light duty vehicles. If these vehicles consume 500 gallons of fuel per year and half of these vehicles are exempt from the excise tax, imposition of the excise tax on the fuel used by these vehicles should generate approximately $590,000 annually. Much of the fuel used by these NGVs is exempt from the excise tax because these NGVs are operated by municipalities, state agencies or transit authorities.

TESTIMONY OF PROPANE VEHICLE COUNCIL

The Propane Vehicle Council ("PVC") hereby submits comments to the Committee on Ways and Means on a technical proposal to achieve tax equity for propane and other alternative fuels. The PVC believes that this minor amendment to the Federal tax code will result in a substantial increase in the demand for alternative fuels.

PVC was established in early 1994 to advance propane's future as a clean, safe and superior-performing alternative transportation fuel. The Council works to remove legislative and regulatory barriers and to increase awareness of propane's advantages as a transportation fuel among government officials, the auto industry and consumers. It also undertakes projects to encourage the development, demonstration and marketing of propane-related technologies and propane-powered vehicles.

Working together with the National Propane Gas Association, PVC is composed of a wide variety of stakeholders with a significant interest in the transportation fuel market for propane. Members include propane marketers, propane producers and pipeline operators, equipment manufacturers and distributors, vehicle and engine manufacturers, and associates.

I. Introduction

A. Current Federal Policy

Both Congress and the President have recognized the importance and role that alternative transportation fuels can play in reducing oil imports, improving air quality and providing domestic jobs. The Clean Air Act Amendments of 1990, the Energy Policy Act of 1992, and Executive Order 12844 all reflect the commitment of the Federal Government to the promotion of alternative transportation fuels. Accordingly, U.S. Government policies, including tax policy, should be consistent, and should support efforts, at all levels of government, to encourage the use of such fuels.

B. Disadvantages Created by Taxes

Taxes, both state and federal, are the primary impediment to the use of alternative fuels. Such taxes have a widely disparate impact, primarily because motor fuels are taxed on a gallonage basis, without regard to fuel energy content. Federal taxes for alternative fuels, when based on a common energy content, vary widely and are in excess of the rate imposed on gasoline. Propane is particularly disadvantaged, paying 24.9 cents per gallon (when based on a common fuel energy content), compared to the 18.3[1/] cents per gallon paid by gasoline. These disparities have been fully documented in several studies by the Congressional Research Service.[2/] Simply put, an owner of a typical propane-fueled fleet vehicle, for example, would pay an additional $100 to $200 per year to operate such a vehicle solely as a result of the inequity and disproportionate tax imposed.

1/ Gasoline pays an additional .1 cent per gallon tax (a total of 18.4 cents per gallon). This extra payment is used to compensate for leaking underground storage tanks (the "LUST" tax); propane does not pay the LUST tax, so the .1 cent per gallon has not been included in the calculation.

2/ See "Disparate Impacts of Federal and State Highway Taxes on Alternative Motor Fuels" issued on March 12, 1993, revised on December 17, 1993, and "Impact of Highway Fuel Taxes on Alternative Fuel Vehicle Economics" issued March 16, 1994.

In 1993, the Federal Fleet Conversion Task Force[3/] prepared a comprehensive report and plan for accelerating the commercialization, production and market acceptance of alternative fuels and alternative fuel vehicles. The report is balanced and fuel neutral; it advocates increasing the use of alternative fuels but permits the market, not regulation, to determine which fuels are better suited for achieving this goal. It analyzes specific problems and recommends viable solutions.

A major problem addressed by the report is the disadvantage created by Federal and state excise tax structures. Accordingly, it recommends the following:

> Significantly reduce or eliminate where possible Federal and State excise taxes on all alternative transportation fuels. In some cases, excise taxes on alternative fuels are higher than the rate on gasoline. Also, some alternative fuels are taxed at much higher rates than others on an energy content basis. This discrepancy should be eliminated as soon as possible and tax parity achieved at the Federal, State and local levels. Excise tax reduction or elimination on all alternative fuels would be an equitable and effective means of stimulating demand and creating new infrastructure;

II. Benefits of Propane

Propane, which is derived primarily from domestic natural gas, has for many years been the nation's most widely used alternative fuel. Unlike gasoline, propane is environmentally friendly and clean burning, with the lowest greenhouse emissions of any currently viable fuel. Propane is used as a safe, reliable energy source throughout the world in homes, farms and businesses, as well as for transportation. For several reasons, propane can most readily be used by fleets and motorists.

First, there is widespread availability of propane through an established infrastructure. There are already at least 3,500 retail refueling outlets across the country, providing drivers with the security that they will be able to obtain fuel wherever they go. Moreover, a propane dispensing pump can be installed at an existing service station inexpensively and quickly.

Second, the cost of converting an automobile to propane is relatively low, about $2,000; in contrast, conversion of an automobile to compressed natural gas ("CNG") is approximately double that amount. Moreover, it is anticipated that the cost for a propane-fueled vehicle could, as more are produced, become only $700 or $800 more than a conventional gasoline-fueled automobile.

Third, propane is an inexpensive fuel. Excluding Federal and State taxes, the retail price of a gallon of propane can be less than 50 cents. Thus, consumer savings from the purchase of propane can be very significant, particularly for vehicles with high fuel consumption.

Fourth, the long driving range provided by propane provides additional convenience and security. In general, a gallon of

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3/ Members include representatives from Federal and state governments, all segments of the alternative fuels industry, automobile manufacturers, fleet managers and other users or potential users of alternative vehicles and fuels, and environmentalists.

propane will take an automobile about 75% as far as a gallon of gasoline. To compensate for the lower energy content, propane-fueled vehicles usually have a slightly larger fuel tank. Thus, they provide drivers with the same driving range as a gasoline-fueled car. Automobiles fueled with most other alternative fuels suffer significant reductions in driving range.

Fifth, there is more than adequate supply of propane to meet current and projected demand. Over 90% of the U.S. requirements are met with domestic production, primarily as a co-product of natural gas extraction. Most of the remaining propane supply comes from Canada. Moreover, sufficient volumes of additional propane can be recovered from natural gas production to meet probable new demand in the transportation fuel market. Established pipeline, storage and terminalling facilities are used to transport and distribute propane; these facilities would require only incremental expansion to meet the rising demand of the automotive market.

As a result of these factors, approximately 350,000 vehicles operate on propane today in the United States and about 4 million, worldwide.

III. Unfair Tax Structure

A. Problem

The Federal excise tax imposed on propane used as a motor fuel has, for a decade, been unfair and excessive. The cause is twofold:

1. Congress failed to recognize that the energy content of a gallon of propane is about 75% that of gasoline. Therefore, what appeared to be a fair approach -- imposing the same tax on propane as on gasoline -- is actually very unfair. Propane pays one of the highest rates of Federal tax of any alternative fuel. There is simply no justification for subjecting the most promising alternative transportation fuel to the most inequitable tax treatment.

2. In recent years, a number of steps have been taken to encourage the use of other alternative fuels. For example, until October, 1993, compressed natural gas was subject to no Federal excise tax. Both methanol and ethanol have been given some tax reduction or subsidy. The propane industry, composed of more than 3,000 small, family-owned businesses, has not, until now, participated in the tax legislative process as actively as other fuel industries.

B. Proposed Solution

1. Tax Parity

Greater tax equity will encourage the use of alternative transportation fuels; such a step will assure that the objectives of the Clean Air Act and the Energy Policy Act -- a cleaner environment and reduction in the nation's dependence on oil imports -- are achieved. Moreover, the tax rate imposed on the various alternative fuels should be structured so that it is never more than the tax rate imposed on gasoline -- the very fuel Congress mandated alternative fuels to displace.

2. Modest Incentive

In addition to equalizing the tax rate with the tax on gasoline on an energy equivalency basis, Congress should consider another component of tax equity -- providing a modest incentive to such fuels for a limited period of time to encourage market penetration. The alternative fuels industry is relatively new

and in the early stages of development. Thus, a modest incentive for a few years would help its "start-up." The tax rate could be set at 12 cents per gallon on an energy equivalency basis on all alternative transportation fuels <u>except</u> CNG. Thus, it would equalize the rate of tax on propane, methanol, ethanol and LNG at a gasoline equivalency of 12 cents per gallon and would retain the current rate of tax on CNG at 5.6 cents. The reasonableness of this proposed rate is confirmed by the <u>Congressional Research Services</u> study on the impact of federal highway fuel taxes on alternative fuel vehicle economics. That report recommended a rate of 12.0 cents per gallon to promote greater tax equity for alternative transportation fuels. Moreover, a modest incentive would, to some degree, compensate for propane's "overpayment" of taxes in the past.

However, the PVC fully recognizes the fiscal restraints under which the Congress is currently operating. Thus, while it believes a modest incentive would be very helpful to the industry, tax parity -- tax imposed at a rate which reflects the energy content of the fuel -- is the most important measure.

The following chart shows the (1) current per gallon tax and its effective tax rate due to differences in energy content of the fuels and (2) proposed rates if fuels were taxed on an energy equivalency basis with gasoline.

Fuels	Current Rates		Proposed Tax Parity
	Tax Rate (cents per gallon)	Effective Rate (Gasoline Equivalent cents per gallon)	Tax Rate (cents per gallon)
Gasoline	18.3[4/]	18.3	18.3
Propane	18.3	24.9	13.56
CNG	4.3[5/]	5.6	5.6
Methanol	11.4	23.0	9.06
Ethanol	13.0	19.7	12.12
LNG	18.3	28.2	11.96

This adjustment would assure greater tax parity and would eliminate the current disincentive to use cleaner fuels created by the tax code.

Changes in the tax code are the single most effective means of encouraging the use of alternative fuels because (1) vehicles which consume the most fuel (often the greatest polluters) would receive the greatest incentive to convert to other fuels; and (2) experience in many other countries has demonstrated that fuel tax equity can dramatically increase alternative fuel vehicles penetration (<u>e.g.</u>, Netherlands - 15%, Italy - 5%., and Canada - 3%).

IV. <u>Revenue Estimates</u>

The PVC has met with representatives of the Joint Committee on Taxation and has provided detailed information on cost

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<u>4/</u> Gasoline pays an additional .1 cent per gallon to compensate for leaking underground storage tanks (the "LUST" tax); most alternative fuels do not pay the LUST tax, so it has been excluded from the equivalency calculation.

<u>5/</u> The tax on CNG is 48.54 cents/MCF, determined at standard temperature and pressure.

estimates for this proposal. Based on a complex industry model, taking into account fuel use profiles for the vehicle fleet, fuel costs, vehicle costs and taxes, it predicts the most economic vehicle/fuel selection for various consumer groups. Pursuant to the computations derived from this model, PVC estimates that if the tax on all alternative fuels, except CNG, were adjusted simply to the same energy equivalent rate as gasoline (18.3 cents per gallon), the revenue impact over 5 years would be a revenue gain of $7.5 million.[6/] The tax on CNG would be maintained at its current incentive rate of 5.6 cents per gasoline equivalent gallon. As a result, the Committee can see that a minor adjustment to promote tax equity will allow the market to make more economic decisions about alternative fuel vehicles and alternative fuels.

V. Conclusion

Congress neither intended to discourage the use of propane or other alternative fuels nor place them at a competitive disadvantage. Both the Congress and the Administration have repeatedly expressed the intent to encourage such fuels and maintain "fuel neutrality" in their alternative fuel policies. Accordingly, good tax policy dictates, at the very least, equalizing the tax rate on an energy equivalency basis on all alternative transportation fuels except CNG. Such a measure would ensure that the Congressional policy to encourage the use of alternative fuels is consistently and effectively implemented. Congress should eliminate the unintended contradiction between the nation's energy security and environmental policy and its tax policy. It is estimated that close to one million alternative fuel vehicles could be placed in operation by the year 2005 as a direct result of the proposed tax change -- computing the tax rate for alternative fuels on a gasoline gallon equivalency.[7/]

Finally, Congress should amend the tax code to ensure that the Federal excise tax rate imposed on the various alternative fuels never exceeds the tax rate imposed on gasoline. In this way, Congress will create, at a minimum, tax equity and will allow the market to determine which transportation fuels will be used.

Thank you very much.

6/ As a result of the tax change, there would be an overall increase in the number of alternative fuel vehicles on the road. However, the mix of vehicles would change slightly, with a greater number operating on alternative fuels that are taxed at a higher rate.

7/ If a modest incentive were provided, about 1.4 million alternative fuel vehicles would be on the road by 2005.

NTDA

NATIONAL TRAILER DEALERS ASSOCIATION
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Phone: 1-800-800-4552 - Fax: 1-701-282-2597

July 10. 1995

Philip Mosley
Chief of Staff
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Mosley,

My name is Jack Olsta. I am the owner of The Jack Olsta Company, Huntsville, Texas. On behalf of NTDA, I am honored to present the following testimony for the Ways and Means Committee Hearing. National Trailer Dealers Association is a nationwide trade group composed of 241 small businesses serving the transportation industry in 48 states.

Moving the point of collection of the trailer excise tax from retail sale to manufacture level is of utmost importance to our industry. From our perspective we are forced to manage and remit to the IRS large sums of money with potentially severe penalties should we err in our procedures. In addition there are inconsistencies within our industry regarding the application of F.E.T. for such items as tires and freight costs. Both these items leave us liable for unwanted and undeserved penalties within a non-profit portion of our business. We are at risk without reward.

From the perspective of the Federal Goverment I believe the system could be simplified by having the point of collection returned to the manufacturer. This would enhance efficient revenue collection as well as save many audit field hours.

I ask as a Texas businessman and member of the National Trailer Dealers Association consideration in changing the F.E.T. back to the manufacturer.

Sincerely,

Jack Olsta

Jack Olsta
The Jack Olsta Co.
323 IH 45
Huntsville, TX 77340

National Trailer Dealers Association is aggressively attacking the F.E.T. issue. We are a growing national trade group of 241 small businesses serving the transportation industry in forty-eight states. We have now joined ranks with National Used Truck Association, National Auto Dealers Association and National Truck Dealers Association. All the above associations are actively working to change F.E.T. collection.

Among the tax issues being considered by the House Ways and Means Committee is one dealing with "moving the point of collection of the heavy truck excise tax from retail sale to manufacture. and clarify (ing) activities which constitute taxable manufacture of existing trucks." National Trailer Dealers Association asks that the discussion be broadened to include terminating the collection of trailer excise taxes at the retail level and reinstating them at the manufacturing level. The Surface Transportation Assistance Act of 1982 could be amended to accomplish this goal.

Although our industry supported this change in 1982 we were unaware of the problems that it would cause. Many of our members have been unable to sell their dealerships because of the F.E.T. liability. Many trailer manufacturers provide no tire pricing guide. The inconsistencies regarding application of F.E.T. for tires and freight are left in the hands and discretion of the I.R.S. agent auditing the company. While dealers across the nation are acting as collection agents for the I.R.S., we have no clear rules governing this collection.

Rather than educating our dealers many I.R.S. agents seem content to attack them. For Example, National Trailer Dealers Association established a fair market tire guide upon request from the dealers. As an industry we believe there should be some uniform formula that we can apply. One East Coast agent has decided our guide is not valid. Large fines have been levied against our members. The agents' suggested formula is very complicated. The same set of tires when put on five different trailers can have a value difference of $1,000.00 on a set of eight. Common sense seems to dictate a set of tires manufactured by Company A of the same size and model should have the same value for excise tax purposes regardless which trailer manufacturer mounts the tire on their equipment. This is just one example of the confusion in our industry regarding this tax.

The I.R.S. says the tax would have to be raised if trailer excise tax goes back to the manufacturer. Why?

1.) When rules were adopted for the leasing of trailers and excise tax due, the I.R.S. ruled there was no constructive markup for trailers although on trucks a percentage markup was applied.

2.) Won't the I.R.S. have a cost savings in less audits of points of collection and paperwork flow with twice monthly receipts, quarterly and yearly filings? Two hundred manufacturers who they still must audit versus two thousand dealers?

3.) When the tax was changed in 1982, it was increased from 10% to 12% due to a projected loss of revenue. What has changed? If anything the value of equipment has increased dramatically.

National Trailer Dealers have many more examples of the potential for fraud and the arbitrary nature of this tax as presently administered. The liability and paperwork dealers of trailers absorb while trying to comply with a tax which has so many potential loop holes, creates an uneven playing field.

On behalf of the members of National Trailer Dealers, the Board of Directors of NTDA ask for your consideration in amending the Surface Transportation Act of 1982. We must return the excise tax back to the manufacturer to protect small business, provide efficient tax collection, eliminate paperwork, and maximize revenues for the federal goverment.

Respectfully,

Brad Theisen
Omni Trailer Sales
President - NTDA
Oklahoma City,OK

Bill Verwys
Hudsonville Trailer Sales
First Vice President - NTDA
Hudsonville, MI

Mark Ellingson
Action Equipment
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NATIONAL TRUCK EQUIPMENT ASSOCIATION

Celebrating 30 Years of Service
1964 – 1994

July 27, 1995

Mr. Philip Mosley
Chief of Staff
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Mosley:

I am writing on behalf of the National Truck Equipment Association (NTEA). The NTEA is very interested in two particular miscellaneous tax proposals that are currently under consideration by the Committee and were subject to debate at the July 11-13 hearings. The two proposals of interest are found in section #7 of the Description of Miscellaneous Tax Proposals as prepared by the staff of the Joint Committee on Taxation. These proposals both concern modifications to the retail truck excise tax (I.R.C. § 4051). We would appreciate if these comments could be submitted for the record of the hearing and the Committee's consideration.

The National Truck Equipment Association represents approximately 1,500 businesses, most of them small and family owned, throughout the nation who distribute and manufacture commercial truck bodies and equipment. These bodies and equipment are installed by NTEA members on trucks or truck chassis produced by companies such as Ford, GM, Navistar, etc. . . to create a completed truck. The vehicles produced by our members would include dump trucks, tow trucks, snow removal equipment, fire trucks, ambulances, beverage delivery trucks and a host of other specialty, single unit, work-related trucks. The NTEA estimates that our membership is responsible for production of over 80% of the vehicles sold in this single unit, work related truck category.

Many of the bodies sold by NTEA members are subject to the 12 percent excise tax imposed on the sale of truck

bodies and chassis that are not suitable for use with vehicles having a gross vehicle weight (GVW) of 33,000 pounds or less. NTEA distributor members typically make their sales directly to end-users or to truck dealers. Although NTEA manufacturer members most frequently sell to their distributors, many of these companies also make direct sales to end-users.

Since the NTEA represents companies that fall on both sides of the retail/manufacturer issue, as an association, we are not taking a position for or against the proposal to move the tax from the first retail sale back to the manufacturer's sale. As an interested and well informed party to the debate, however, we would like to point out a number of areas that the Committee should consider when they look at possibly changing the point of collection of this tax.

Most manufacturer level sales of truck bodies are wholesale sales of inventory to distributors. If the point of collection is changed, the existing 12 percent rate will presumably need to be increased, assuming revenue neutrality is the Committee's goal. Although retail sales by truck body manufacturers are now subject to a four percent "presumed mark-up percentage," a good deal of analysis would be needed to determine a fair and equitable rate hike.

More troublesome than the issue of collection point for the retail truck excise tax is the lack of objective standards on the part of the IRS when determining whether a body or chassis is taxable. This lack of objectivity creates a situation where one seller, who may be willing to risk an audit on a questionable transaction and does not choose to charge the excise tax, is able to gain a 12 percent competitive edge over another seller who views the transaction more conservatively for tax purposes. Unfortunately, the IRS has not issued many rulings that provide objective means of applying the tax or that create safe harbors.

We have attached two documents to this letter which will help you better understand the difficulties faced by small businesses who have to comply with these tax regulations. The first is simply a document containing a variety of situations faced by the small businesses who deal with the truck excise tax. The second document is a background paper on the truck excise tax itself and provides a very good, although brief, overview of current tax applicability.

If you choose to proceed with these tax proposals or any other possible changes to the truck excise tax we would be very interested in working with you. Please feel free to contact me at (202) 628-2010.

Sincerely,

Mike Kast

Michael E. Kastner
Director of Government Relations
NTEA Washington, D.C. Office

DISCUSSION POINTS

ON

ISSUES PRESENTED BY THE RETAIL EXCISE TAX ON TRUCK, TRAILER AND SEMITRAILER BODIES AND CHASSIS AND TRACTORS UNDER I.R.C. § 4051-53

I. Lack of Objective Standards. In theory, any particular truck body or chassis is always taxable or always nontaxable, regardless of who the retail seller is or where the retail seller is located. For this to actually occur, there needs to be an objective basis for determining whether a body or chassis is taxable. Currently, such objective standards do not exist.

A. Suitable for Use -- The Code currently excludes from the 12 percent tax those truck bodies and chassis that are "suitable for use" with vehicles rated 33,000 pounds Gross Vehicle Weight (GVW) or less. Neither the regulations issued under I.R.C. § 4051 nor the rulings issued by the Service provide any objective basis for ascertaining "suitability" for use. The reference in the regulations to "commercial and practical fitness" for use with vehicles rated below the taxable threshold is completely subjective.

For Instance:

1. Is a body that is mounted 10 percent of the time on vehicle rated 33,000 lbs. GVW or less "suitable for use" with vehicles rated 33,000 lbs. GVW or less? 5 percent of the time?

2. If a retail seller sells only two 22-foot platform bodies in a given period, and those bodies are both mounted on vehicles rated over 33,000 lbs. GVW, are those bodies taxable even if such bodies can be and routinely are mounted by others on vehicles rated 33,000 lbs. GVW or less? Is the retailer required to show evidence as to the sales of third parties?

3. Should regional differences in the application of trucks affect taxability of an article? The same truck body used to haul high density, bulk commodities in rural areas may be used to haul high cube, low weight consumer goods in urban areas.

B. Gross Vehicle Weight -- The Code, regulations and revenue rulings state that gross vehicle weight ("GVW") -- maximum loaded weight of a vehicle -- must be assigned by the retail seller to each taxable article it sells. Per IRS rulings, the GVW is determined by reference to axle capacity and placement and strength of the chassis frame. The determination of GVW is done by chassis manufacturers based on extensive track and simulation testing, as well as subjective factors such as expected vehicle life. Every chassis can be reasonably rated over a range of GVW values. On the other hand, bodies, taken alone, do not have a GVW, i.e., a body is not a vehicle in any sense.

1. How can retail sellers who modify chassis, as is often required by the marketplace, be expected to

increase the GVW of that chassis, when the chassis manufacturers treat the methodology of establishing the GVW as a trade secret? Such an analysis would be technologically and financially infeasible for any individual retailer.

2. Given that there often is no obvious difference between a chassis rated 32,000 lbs. GVW and a chassis rated 34,000 lbs. GVW, and that the IRS has no objective methodology for calculating GVW, how can retail seller be held accountable for tax determinations based on GVW?

C. Uncertainty Results in Conservative Companies Giving Up a 12% Edge -- Because the "suitable for use" and GVW concepts are so subjective, those companies willing to bear audit risk get a 12 percent price advantage. Companies that treat "gray area" articles as taxable lose sales to the aggressive and unscrupulous.

II. Imposition of the Tax on End-Users Creates Inequities. Modifications of customer-owned truck bodies/chassis result in the excise tax being imposed on the customer, not the modifier. This often leads to tax avoidance and nonproductive restructuring of transactions.

A. The deduction for the value of used components can be utilized by a customer, but generally cannot be utilized by a used vehicle dealer. Thus, if a dealer buys a used truck, converts it into a tractor and sells it, the full retail price of the tractor is taxable (less usual deductions). If a customer buys the used truck from a dealer and then takes it to a truck equipment distributor to be modified into a tractor, only the cost of the modification would be taxable. The used truck owner, not the modifier, would be responsible for filing a tax return and paying the tax. Few end-users understand the tax or that they must file a return (Form 720), resulting in revenue loss to the Service.

III. Provisions that are Vague, Unworkable or Ill-Advised. The retail truck excise tax has numerous provisions that make little sense and should be reevaluated.

A. Re-sale Certificates -- Sales by a manufacturer to its dealers are treated as taxable "retail sales" unless the manufacturer first obtains a written resale certificate stating that the articles will be resold. Failure to meet this administrative requirement results in wholesale transactions being taxed, contrary to the Congressional intent that only retail sales be taxed.

B. Four Percent Mark-up Percentage -- Retail sales by manufacturers and importers of new truck bodies and chassis and new tractors are subject to a four percent presumed markup percentage on the theory that direct sales by manufacturers are discounted fleet sales. In the truck body industry, manufacturers frequently sell direct in transactions that do not involve fleets or discounts. Nonfleet transactions (e.g., sales of less than 5 units to a single customer) should not be marked-up.

C. <u>Installation Charges</u> -- The deduction for installation charges is extremely vague and has never been clarified by a revenue ruling.

D. <u>Off-Road Vehicles</u> -- The IRS regulations concerning what types of vehicles constitute nontaxable nonhighway vehicles are extremely vague. The IRS has reversed two previously issued private letter rulings in the recent past creating even greater uncertainty.

E. <u>Imports</u> -- Importers of used vehicles now must pay tax on their sales unless they can show that the truck body or chassis in question was previously taxed in the United States or was sold tax-free in the United States in an exempt sale. It is usually impossible for the importer to obtain sufficient facts about the vehicle to determine if this is the case.

F. <u>Demonstrators</u> -- Demonstrator vehicles are subject to tax when put into service as a demonstrator. Demonstrator vehicles sold within a year should be taxed upon sale (at the lowest retail price charged by the seller for the same model vehicle new).

AN OVERVIEW OF FEDERAL EXCISE TAX ISSUES THAT AFFECT TRUCK EQUIPMENT MANUFACTURERS AND DISTRIBUTORS

By Mark H. Sidman, Esq.

The federal excise tax (FET) on retail sales of truck, trailer and semitrailer bodies and chassis, and on retail sales of tractors, is set forth in the Internal Revenue Code at sections 4051-53. Other relevant sections of the Internal Revenue Code include sections 4216 (determination of price), 4221 (tax-exempt sales) and 4222 (tax-exempt sales registration).

The temporary regulations, adopted largely in 1983, are found principally at Treas. Reg. § 145.4051 and Treas. Reg. § 145.4052. This outline is a distillation of the critical FET concepts that must be understood in order to apply the tax correctly. It is strongly recommended that the person responsible for FET in your organization review all of the relevant statutory and regulatory materials, as well as the Excise Tax Quarterly published by the NTEA, in order to become familiar with the nuances of the law and the regulatory and judicial interpretations of the law that evolve over time.

I. TRANSACTIONS THAT MAY BE SUBJECT TO FET.

A. Sale of a body alone to an end-user, whether or not installed on a chassis.
Sale of a chassis alone to an end-user, whether or not a body is installed on it.
Sale of a body and chassis.
Sale of a tractor.

**NOTE: It is possible in a sale of a completed vehicle that the chassis is taxable and the body is nontaxable, or vice versa (*see* section III, below). Treas. Reg. § 145.4051-1(a)(4).

B. Sale of a body, chassis or completed vehicle or tractor to a entity that will lease the article on a short-term basis (*i.e.*, for less than one year).

NOTE: Sale of an otherwise taxable article can be made tax-free **only if (1) the seller **obtains a certificate** from the buyer stating it will resell or long-term lease (i.e., one year or more) prior to any other use, or (2) the sale qualifies as a tax-exempt sale and all **registration requirements are met** (see section II.F., below).

C. Lease of a body, chassis or completed vehicle or trailer to an end-user, unless tax was paid upon acquisition of the article in question (i.e., if lessor manufactured the article in question or provided the certificate referred to in section I.B., above, and the lessor's acquisition transaction was not subject to FET).

D. Installation of parts and accessories under the so-called "**six-month rule**" if (1) the parts and accessories are installed on a taxable body or chassis first placed in service within six months of the installation, (ii) the aggregate price of parts and accessories installed on the body or chassis after its sale (including installation) exceeds $200, and (iii) the parts and accessories are not replacement parts or accessories. I.R.C. § 4051(b).

NOTE: The **customer is primarily liable for the tax under the six-month rule; the **installer has secondary liability**. I.R.C. § 4051(b).

E. Use of a taxable article following its manufacture, production or importation, and prior to its first retail sale.

NOTE: Use of vehicle as a demonstrator triggers FET, and the owner must pay tax as if the vehicle was sold. IRS Letter Ruling 8447092.

F. NOTE: **FET applies to the sale of a replacement body,** if the body meets the taxable threshold (see section III, below).

G. NOTE: **FET applies to sales of used bodies and chassis** that have been "**further manufactured**" by the seller (see section V, below). HOWEVER, further manufacture of a **customer-owned** article results in a tax liability for the owner, not the modifier.

H. NOTE: Parts and accessories are taxable when sold or in connection with a taxable body, chassis or tractor.

II. TRANSACTIONS THAT ARE NOT SUBJECT TO FET.

A. Sales of parts or accessories are not taxable, unless made on or in connection with the sale of taxable body, chassis or tractor. NOTE: Articles that have been ruled to be the "load" of a vehicle are not treated as parts and accessories and would not be subject to FET even when sold on or in connection with a taxable body or chassis. See Treas. Reg. § 145.4051-1(c). Examples include air conditioning equipment, aerial platforms, and cranes designed for purposes other than loading or unloading the vehicles on which they are mounted.

B. Sales of truck bodies and chassis that are suitable for use with vehicles of 33,000 lbs. GVW or less. (See section III, below).

C. Sales of trailer and semitrailer bodies and chassis that are suitable for use with trailers or semitrailers of 26,000 lbs or less (see section III, below).

D. Further manufacture of customer-owned articles (see section V, below).

**NOTE: Such transactions may result in FET payable by the customer of the vehicle, but not by the modifier.

E. Modifications that involve "mere combination" (see section V, below).

F. Sales to entities qualified to engage in tax-exempt transactions:

- state or local governments; sales for export; nonprofit educational organizations; sales for supplies for vessels or aircraft; sales to further manufacturers. I.R.C. § 4052(d); § 4221.

- seller must register for tax-free sales under I.R.C. § 4222. File IRS Form 637 and obtain Certificate of Registry.

- seller must advise buyer in writing that (1) articles in question normally are taxable, and (2) articles are being furnished pursuant to an exemption certificate or equivalent. Treas. Reg.

§ 48.4221-1(b)(5). NOTE: Sales to exporters require proof of subsequent exportation within six months. See Treas. Reg. § 48.4221-3.

- **buyer must provide tax-free sales registration number** (or, in the case of exporters, suppliers of vessels or aircraft, and state or local governments, an exemption certificate may be used in lieu of registration).

G. Sales of nonhighway vehicles (see section IV, below).

H. Sales of specifically exempted articles: camper coaches for self-propelled homes; feed, seed and fertilizer bodies; house trailers; ambulances and hearses; concrete mixers; trash containers; rail trailers and rail vans. I.R.C. § 4053.

III. SUITABLE FOR USE TEST

A. ****NOTE:** If a **body model** is a "suitable for" use with a vehicle of 33,000 lbs. GVW or less or a trailer or semitrailer of 26,000 lbs. GVW or less, **that model body is nontaxable in all sales, regardless of whether it is incorporated into a vehicle that exceeds the GVW threshold in any particular case.**

B. The IRS regulations provide that a body or chassis is suitable for use with a vehicle below the taxable GVW threshold if it has (1) **"commercial fitness"** for such use (i.e., it is priced appropriately for such use), and (2) **"practicable fitness"** for such use (i.e., it is reasonable from an engineering perspective for such use). Treas. Reg. § 145.4051-1(a)(4).

C. **BEST TEST OF COMMERCIAL AND PRACTICAL FITNESS: Prior sales of such article for use in vehicles below the taxable threshold. IRS Technical Advice Memorandum 8746001.

- evidence of **your own prior sales.**
- evidence of **prior sales of others.**
- in audit situation, **documentation is critical.**

D. **WHAT PERCENTAGE OF USE EQUALS SUITABLE FOR USE? IRS says "a significant number." Technical Advice Memorandum 8746001.

- No clear guidance, but based on informal conversations with IRS, 30% to 40% use below threshold certainly should justify treating body as nontaxable; good argument that percentage could be **much lower** so long as sample is substantial and use is reasonable.

E. Chassis: IRS does not apply a suitable for use test; instead, **compute GVW based solely on frame strength, axle capacity and axle placement.** Rev. Rul. 85-196, as modified by Rev. Rul. 86-43, and clarified by Rev. Rul. 86-38.

NOTE: For sales on and after October 1, 1986, GVW **cannot be reduced for FET purposes on account of readily attachable components** (e.g., springs, brakes, rims and tires).

IV. NONHIGHWAY VEHICLES

A. FET does not apply to bodies and chassis incorporated into **nonhighway vehicles.**

B. IRS has **two tests** for nonhighway vehicles:

1. A self-propelled vehicle or trailer or semitrailer, is not a highway vehicle if (i) it consists of a chassis to which there has been permenently attached machinery or equipment to perform a construction, manufacturing, processing, farming, mining, drilling, timbering or similar operation if the equipment is unrelated to transportation on or off-highway, (ii) the chassis has specially designed to serve only as a mobile mount (and power source where applicable) for the equipment or machinery, and (iii) by reason of such design, it could not serve some other function without substantial structural modification. Treas. Reg. § 48.4061(a)-1(d)(2)(i).

2. A self-propelled vehicle, or trailer or semitrailer, is not a highway vehicle if (i) it is specially designed for the primary function of

transporting a particular type of load other than over the public highway in connection with construction, manufacturing, processing, farming, mining, drilling, timbering or similar operation, and (ii) by reason of its special design, the use of such vehicle to transport such loan over the public highways is substantially limited or impaired. Factors considered in determining limitation or impairment for on-highway use: reduced speed; overweight, overheight or overwidth; need for special permit; other relevant considerations. Treas. Reg. § 48.4061(a)-1(d)(2)(ii).

V. FURTHER MANUFACTURING

A. **Further manufacturing will result in the liability for a modifier **only** with respect to articles to which the **modifier holds title.**

- ° If distributor takes a trade-in, further manufactures it into a taxable article and then sells, leases or uses it, FET will be triggered.

B. Further manufacturing of customer-owned articles may result in tax liability for the customer, but not for the modifier. [NOTE: Installation of parts and accessories on customer-owned vehicles may result in secondary liability for installer under the six-month rule. See section I.D., above].

C. Further manufacturing occurs when modifications **substantially improve** or change the articles transportation function or result in a **"different article."** Rev. Rul. 82-157.

D. Examples of further manufacturing:

- ° Stretch 40-ft trailers to 45-ft. Rev. Rul 83-149.
- ° Conversion of truck into tractor. Rev. Rul. 60-155.
- ° Substantial restoration of semitrailers, including fabrication of body. Rev. Rul. 63-128
- ° Insulation of body shells. Rev. Rul. 64-335.

- Installation of tag-axle or pusher-axle. Rev. Rul. 75-129.

NOTE: Repairs are not treated as further manufacturing, unless the repairs are so substantial as to turn an article that has no function as a body or chassis into a functional body or chassis.

NOTE: The IRS recently ruled that Rev. Rul. 69-419, in which restoration of milk tank bodies was held to be further manufacture if the cost of materials and labor exceeded 25 percent of the retail selling price of the restored bodies, does not apply across-the-board. Therefore, it is possible to exceed the 25 percent threshold and not be ruled to be a further manufacturer. See IRS Letter Ruling 8620003.

E. Modifications that are "mere combination" under I.R.C. § 4052(c) are not treated as further manufacturing and do not trigger FET. Installation of the following items are treated as "mere combination":

- coupling devices, including fifth wheels
- wrecker cranes
- loading and unloading equipment (including cranes, hoists, winches and power liftgates)
- aerial ladders or towers
- snow or ice control equipments
- spreaders
- sleeper cabs
- cab shields
- wood or metal floors

F. **NOTE: Special price rules apply to further manufacturing (see section VI, below).

VI. TAXABLE PRICE

A. Taxable price includes **total consideration** paid for taxable articles in question. NOTE: Be sure to provide justifiable allocation of purchase price between body and chassis if one component is taxable and the other is not.

B. Deductions from sales price for FET computation.

- state or D.C. sales tax

- **cost of transportation or delivery** from seller's place of business to the purchaser. NOTE: On distributor sales in which the goods are shipped directly from the manufacturer to the customer, delivery charges can be deducted only to the extent they exceed the charge that would have been imposed to deliver the goods from the manufacturer's facility to the distributor. Rev. Rul 86-68.

- **Fair market value of tires.** NOTE: If the retailer makes separate sales of the tires in question, it must use its lowest established retail price for such tires as its fair market value of the tires. If the retailer does not make separate sales of such tires, and therefore has no established price, the retailer may use the tire manufacturer's predetermined price list, which is published in accordance with Federal Trade Commission rules under 16 C.F.R. § 228.16 in connection with advertisement of tire warranties. If the tire manufacturer for the tire in question has not published a predetermined price list, the retailer may rely on the predetermined price list price for a competitive tire of comparable size with appropriate adjustment for the difference in the cost of the two tires (i.e., the ratio of the fair market value to the seller's cost should be the same for both tires). Rev. Rul. 86-93.

- **installation charges,** which must be reasonable and supportable. See Rev. Rul. 87, 1953-1; Rev. Rul. 57-253. The IRS has provided very little guidance in this area, and sellers should be sure to document carefully all deductions for installation. NOTE: installation charges cannot

be deducted in the sale of a complete vehicle that has a taxable body and chassis.

C. **NOTE: Leases and direct sales -- for new truck bodies and chassis and new tractors, on and after October 1, 1987, the sale price for FET purposes on long-term leases and sales direct from a manufacturer must be marked up by four percent (4%) (the so-called "presumed markup percentage").

D. Tax triggered by use of taxable article following its manufacture or importation is based on lowest established retail price if the taxpayer sells such articles in the ordinary course of business. If a person manufacturers and uses a taxable article that it does not sell, the taxable price equals the cost of the parts and accessories, plus 150% of the labor costs (including overhead). Rev. Rul. 86-130 (ruling addressing glider kits, which should have general application).

E. If a distributor further manufactures a customer's vehicle, the customer must pay tax based on the cost to the customer (exclusive of used components supplied by the customer for their intended purpose). Rev. Rul. 86-130.

Truck Trailer Manufacturers Association

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PRESIDENT

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July 21, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways & Means
United States. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

The following statement is submitted on behalf of the Truck Trailer Manufacturers Association specifically relating to the proposal to move the 12% Federal Excise Tax on heavy trucks and trailers from the first retail sale to the sale by the manufacturer.

TTMA is an international organization serving the manufacturers of heavy duty truck trailers. Our member companies build all types of commercial trailers and our associate members are the suppliers of components and material for trailer manufacturing. TTMA trailer manufacturing companies account for approximately 90% of United States trailer production.

Changing the incidence of excise tax on heavy trucks and trailers from the first retail sale back to the sale by a manufacturer raises a number of questions which are not addressed in the Joint Committee on Taxation's Description of Miscellaneous Tax Proposals on page 115.

For example, when the tax was at the manufacturer's level prior to April 1, 1983, the threshold was 10,001 pounds. The current threshold on trailers and semitrailers is 26,001 pounds. Also, the current tax rate is 12% on the first retail sale but prior to April 1, 1983 the tax rate was 10% at the manufacturer's level.

If it is the Committee's intent to maintain revenue neutrality on tax code changes then we believe that the issues noted above should be the subject of separate hearings so that all interested and affected parties might have the opportunity to present their views.

We would be pleased to furnish any additional information which the Committee might desire.

Sincerely,

Richard P. Bowling
President

RPB/lw

TESTIMONY OF FORD N. KYES
ASSOCIATION OF AIR MEDICAL SERVICES

Statement of the Impact of
the Federal Aviation Excise Tax on Air Ambulances

Each year a large number of people living in rural or remote areas suffer serious injuries or illnesses. Fortunately, doctors have access to specially equipped and staffed air ambulances which provide transportation to trauma, burn, cardiac or other acute care facilities. The speed of the transport and the quality of care the patients receive ensures recovery.

Unfortunately, these patients discover that they are treated as airline passengers for tax purposes and a 10 percent "ticket tax" is added to the aviation cost of their transport. The Federal government raises only $5 million a year from taxing trauma patients, but the added health care cost to individuals and administrative burden on the provider can be enough to "break the camel's back."

This statement will address the impact of the Federal aviation excise tax on critically ill or injured patients, access to rural health care and air medical services.

Background

The Association of Air Medical Services (AAMS) comprises hospital, public agency and private sector operators of air ambulances. These air ambulances, both fixed-wing and helicopter, transport more than 175,000 patients annually. Their availability supports the concept of regionalized health care and compensates for the large number of hospital closures.

An air ambulance is a specially equipped and medically staffed rotor- or fixed-wing aircraft used to transport critically ill or injured patients to a higher level of care. Almost every county in the country either has an air medical program located there or is supported by one. The growth and role of air medical services cannot be overstated.

Present law assesses a 10 percent excise tax on domestic commercial air transportation of individuals. Certain emergency medical transportation flights are currently exempt from the tax (air ambulances which do not utilize facilities or services eligible for assistance under the Airport and Airway Development Act of 1970, have a certified takeoff weight of less than 6,000 pounds or are not operated on an established [scheduled] line are exempt from the tax). Those air medical flights which are not exempt are primarily fixed-wing or centrally-located helicopter air ambulances in very rural or remote locations.

Congress last addressed this portion of the Internal Revenue Code in 1987. However, the regionalization of health care, which drives efficiency, and the large number of hospital closures have increased the use of fixed-wing or centrally-located rotor wing air ambulances. Now we have inconsistent tax treatment of similar patients simply because they live in rural or remote areas. Simply put, some patients are covered by the tax while others are not.

Congressman Wally Herger from California has introduced a bill, H.R. 635, that would correct this problem. It has received extensive bi-partisan support from Members of the House Ways and Means Committee. In addition to the support of the Association of Air Medical Services, H.R. 635 has also been endorsed by the National Association of EMS Physicians, the American College of Emergency Physicians, Helicopter Association International and the National Air Transport Association. A similar bill in the Senate, S. 358, introduced by Senators Howell Heflin and Trent Lott, has also received broad support.

Evolution of Air Medical Transport

Air medical transportation has evolved to provide rapid access and transportation to critically ill or injured patients over large geographic regions. Throughout the 1980's, air ambulance systems pioneered the concept of regionalized emergency care while augmenting and enhancing existing community based ground ambulance systems. Rapid access combined with critical care during transport to tertiary centers has directly contributed to improved outcomes for critically ill patients.

The air ambulance was first used for medical transportation during the Korean War. The decreased mortality rate of 2.4 percent in Korea, compared to 5.8 percent in World War II, has been attributed in part to the concept of direct transportation from the battlefield to a mobile army surgical hospital. Further reduction in overall mortality occurred during the Vietnam War, despite the use of more advanced weapons with more destructive power. The Huey helicopter in Vietnam was larger than those used in Korea and could carry an advanced life support (ALS) crew. The medical crews in Vietnam were trained in advanced life support and started intravenous lines in the field.

Rapid medical transport was slowly integrated into the civilian environment in the early 1960's. St. Anthony's Hospital in Denver instituted the first continuously operating civilian hospital-based helicopter program in 1972. Since that beginning over twenty years ago, civilian air medical transport has grown significantly. As of June 1995, there are over 300 rotory- and fixed-wing air medical programs in operation.

Recent years have seen the proliferation of fixed-wing air ambulances as a result of health care regionalization and hospital closures. The geographic distances between rural and community hospitals and acute care facilities have grown dramatically. Due to their greater range, fixed-wing air ambulances are particularly well equipped to perform this role. Fixed-wing air ambulances also have greater all weather capability and can provide medical transportation in many instances where helicopters are prevented from flying. Generally, fixed-wing aircraft have additional capability due to their larger space which allow for greater medical staffing and equipment flexibility. Since the regionalization and hospital closure trend will continue, the growing reliance on fixed-wing air ambulances is also likely to continue.

Improved Access Through the Use of Air Medical Transport

Many rural communities cannot maintain the specialized services and facilities required for critically ill and injured patients. Data from the American Hospital Association show that 940 hospitals permanently closed between 1980 and 1993. Of this total, 675 were community hospitals. The state of Texas had 124 community hospital closures, almost twice the number of any other state during the same period. Air medical transport has a proven record of offsetting many of these closures.

Air medical transport often represents the only access patients in rural communities have to advanced life support (ALS) care. Rural and wilderness areas are often medically-underserved by even basic-level emergency ambulance support. These aircraft carry clinical services and equipment to the patient for the initiation of sophisticated medical care specific to the patient's needs before the patient arrives at the destination hospital. This care is provided under the direction of specialists in emergency medicine and intensive care. In this manner, the aircraft fill the inevitable gap left by rural hospital closures. Patients directly benefit from the equipment and advanced clinical capabilities they receive early on.

The effective transport time to get the critically ill or injured person to definitive care is drastically reduced by air medical transport. Trauma patients and cardiac patients, both of which are time-sensitive medical conditions, have significantly benefited through accessing sophisticated care during the "golden hour" via air medical transport. Thus, the aircraft and their medical teams complement and most often exceed the clinical capabilities of rural health care facilities.

Federal Aviation Excise Tax Has Negative Impact

Air ambulance flights are reimbursed by Medicare, Medicaid, CHAMPUS, state programs, hospitals, insurance plans and individuals. Since air ambulances are reimbursed for providing this service, they are considered charter operators, and are therefore required to pay the 10 percent tax for aviation services imposed by IRS Code Section 4261. Certain emergency medical transportation flights are currently exempt from the tax (air ambulances which do not utilize facilities or services eligible for assistance under the Airport and Airway Development Act of 1970, have a certified takeoff weight of less than 6,000 pounds or are not operated on an established [scheduled] line are exempt from the tax). Air ambulances which do not meet the exemption are generally fixed-wing or centrally located, airport-based rotor-wing.

Revenues raised by the Federal aviation excise tax required by IRS Code Section 4261 are contributed to the Airport and Airway Trust Fund. Trust fund revenues finance airport improvement grants, facilities and equipment, research, and a portion of operations. The Joint Tax Committee has estimated that air ambulances contribute $6 million annually to the Airport and Airway Trust Fund, which totaled nearly $6.3 billion during fiscal year 1994. Furthermore, it is estimated by the Congressional Budget Office that $1 million of the $6 million contributed by air ambulances each year are paid by other Federal government health programs such as Medicare which results in a net impact on the Federal government of $5 million annually. In addition, state health plans are also subject to the tax resulting in further negative impact on government health costs.

Even though the total portion of tax revenue generated by air ambulances is small compared to airlines -- with approximately 45,000 covered air medical transports compared to 500 million commercial and charter passengers -- the financial burden on patients and their health care providers is significant.

Furthermore, since as many as half of all flights are reimbursed from government programs such as Medicare, Medicaid, CHAMPUS and state plans, the tax revenue generated is often simply one government agency paying a tax to another with an air ambulance program acting as tax collector. Even though airlines pass this tax on to their paying customers, an air ambulance tax is passed on to the payor regardless of whether or not that payor is another government program such as Medicare.

Conclusion

The current language treats patients on fixed-wing and many helicopter air ambulances as if they were passengers on commercial flights which require them to pay the Federal aviation excise tax.

- When this law was passed the intent was surely not to further tax patients who are critically ill or injured

- Since as much as one-third of all health care expenditures are from government health programs (Federal and state), nearly 1/3 of the excise tax contributions are coming from one government agency or another (this is a tax that the government is largely paying itself)

- Air medical transport is a resource to ensure access in rural areas to emergency and trauma care. The administrative burden and cost of the excise tax is an unnecessary impediment

- The total cost to the Federal government is small (Joint Tax Committee states air ambulances will contribute about $6 million in FY 1996. The Congressional Budget Office is conducting an analysis of the cost to Federal programs paying the tax. This is estimated to be $1 million annually, resulting in a net reduction in revenue of only $5 million)

Congress is encouraged to adopt the language in the Herger bill. It will make the tax treatment of air ambulance patients consistent, allow for the continued development of regionalized health care, off-set many hospital closures and have an almost insignificant impact on Federal revenues.

Thank you for your consideration of this important issue.

TESTIMONY SUBMITTED FOR THE RECORD BY REP. JIM MCDERMOTT (D-WA) IN SUPPORT OF H.R. 1138.

COMMITTEE ON WAYS AND MEANS HEARINGS OF MISCELLANEOUS TAX REFORMS JULY 11, 1995

Chairman Archer and Members of the Committee:

Thank you for holding these hearings. I am submitting this testimony in support of H.R. 1138, legislation I introduced with Rep. Jennifer Dunn (R-WA) which will roll back the Harbor Maintenance Tax (HMT) and provide truth in budgeting. This legislation is very important to me and the people of Seattle. The HMT raises much more money than is needed for harbor maintenance and the Harbor Maintenance Trust Fund contains a huge surplus which is hurting our ports and being used to reduce the size of the federal deficit. The current high tax rate raises the cost of U.S. exports and encourages shippers to divert cargo to Canadian ports where no such tax is collected. The HMT rate should be rolled back or reduced so that it raises only 100% of the costs of harbor maintenance.

The Water Resources Development Act of 1986 established a HMT of 0.04 percent of cargo value to pay for 40 percent of the harbor maintenance activities of the Army Corps of Engineers. In 1990, the Bush Administration proposed raising the tax rate to 0.125 percent of cargo value to pay for 100 percent of harbor maintenance work (0.115 percent) and certain extraneous activities (0.01 percent) of the National Oceanic and Atmospheric Administration (NOAA). The 1990 budget agreement approved the full tax rate increase but rejected the diversion of the trust funds to NOAA.

Harbor Maintenance Trust Fund revenues have increased much faster than expenditures as a result of increased trade, stricter enforcement of the tax, fairly constant Corps harbor maintenance appropriations and the artificially high HMT rate. The surplus in the trust fund grew from $120.6 million at the end of FY 1992 to $302.3 million at the end of FY 1993 to $451.4 million at the end of FY 1994. The Administration projects that the trust fund surplus will grow to $644.3 million by the end of FY 1995 and $802.9 million by the end of FY 1996.

In FY 1994, the Harbor Maintenance Trust Fund distributed $497.1 million for harbor maintenance activities by the Army Corps of Engineers, but collected $646.2 million, or 130% of expenditures. With the additional funds for enforcement of the HMT included in the implementing legislation for GATT, the trust fund surplus may grow even faster in the coming years.

This growing surplus is especially disturbing because of the way the HMT harms the competitiveness of U.S. exports in the international marketplace and diverts cargo to Canadian (and potentially Mexican) ports where no such tax is collected. For example, on all import containers coming into the Port of Seattle, the HMT adds an average cost of $108 per container, taxes which a shipper does not have to pay if he routes the cargo through a Canadian port.

The HMT is especially burdensome to U.S. ports in the Pacific Northwest, Great Lakes region and the Northeast which compete directly with nearby Canadian ports. The burden is even greater for northern ports like Seattle, Tacoma and Boston that need very little harbor maintenance. The Ports of Seattle and Tacoma estimate that their shippers annually pay OVER $50 million in harbor maintenance taxes while the ports receive LESS THAN $1 million annually in harbor maintenance -- this amounts to less than two cents back on the dollar!

The growing trust fund surplus may also violate Article II of the GATT which only permits "fees or other charges," on trade which are "commensurate with the cost of services rendered." Several European nations have expressed concern to the U.S. government about this possible GATT violation.

This legislation would roll back the HMT as follows:

1.) Reduce the harbor maintenance tax rate by 0.02 percentage points in three successive years to 0.65 percent of cargo value; and

2.) Provide that in any year thereafter that begins with a Harbor Maintenance Trust Fund balance of under $100 million, the HMT rate will be increased by 0.01 percentage point, and that, in any year that begins with a trust fund balance of <u>over</u> $100 million, the tax rate will be decreased by 0.01 percentage point.

This method will ensure that the Harbor Maintenance Trust Fund will always have a positive, but <u>medium-sized</u>, balance. The trigger provision would probably not come into play for 6 - 8 years. The Hazardous Substance Superfund and the Oil Spill Liability Trust Funds operate with similar triggers.

A rollback of the Harbor Maintenance Tax is supported by many shippers, carriers and ports involved in international trade. This legislation would be a modest step to control the growing surplus in the Harbor Maintenance Trust Fund and check the deleterious effects of the Harbor Maintenance Tax.

STATEMENT OF J. VERNON HINELY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CARBONIC INDUSTRIES CORPORATION
on the
ELIMINATION OF THE UNINTENDED TAX SUBSIDY FOR CARBON DIOXIDE PRODUCED AS A BY-PRODUCT OF ETHANOL
submitted to the
HOUSE COMMITTEE ON WAYS AND MEANS
for the record of the hearings on Miscellaneous Tax Reforms
July 11-12, 1995

The Congress never intended to subsidize the production of carbon dioxide, yet that is exactly what has occurred as a result of the Gas tax exemption for ethanol and related provisions of the Internal Revenue Code. I and others in the carbon dioxide industry strongly urge, as a matter of fundamental fairness, the enactment of legislation to "back out" the cost advantage that ethanol producers obtain when they co-generate CO2 for sale in the retail market. These tax subsidies should be reduced, because a federal subsidy is unnecessary to the extent current law already enables ethanol producers to supplement their revenues by selling CO2 at retail.

I. THE CARBON DIOXIDE INDUSTRY MATURED WITHOUT THE AID OF FEDERAL SUBSIDIES

A mature (half billion dollar a year) CO2 market developed in this country without the benefit of federal government subsidies. Refined CO2 has countless commercial applications, including food preservation, beverage carbonation, water treatment, and firefighting. Because there are few natural CO2 gas wells, the primary source of CO2 is as an industrial by-product, particularly from ammonia production and petroleum refining.

CO2 is a gas that is found naturally in our atmosphere. The commercial production of CO2 begins with CO2 in a gaseous state; liquid CO2 is produced by cooling and compressing carbon dioxide gas under high pressures. Below -69.9 degrees Fahrenheit, liquid CO2 freezes to form a solid (known commonly as "dry ice").

It is uneconomic to transport crude CO2 gas, even over a distance as short as a quarter of a mile. For this reason, CO2 refining operations[1] are located at the source -- that is, a CO2 company's recovery and processing equipment must be connected to an unrelated supplier's industrial plant. The economics of transporting raw CO2 also explains why there is no national wholesale market for this commodity; instead, there are overlapping regional wholesale markets.

The aggregate wholesale market is a "seller's market," characterized by sharp competition for reliable streams of CO2 of sufficient purity and volume. Not surprisingly, longterm "take or pay" supply contracts are prevalent. The typical CO2 supply contract has a term of 15 years and calls for a fixed price.

II. THE ETHANOL MARKET AS WE KNOW IT TODAY WOULD NOT EXIST BUT FOR FEDERAL TAX SUBSIDIES.[2]

Ethanol is an alcohol that may be produced from a variety of feedstocks, although about 95 percent of current ethanol production is derived from corn. Beginning in 1978, the Congress enacted five tax incentives to encourage the use of ethanol in gasoline and

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[1] A merchant liquid carbon dioxide plant consists of filtration, compression, and refrigeration equipment with related controls, instrumentation, and storage.

[2] The market information in this section was drawn from a recent analysis of the Federal tax incentives for ethanol: Alcohol Fuels Tax Incentives and EPAs Renewable Oxygenate Requirement, by Salvatore Lazzari, Specialist in Public Finance, Economics Division, Congressional Research Service, The Library of Congress (94-785 E) October 7, 1994.

diesel: (a) exemptions from the motor fuels excise taxes on gasoline and diesel (generally referred to as the "Gas tax"); (b) a blender's tax credit; (c) a small ethanol producers tax credit; (d) tax deductions for clean-fuel burning vehicles; and (5) the alternative fuels production tax credit. Since the enactment of the first Gas tax exemption, the ethanol fuels market has expanded from a few million gallons per year prior to 1978 to over a billion gallons per year today.[3]

A. The Gas Tax Exemption Has Been The Most Effective Federal Tax Incentive In Stimulating Ethanol Production.

The Gas tax is imposed at the rate of 18.4 cents per gallon on gasoline and 24.4 cents per gallon on diesel used in highway motor vehicles. 11.5 cents of the 18.4 cents rate (17.5 cents of the diesel tax rate) finances the Highway Trust Fund.[4] While the Gas tax has always had an expiration date (and is currently scheduled to expire on October 1, 1999) it has always been extended before expiration.

1. **The Internal Revenue Code Provides For Three Tiers Of Exemptions, Depending On The Percentage Of Ethanol Per Gallon Of Gasoline.**

Gasohol -- blends of gasoline and ethanol that are at least 10 percent ethanol -- is exempt from 5.4 cents of the 18.4 cents Gas tax; thus, gasohol is taxed at only 13 cents per gallon. Mixtures of gasoline and ethanol that are at least 7.7 percent ethanol are exempt from 4.16 cents of the Gas tax, and mixtures that are 5.7 percent ethanol are exempt from 3.08 cents of the Gas tax. Straight alcohol fuels also qualify for Gas tax exemptions. Ethanol that qualifies for the Gas tax exemption must meet two definitional requirements. First, the ethanol cannot be derived from petroleum, natural gas, or coal (including peat). Secondly, the ethanol must be at least 190 proof (or, 95 percent pure alcohol, determined without regard to any denaturants). The Gas tax exemptions for ethanol expire after September 30, 2000.[5]

2. **The Economic Benefit Of The Gas Tax Exemption Goes To Ethanol Producers.**

The Gas tax is levied -- and the exemption is claimed -- at the time gasoline is removed from a "terminal" (a gasoline storage and distribution facility that is supplied by pipeline or vessel). Although the owner of the gasoline (e.g., a major oil company) is liable for the Gas tax, it is the ethanol producer that receives the economic benefit of the Gas tax exemption. This is so because ethanol producers set their prices to be equal to the Federal tax subsidy plus the current price of unleaded gasoline[6]. Further, it is the invoice supplied by the ethanol producer that the Internal Revenue Service ("IRS") relies on in determining whether taxpayers that claimed Gas tax exemptions have complied with the definitional requirements as to source and proof of ethanol.

Note that the IRS's acceptance of an ethanol producer's invoice as proof of compliance with source and purity requirements is not misplaced. Because ethanol

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[3] Further Administrative actions by the Environmental Protection Agency ("EPA") and Internal Revenue Service ("IRS") artificially increase the demand for ethanol. First, the EPA interpreted the Clean Air Act as giving it discretion to require that a portion of required oxygenates be derived from renewable resources, and mandated 30 percent; the U.S. Court of Appeals for the District of Columbia, however, struck down this rule on April 28, 1995. The EPA requirement effectively mandated the use of ethanol, as the technology for producing the alternative -- methanol from biomass -- is experimental and uneconomic at present; if the court case is not appealed, the case would not prevent refiners from using etanol voluntarily. Secondly, the IRS has ruled that ETBE (Ethyl Tertiary Butyl Ether, a compound --not an alcohol-- resulting from a chemical reaction between ethanol and isobutylene) qualifies for the blenders tax credit noted above.

[4] The other components of the 18.4 and 24.4 cents tax rates are a 6.8 cents Deficit Reduction rate and a .1 cent Leaking Underground Storage Tank ("LUST") rate.

[5] Regarding the difference between the dates of expiration of the Gas Tax and the exemptions, the exemptions have always been drafted to expire after the Gas Tax

[6] See page 5 of the 1994 CRS analysis cited in note 2, above.

producers are makers of alcohol, they are closely monitored by the Bureau of Alcohol, Tobacco, and Firearms ("ATF"). Thus, the IRS can be fairly confident that an ethanol producer will have few (if any) opportunities to engage in noncompliance.

B. Ethanol Tax Credits Are Available In Lieu Of the Gas Tax exemption.

The "Blenders" credit is 54 cents per gallon of ethanol that is used in a mixture of alcohol and gasoline and sold as a fuel or used by the blender in its trade or business as a fuel. A separate 10 cents per gallon credit is provided for small ethanol producers (defined as one with ethanol production capacity of not more than 30 million gallons per year). A 54 cents per gallon credit is also available for straight ethanol. While the Gas tax exemption reduces revenues to the Highway Trust Fund, the ethanol credits reduce general revenues.

The alcohol fuel credits are designed to provide the same economic benefit as the 5.4 cents Gas tax exemption. Generally, a taxpayer has the choice of the credit or the exemption, but not both.[7] Taxpayers prefer the Gas tax exemption over the income tax credit, primarily because the exemption provides an immediate tax benefit while the credit is not claimed ~~until an~~ income tax return is filed (and is useful only to the extent of tax liability). Further, the exemption is more profitable, because the amount of credit is subject to tax and so the after-tax benefit is reduced to 35 cents per gallon (a 54 cents credit minus the 54 cents included in income and taxed at the 35-percent corporate income tax rate).

C. The Ethanol Industry Is Now Using Its Government Subsidized Cost Advantage to Compete In The Retail CO2 Market.[8]

Fermentation of grain in an ethanol plant generates CO2: 6.8 pounds of CO2 are produced per gallon of ethanol.[9] Utilizing their enormous capacity to generate CO2, ethanol producers are competing directly with traditional CO2 companies selling at retail [10] The vast quantities of CO2 available to ethanol producers is a direct but unintended consequence of the Federal tax subsidies for ethanol. Because ethanol producers source their raw CO2 from themselves at virtually no cost,[11] they enjoy a competitive edge over traditional CO2 companies that purchase and refine CO2 without the benefit of a Federal tax subsidy.

III. A FEDERAL TAX SUBSIDY IS UNNECESSARY TO THE EXTENT CURRENT LAW ALREADY ENABLES ETHANOL PRODUCERS TO SUPPLEMENT THEIR REVENUES BY SELLING CO2 AT RETAIL.

A. Groundwork For A Corrective Amendment Was Laid During The Last Congress.

The unintended effect of ethanol subsidies on the CO2 industry was the subject of a hearing during the last Congress where I testified before another subcommittee of the Ways and Means Committee.[12] Further, the staff of the Joint Committee on Taxation ("Joint Tax") did some preliminary work on estimating the revenue that could be raised by backing out the unintended tax subsidy for ethanol-based CO2. The proposal

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[7] A mixture that is more than 10 percent ethanol is eligible for both the exemption and the credit, but in such a case the credit is reduced by the amount of the exemption.
[8] See "Fed Subsidy a Gas for one Biz, a Fizzle for Other," Crain's (Metro Chicago's Business Authority) Sept. 12-18, 1994.
[9] As calculated by the Congressional Research Service in the memorandum, dated February 15, 1994, entitled "Carbon Dioxide from Ethanol Production" by David E. Gushee, a senior fellow in environmental policy.
[10] See "Improve Ethanol Project Economics With Carbon Dioxide Recovery Capability," from the Sept./Oct. 1993 issue of Fuel Reformulation magazine.
[11] See the Congressional Research memorandum cited in note 9, above.
[12] See "Testimony of J. Vernon Hinely, Chairman and Chief Executive Officer of Carbonic Industries Corporation, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, on September 23, 1993."

described herein does not involve the imposition of a new tax and would be designed to enhance revenues.

B. Current Law Should Be Amended To Reduce The Ethanol Tax Incentives By An Amount That Corresponds To The Advantage Gained In The Retail CO2 Market.

1. The Proposal Would Provide Reduced Exemption Rates For Ethanol That Is Co-generated With CO2, (Just As Current Law Already Provides Different Rates Depending On The Percentage of Ethanol).

Except in the case of alcohol produced by small ethanol producers, the proposal would provide different rates for ethanol that is co-generated with marketable quantities of refined CO2. The invoice rendered by an ethanol producer would indicate whether the alcohol was co-generated with CO2 for sale at retail. Just as under current law, ATF monitoring of ethanol production facilities should obviate any concern about non-compliance with the proposed definitional requirement. In this regard, note that the logistics of recovering and refining CO2 requires the location of a merchant liquid CO2 plant at the site of the ethanol production facility. (In contrast, the sale of CO2 by-product as crude gas eliminates much of the capital and operating expense associated with refining CO2 for sale at retail).

While it is clear that ethanol producers would have little opportunity to engage in fraud, I understand that the Internal Revenue Service has raised questions about the potential for fraud on the part of "Blenders." In response to this concern, I would support the inclusion of a provision to strengthen the existing penalties applicable to Blenders. Based on informal conversations between my representative and Treasury, I understand that Treasury would not object to this approach. Further, given the government's experience with recently enacted penalties for dyed fuel, it is fair to assume that enhanced penalties would deter fraud if only because they would serve to increase the awareness of the applicable rules. Specifically, I would model the penalty after the existing rules for dyed fuel, imposing a penalty equal to the greater of $1,000 or $10 for each gallon of fuel involved in a violation of the proposed rules applicable to ethanol that is co-generated with carbon dioxide.

2. The Reduced Rates Would Be Designed To Enhance The Revenue Raised By The Proposal.

In the first instance, the reduced exemptions would not be prohibitive; that is, the rates should be set so ethanol remains competitive with other oxygenates (such as methanol). At the same time, the exemptions should take into account the supplemental revenues generated by retail sales of CO2, because it is in the retail market that ethanol producers realize the cost advantage made possible by the Federal tax subsidy.

As a starting point, the cost advantage enjoyed by ethanol producers can be quantified as follows:

(a) The average purchase price of crude CO2 is $15 per ton (exclusive of transportation and other indirect costs);

(b) It takes 294 gallons of ethanol to produce a ton of CO2 (6.8 pounds of CO2 is produced for every gallon of ethanol; and two thousand pounds divided by 6.8 is equal to 294); thus,

(c) For every gallon of ethanol, a producer saves 5 cents (**$15 -- the per ton purchase price for crude CO2 -- divided by the 294 gallons of ethanol required to produce a ton of CO2**).

While the 5 cents per gallon savings is a clearly identifiable cost advantage that ethanol producers have over traditional CO2 companies, the revenue estimate should assume the rate reduction that would result in the smallest decline in production of ethanol-based CO2.

3. Conforming Amendments To The Ethanol Tax Credits Would Be Necessary.

Because the ethanol tax credits are designed to be equivalent to the Gas tax exemptions, the credits should be conformed to the applicable rates for ethanol that is co-generated with refined CO2

IV. CONCLUSION

. As a matter of fairness and equity, I urge the enactment of the proposal that would mitigate the effects of the ethanol tax subsidy on the carbon dioxide industry by reducing the tax subsidies for ethanol that is produced as part of a process that includes co-generating and refining carbon dioxide for sale at retail.

Statement of
H.P. BULMER HOLDINGS P.L.C.

Before the
COMMITTEE ON WAYS AND MEANS

Submitted for the Record for Hearings on
Miscellaneous Tax Reforms
July 11, 12 and 13, 1995
Washington, D.C.

Executive Summary

H.P. Bulmer Holdings P.L.C. ("Bulmer") is pleased to provide this written statement for the July 11-13, 1995 hearings of the Committee on Ways and Means on miscellaneous tax reforms.

Bulmer, along with a growing list of supporters from more than 12 states and including nine directors of state Departments of Agriculture, strongly supports enactment of a proposal to clarify the excise tax statutes to tax "draft cider" similar to beer. This proposal is set forth as Excise Taxes, Item #13 of the House Ways & Means Committee Release No. FC-8 dated June 30, 1995.

A similar proposal was recently introduced in Congress by Congressmen English, Neal, Houghton and Dooley as H.R. 2078, a bill to clarify the excise tax treatment of draft cider. Earlier this year, Senators Leahy and Jeffords introduced a similar bill, S. 401, in the Senate. That proposal was scored by the Joint Committee on Taxation ("JCT") as having an impact on Federal budget receipts of less than $1 million per year.

The draft cider proposal is a minor, non-controversial tax reform which has wide bi-partisan support and which has been scored by JCT as having a negligible revenue impact (less than $1 million per year). It should be enacted into law as soon as possible.

Proposal

The draft cider proposal as set forth in H.R. 2078 would amend the excise tax provisions of the Internal Revenue Code of 1986 to clarify that "draft cider" is to be taxed similar to beer.

Background

Draft cider has a long history in the United Kingdom, Europe and other places of the world as a long drink served as an alternative to beer. It is one of the oldest categories of alcoholic beverages in North America and through the 19th Century was sold equally with beer. Recently, draft cider has once again become a popular beverage in the United States.

Beer and draft cider have many of the same characteristics, all of which are distinguishable from wine. For example, beer and cider are often sold on draft from kegs, in bottles or in cans. Their serving size is typically 12 ounces and their alcoholic content is generally below 7 percent of alcohol by volume. Other similar characteristics such as distribution, packaging, filtration and fermentation are set forth in Attachment A.

Wine on the other hand, is generally served by the glass, has an alcoholic content of between 12% and 20%, and has an indefinite shelf life. A listing of characteristics which distinguish beer/cider from wine is set forth in Attachment B.

Despite the fact that beer and cider are similar in almost all respects, the Federal excise tax laws presently tax apple cider (regardless of its alcohol level) as a wine, subject to a tax of $1.07 per wine gallon; by contrast, beer is taxed at approximately $0.58 per barrel. A lower tax rate applies to beer produced by a small brewery and, by way of a tax credit, to wine produced by a small winery.

This tax treatment creates an artificial barrier to the growth of draft cider and has a negative impact on apple growers and processors throughout the country. A minor tax reform change is needed to allow cider producers and apple growers to compete fairly with comparable beverage makers and suppliers.

H.R. 2078, S.401, and the tax reform proposal being considered by the Ways & Means Committee would provide a new tax rate of 22.6 cents per gallon for draft cider containing at least one-half of 1 percent and not more than 7 percent of alcoh
ol by volume.

This tax change is absolutely necessary in order for draft cider to compete fairly with beer and other beverages, and to allow for the growth and prosperity of apple growers and processors throughout the United States.

Other Background

H.P. Bulmer Holdings P.L.C. is a U.K. producer of various beverages, including draft cider. Bulmer and its subsidiaries export draft cider to several countries, including the U.S. It is joined in supporting H.R. 2078 by constituents from throughout the U.S., including the directors of many state Departments of Agriculture and the chief officers of several U.S. agricultural concerns, including wineries, cider producers and apple producers.

Recommendation

Enact H.R. 2078 as soon as possible.

ATTACHMENT A

BEER AND CIDER MANUFACTURING PROCESSES

OPERATION	BEER MANUFACTURING	CIDER MANUFACTURING
Package Size	Draft, bottle and can	Draft, bottle and can
Serving Size	12 oz.	12 oz.
Alcohol Content	3-5% Abv	3-5% Abv
Consumer	M/F 21-65+ Long drink refreshment	M/F 21-65+ Long drink refreshment
Distribution	Bars/pubs/supermarkets/hotels/restaurants	Bars/pubs/supermarkets/hotels/restaurants
Packaging	Carbonated and packaged into bottles, cans and kegs	Carbonated and packaged into bottles, cans and kegs
Filtration	Filter sheets or Kieselguhr	Filter sheets or Kieselguhr/microfiltration
Conditioning	Lagering	Maturation
Fermentation	Addition of yeast and temperature control	Addition of yeast and temperature control
Wort/Juice Sterilisation	Heat treatment - boiling	Heat treatment - pasteurisation and/or sulphur dioxide addition
Adjunct Addition	Modified wheat/maize grains = Glucose syrup	Glucose syrup from modified wheat/maize grains
Collection of Wort/Apple Juice	Collection of initial runnings from lauter tun followed by sparging for 1st and 2nd runnings	Pressing of apples first and second time to extract apple juice
Milling	Malted barley + cereal	Apples

ATTACHMENT B

WINE AND CIDER/BEER CHARACTERISTICS

NO.	ITEM	WINE	CIDER/BEER
1.	Alcohol content	12% to 20%	3% to 5%
2.	Serving size	Glass	Pint/Draft
3.	Vintage Identification	Yes	No
4.	Shelf Life	Indefinite	1 year
5.	Production	Seasonal	Batch
6.	Retail Shelf Position	Separate from beer	Intermingled

Testimony Of U.S. Senator Patrick Leahy
On The Tax Treatment Of Hard Apple Cider
House Committee On Ways And Means
Hearings On Miscellaneous Tax Reforms
July 11 and 12, 1995

I want to thank Chairman Archer and the Members of the Ways and Means Committee for holding these hearings

I am a strong supporter of revising the federal excise tax on hard apple cider, more commonly known as draft cider, to beer tax rates. As the ranking member of the Senate Agriculture Committee, I believe this small revision to our federal excise tax law will stimulate the apple industry throughout the United States.

Draft cider is one of the oldest categories of alcoholic beverages in North America. Back in colonial times, nearly every innkeeper served draft cider to his or her patrons during the long winter. In fact, through the 19th Century, beer and draft cider sold equally in the U.S.

Recently, draft cider has once again become a popular beverage. Current tax law, however, unfairly taxes draft cider at a much higher rate than beer despite the two beverages similar alcohol levels. This tax treatment, I believe, creates an artificial barrier to the growth of draft cider. I have introduced a bill in the Senate, S. 401, to correct this inequity.

Present law taxes draft cider, regardless of its alcohol level, as a wine at a rate of $1.07 per gallon. My legislation and the proposal before the Ways and Means Committee would clarify that draft cider containing not more than 7 percent alcohol would be taxed at the beer rate of 22.6 cents per gallon.

I believe this tax change would allow draft cider producers to compete fairly with comparable beverage makers. As draft cider grows in popularity, apple growers and processors across the country should prosper because draft cider is made from culled apples, the least marketable apples.

About 20 percent of U.S. apple production is graded as culled apples. The growth of draft cider should convert these least marketable apples into a high value product, helping the nation's struggling apple farmers. Indeed, I have received letters from officials at ten state agriculture departments--Arizona, Connecticut, Georgia, Maine, Massachusetts, New Hampshire, New York, Pennsylvania, Vermont and Virginia--supporting the taxing of draft cider at the beer rate because this change would allow apple farmers and processors in their states to reap the benefits of an expanded culled apple market.

I have also heard from the Northeast McIntosh Apple Growers Association, the New York Apple Association and many apple farmers, processors and cider producers that support revising the excise tax on draft cider.

I believe this small tax change will have a large positive impact on the nation's apple industry. I urge my House and Senate colleagues to support it.

TODHUNTER INTERNATIONAL
INCORPORATED

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg
Washington, DC 20515

July 25, 1995

Dear Mr. Moseley:

We, Todhunter International, Inc., Canandaigua Wine Company and Meier's Wine Cellars, Inc., hereby express our strongest possible objections to the Miscellaneous proposal #14 under "Excise Taxes", which would "expand the tax credit for alcohol derived from fruit that is blended into distilled spirits to include alcohol from other agricultural products (e.g. whey)."

The proposal is targeted tax relief and a rifle shot of the worst kind. It would benefit only Monarch Wine Company of Georgia and is identical to H. R. 1435 introduced on April 16th by Congressman John Lewis (D-GA).

The provision would expand the definition of a permissible wine spirit authorized to be used in wine production by amending Section 5373(a) of the Internal Revenue Code. Wine spirits are used to raise the alcohol content level of wines. Traditionally, wine spirits used in wine production have been brandy made from wine or wine spirits produced exclusively from fruit. Fruit farmers in California, Florida, Ohio and New York and other states have for many years relied on this winery and distillery outlet for their crops.

This provision would destroy the existing competitive environment by authorizing wine spirits to be produced from other non-fruit and non-wine agricultural products including waste agricultural products. The use of cheap agricultural products would adversely affect the competitive position built up over many years by California, Florida, Ohio and New York farmers and other persons with substantial capital investment already in the wine industry.

We respectively urge that this proposal be rejected and not be included as a member amendment or in any other kind of legislation.

Sincerely,

CANANDAIGUA WINE COMPANY
MEIER'S WINE CELLARS, INC.
TODHUNTER INTERNATIONAL, INC.

By: [signature]
A. Kenneth Pincourt, Jr.
Chairman and Chief Executive Officer
of TODHUNTER INTERNATIONAL, INC.

TESTIMONY OF ASSOCIATION OF INTERNATIONAL AUTOMOBILE MANUFACTURERS

The Association of International Automobile Manufacturers (AIAM) represents the U.S. subsidiaries of the international automobile companies doing business in the United States. AIAM members distribute world class passenger cars, multipurpose passenger vehicles, and light trucks in the United States.

AIAM's members support more than 550,000 American jobs in their design, R&D, sourcing, manufacturing, transportation, distribution, sales, and service operations here. Overall, AIAM members have invested more that $14 billion in the U.S. economy and annually purchase nearly $21 billion in American-made auto parts.

AIAM members build one in four cars manufactured in America; collectively, they produce more cars in America than Ford and three times more than Chrysler. AIAM's member companies are also the leading exporters of American-built automobiles overseas.

United Industry Supports Phase-Out

AIAM commends the Ways and Means Committee for undertaking a review of the sole remnant of the 1990 taxes on so-called luxury items, the regressive and unfair ten percent excise tax on amounts exceeding $32,000 for high-line passenger cars. This is the last remaining of the original so-called luxury taxes on private aircraft, boats, furs, jewelry and automobiles that went into effect in 1991.

Congress has seen fit to repeal luxury taxes on every product except automobiles. There were compelling reasons for repealing the taxes on other products and the arguments for ending the tax on automobiles are even more persuasive. AIAM joins with domestic and international dealers, and with General Motors and Ford to ask the Committee to support a graduated phase-out of this harmful tax.

The tax is not only unfair, it has cost jobs, injured small businesses and it is damaging to the American economy.

Who Pays The Tax?

This tax was enacted in 1990 and was intended as a tax on the wealthy. Instead, it has become a tax on small businessmen and women as well as a threat to the jobs of their employees.

Dealers will testify that many potential buyers flatly refuse to pay the tax, which can add several thousand dollars to the price of the car. Many simply walk away from the dealership when they learn the amount of the tax. In most of these cases, the dealer winds up absorbing the tax; the burden is passed from the targeted consumer to the dealer.

The committee must recognize that the tax is a serious burden on retail businesses that already have severe economic problems. In good times or bad, this tax constitutes a crushing problem for dealers retailing cars targeted by the tax.

The tax has contributed to the sharp increase in the number of high-line vehicles that are leased, rather than purchased outright. The tax thus becomes a part of the monthly leasing fee, making it more manageable, even if no more palatable, for the consumer.

In some jurisdictions, local taxes are levied against the amount of the monthly lease payments. Since these payments include the cost of the luxury tax, consumers in such instances are paying a tax on a tax.

Regardless of whether the tax is absorbed by the dealer, or paid by the consumer as part of his leasing cost, it remains a drag on the economy and an unfair tax that now falls on middle-income families. With the entry of General Motors, Ford, and Chrysler into the luxury and near-luxury fields, the tax is now applied to minivans, sports utility vehicles, and family sedans, traditional models produced by Chevrolet, Ford, Chrysler, Dodge, Oldsmobile, and Buick.

A Tax on Quality

The tax also has the peculiar effect of penalizing quality and customer satisfaction. Four of the five automobiles named in a recent consumer survey as the highest quality vehicles sold in America are hit by the tax.

These vehicles, all imports, serve as an example of the kind of high quality vehicles that all manufacturers can produce.

The Cost in American Jobs

There are more than 3,000 dealerships representing international automakers that are significantly effected by the tax on high-line vehicles. In addition, there are more than 3,000 Cadillac and Lincoln dealerships that are negatively impacted. As prices have risen in the years since the tax was imposed, the tax now falls on product sold by domestic dealers representing makes aimed at middle-income families, as well.

Lost sales and, more significantly, lost profits have required a cutback in employment at virtually all the international dealerships representing makes affected by the tax. So the worst effects of the tax have fallen, not on the targeted well-to-do, but on American wage earners who have seen their jobs threatened or eliminated altogether.

Effects of a Tax Phase-Out

Phasing out the tax on high-line vehicles will give an immediate stimulus to sales. Higher sales will mean additional sales tax collections for state and local governments. Additional sales and the additional income created by removing dealers' obligation to pay the tax in full or in part will prompt dealers to add additional staff, increasing employment.

Industry United In Support of Phase-Out

The automobile industry, domestic and international, now stands behind a graduated phase-out of the tax. General Motors and Ford, international automakers, and dealers for all makes are united in supporting the gradual elimination of this regressive and burdensome tax.

In any overhaul of the United States tax system, ridding the nation's businesses and its consumers of this damaging tax should have a top priority. Phasing out the tax over a period of years will ease the transition for the government and still provide a positive stimulus for business and the economy.

July 26, 1995

STATEMENT OF
MERCEDES-BENZ OF NORTH AMERICA, INC.

SUBMITTED TO THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS & MEANS

FOR HEARINGS ON
MISCELLANEOUS TAX ISSUES
JULY 11-12, 1995

REGARDING
LUXURY TAX ON AUTOMOBILES

Mercedes-Benz of North America, Inc. ("MBNA"), the U.S. distributor of Mercedes-Benz automobiles and parts made in Germany, submits this statement with respect to Item 15 of "Excise Taxes" from the Committee on Ways & Means Press Release dated June 30, 1995 (No. FC-8) which reads "modify or phaseout the excise tax on luxury automobiles." MBNA's dealers and customers are heavily and unfairly burdened by the "luxury" tax on automobiles sold in the United States. No similar tax or other non-tariff barrier to free market competition applies to American automotive products sold in Germany. MBNA strongly supports the elimination or phaseout of the excise tax on automobiles as soon as possible.

I. Current Law Imposes a "Luxury" Tax Only On Automobiles Sold for More than $32,000.

The Budget negotiations in 1990 focused on taxing a variety of "luxury" products that were thought to be consumed only by "wealthy" persons who generated little sympathy from the electorate. The tax as finally enacted applied to automobiles to the extent that the retail purchase price exceeded $30,000, yachts with a retail price over $100,000, airplanes with a retail price over $250,000, and jewelry and furs with a retail price over $10,000. However, once the luxury tax took effect, the consequence was a severe economic disruption in the markets for the "luxuries" targeted by the tax, resulting in adverse effects on people employed in those industries who were not "wealthy." Accordingly, all luxury taxes except the tax on automobiles were repealed in 1993, primarily because of the damage those taxes were causing to those people in the affected industries. In essence, Congress realized that the "luxury" tax was a mistake which had no tax policy basis and harmed middle class Americans who worked in those industries.

The automobile "luxury" tax, however, was not repealed in 1993 but rather the $30,000 threshold was indexed for inflation. Currently the automobile luxury tax is imposed at a 10 percent rate on the portion of the retail price of a new automobile that exceeds $32,000 in 1995. The automobile "luxury" tax is scheduled to expire on January 1, 2000.

II. There is No Sound Tax Policy Basis for the Luxury Tax on Automobiles.

A. A Narrowly-Based Excise Tax is Inherently Unfair Unless it has a Tax Policy Justification.

Tax policy authorities generally agree that the fairest type of excise tax is a broad-based tax with a low rate. Examples of such a tax include the value added tax and a general sales tax. By contrast, a narrowly-based excise tax is inherently unfair. In his book Federal Tax Policy, Dr. Joseph Pechman made the following statement:

> The case for selective excise taxes is weak. Conceivably, there are excise taxes that would not reduce consumer welfare, but there is no basis for making such a selection. Excise taxes should be avoided unless there are compelling reasons for altering the allocation of resources, discriminating among individuals and families on the basis of their consumption preferences, or discouraging consumption of the taxed commodities.[1]

Thus, a narrowly-based excise tax is normally hard to justify from a tax policy perspective. However, the U.S. Treasury Department has identified three policy justifications for a narrowly-based excise tax: negative external costs, a surrogate user fee, or inelastic demand.[2]

For example, because consumption of alcohol results in accidents and sickness which should be more properly borne by the user of alcohol rather than society in general, an excise tax on alcoholic beverages has a sound tax policy rationale. An example of an excise tax as a surrogate user fee is the Federal excise tax on gasoline and diesel fuels, most of the revenues from which are used to construct highways. Finally, if demand for a consumer product is unresponsive to price changes, an excise tax on that product would minimally distort consumer choices and therefore may be acceptable from a tax policy perspective.

B. The Excise Tax on "Luxury" Cars Has No Tax Policy Rationale.

An excise tax on "luxury" cars does not meet any of these three tax policy justifications for a narrowly-based excise tax. First, "luxury" cars subject to the tax do not involve social cost (as compared to "non-luxury" cars), but instead result in advanced automobile technology which ultimately benefits consumers of all cars. Safety innovations such as anti-lock brakes, traction control systems, crumple zone (front end) crashworthiness, seat belt technology and air bags were developed by the producers of these targeted "luxury" automobiles, including particularly Mercedes-Benz.

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[1] Pechman, Federal Tax Policy at 194 (Fifth Edition 1987).

[2] See Statement of J. Roger Mentz, Assistant Secretary of the Treasury (Tax Policy) of April 21, 1986 before Senate Committee on Finance at 14-16 (Appendix).

Second, there is no basis for an excise tax on a narrow grouping of automobiles as a surrogate user fee. The excise tax on motor fuels is the current user fee for operation of an automobile. No further user fee on a small segment of the automobile market is justified.

Third, demand for automobiles is highly elastic. When an automotive product is burdened by an additional cost that a competitive product does not have, the American consumer can easily switch, and does switch, to the competitive product.

Thus, the "luxury" tax on automobiles does not satisfy any of the three tax policy criteria for narrowly-based excise taxes. In fact, the excise tax distorts consumer choices in the automobile market, the fundamental objection to a narrowly-based excise tax.

III. Conclusion

In retrospect, there was little tax policy justification for enactment of any of the luxury taxes in 1990, since they were levied on a narrow group of products arbitrarily considered to be "luxuries." Although Congress taxed automobiles, yachts, airplanes, jewelry and furs, many other high cost consumer items were not included, such as antiques, art, sterling silver, expensive wines and polo ponies. Today there is no rationale for the "luxury" automobile excise tax, since Congress has repealed the tax on all other items identified as "luxuries" in 1990. All that remains is a tax on a narrow group of automobiles.

The "luxury" tax also cannot be justified as a tax on automobiles, since it impacts only a very small fraction of the U.S. automobile market. Thus, the only basis for justifying the existence of the automobile luxury tax is purely revenue. At a time when the Ways & Means Committee is considering fundamental reform of our nation's tax system, such a glaring unfairness cannot be overlooked. The luxury tax on automobiles should be phased down in stages beginning immediately so that it is at a zero rate by the year 2000.

APPENDIX

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2

For Release Upon Delivery
Expected at 9:30 a.m., EST
April 21, 1986

STATEMENT OF
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to discuss the Treasury Department's views regarding the proposals in Chairman Packwood's tax reform markup document (the "Chairman's Plan") relating to Federal excise taxes and tariffs. The proposals would make Federal excise taxes and tariffs nondeductible for Federal income tax purposes, increase the rate of Federal excise tax on certain wines to the rate currently applied to beer, and adjust the rates of Federal excise tax on alcohol and tobacco products and certain fuels to reflect future price increases.

The achievement of fundamental tax reform is a central goal of this Administration. In the President's view, the key elements of a revenue-neutral tax reform bill are a full $2,000 personal exemption for both itemizers and nonitemizers, at least for individuals in the lower- and middle-income tax brackets; a rate structure with a maximum rate

the effective increase in tariffs under the proposal. The effects on imports and exports would to some extent offset, and, on balance, we would expect a relatively small decline in the level of exports and imports.

Tax Policy Considerations

Justification for Selective Excise Taxes. As I have already stated, we believe that the proposal to deny a deduction for the payment of Federal excise taxes is properly analyzed as similar in effect to a direct increase in excise taxes. In evaluating the proposal, it is thus necessary to consider the circumstances in which the imposition of an excise tax or an increase in existing rates may be justified.

1. External Social Costs. One of the traditional justifications for imposing an excise tax is to ensure that the market price of a good reflects any external social costs associated with its production or consumption. The free market will efficiently allocate economic resources to the extent that, "at the margin," all of the economic costs to society of the good are reflected in the price charged by the producer and all of the economic benefits to society of the good are reflected in the price paid by the consumer. In most cases, essentially all of the costs to society of the good are borne by the producer, and hence will be reflected in the price charged by the producer. Similarly, essentially all of the benefits to society are received by the consumer, and hence will be reflected in the price paid by the consumer. In some cases, however, the social costs of producing or consuming a particular good exceed the cost to the producer or consumer. These external, uncompensated costs are borne by other members of society who do not directly benefit from the production or consumption of the good. When external costs are present, the imposition of an excise tax can make the allocation of economic resources more efficient by raising the price of the damaging activity and thereby internalizing the external cost.

For example, it is widely accepted that the public health and other social costs resulting from the consumption of alcoholic beverages and tobacco products would not be reflected in the price for these products that would be set by market factors alone. To illustrate, the external costs attributable to alcohol abuse include such direct costs as property damage and personal injuries incurred by innocent victims of alcohol-related auto accidents, as well as such indirect costs as the burden of extra health care costs shifted from an alcoholic to society at large by insurance or public health care programs. Although excise taxes are currently imposed on alcohol and tobacco products, many believe that the current tax levels do not adequately reflect the external costs of these products. Some evidence

that this view is widely held is the fact that current law also places restrictions on the advertisement of these products. It is notable as well that a group of prominent economists recently has called for substantial increases in the Federal excise taxes on alcohol.*

It also may be true that the market prices of gasoline and other petroleum products, particularly at the current depressed levels, do not fully reflect the social costs of producing or consuming these products. For example, among the external social costs associated with gasoline consumption are air pollution and the prospect that future economic growth may be endangered by reliance on uncertain foreign supplies of oil. In addition, increased excise taxes on petroleum products also may be appropriate to encourage energy conservation and thus reflect the value of nonrenewable resources to future generations.

2. Surrogate User Fees. The imposition of an excise tax also may be justified as a surrogate user fee where the Federal government provides services that directly benefit users of certain goods or services. Examples of such surrogate user fees are the Federal excise taxes on gasoline and diesel fuels, most of the revenues from which are used for Federal-aid highway programs. Excise taxation of certain goods, such as motor fuels, may be justified both as a surrogate user fee and as a way to internalize external costs.

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* A group of 67 economists, including Nobel laureates Franco Modigliani, Paul Samuelson, and James Tobin, has signed a petition supporting efforts to increase Federal excise taxes on alcoholic beverages and eliminate or modify the differential tax treatment between beer, wine, and distilled spirits. See Tax Notes, March 17, 1986, p. 1178.

3. <u>Demand Unresponsive to Price Changes</u>. A final justification for imposing excise taxes is their ability, in certain circumstances, to raise revenue with minimal distortion of consumer choices. If demand by consumers for a particular good is quite unresponsive to price changes, an excise tax on that good would cause very little change in the amount of the good consumers would purchase. Hence, distortion of consumer choices would be minimized. Since a basic goal of tax policy is to raise revenue without distorting economic behavior, an excise tax may in some circumstances be a legitimate alternative to more broadly based tax measures.

<u>Use of Revenues</u>

Excise taxes serve to reflect external social costs or user benefits in two ways. First, by increasing the price of the taxed good, they reduce demand for the good and thereby the level of associated external costs, or the need to provide associated user benefits. Second, the excise taxes provide revenues to help pay for associated external costs or user benefits. These revenues may be used directly in related government programs, for example, to finance highway construction. These revenues also may be used to reduce other Federal taxes, and thus provide indirect compensation for the external costs borne by private persons. Excise taxes on goods with price-unresponsive demand also could provide revenue to replace revenues from other sources that distort economic behavior to a greater extent. Thus, under the proper circumstances, we believe it would be reasonable to use certain excise tax revenues as a means of reducing income tax burdens, as the Chairman's Plan contemplates.

<u>Distributional Impact</u>

One of the President's principal tax reform objectives is that families below the poverty line not be required to pay Federal income taxes. The President's tax reform proposals sought as well to reduce the tax burden on middle-income working Americans. These objectives relate to the basic fairness of the tax system, and require that we carefully evaluate the distributional impact of the proposal to deny a deduction for Federal excise taxes and tariffs.

In general, the distributional effect of the proposal will depend on the extent to which the incidence of the excise taxes and tariffs are passed on in price increases, as well as on the consumption by different income classes of the goods and services subject to the levies. Conventionally, analysis of the distributional effect of excise taxes

TESTIMONY OF THE AMERICAN LUNG ASSOCIATION AND THE AMERICAN THORACIC SOCIETY

The American Lung Association welcomes this opportunity to submit testimony regarding the federal excise tax on ozone depleting chemicals. The application of this tax to ozone-depleting chemicals used in medical aerosol produces is a matter of serious concern to our organization.

The American Lung Association is the oldest voluntary health organization in the United States its mission is the conquest of lung disease and the promotion of lung health. Asthma is its top programmatic priority.

Asthmatics represent a large and growing segment of the total U.S. population. There are currently an estimated 12.4 million asthmatics in the United States. The number of Americans with asthma has increased steadily over the past twenty years and is expected to continue to increase through the end of the decade. American Lung Association projects that the number of Americans suffering from asthma will reach 18 million by the year 2000.

Background on Metered Dose Inhalers

Metered dose inhalers metered dose inhalers are pocket-sized aerosol devices used to treat asthma and other diseases. Asthma patients rely on these devices to deliver medication into their lungs in precisely measured quanitites.

Metered Dose Inhalers use small amounts of chlorofluorocarbons as propellants. Because the quantities involved are minimal, use of chlorofluorocarbons in metered dose inhalers through the end of the decade is expected to have little or no impact on the stratospheric ozone layer.

Although most aerosol devices that use chlorofluorocarbons have been banned in the United States since 1978, Food and Drug Administration has exempted from the ban certain metered donse inhalers, including metered dose inhalers used in the treatment of asthma. The Food and Drug Administration regards these medical aerosols as essential to patient needs. In addition, the Parties to the Montreal Protocol, the international treaty on stratospheric ozone depletion, have declared "essential" the use of chlorofluorocarbons in metered dose inhalers designed for the treatment of asthma and chronic obstructive pulmonary disease (COPD). The Parties have authorized continued production of chlorofluorocarbons for these uses.

No adequate substitute for chlorofluorocarbons-driven metered dose inhalers is currently available in the U.S. However, metered dose inhalers manufacturers are far along in the process of reformulating their products with new propellants that have no ozone depleting potential. Competitive forces within the industry are stimulating the effort to develop chlorofluorocarbons-free metered dose inhalers. There is no need for a tax incentive to move the metered dose inhalers industry to consider non-chlorofluorocarbons options.

The process of introducing chlorofluorocarbons-free metered dose inhalers in necessarily lengthy. Joint industry research programs on substitute propellants were begun in 1990 and are now substantially complete. Nevertheless, metered dose inhalers, reformulated with these propellants must undergo extensive testing and regulatory scrutiny to show that they are safe and effective. Thus, it will be years before the reformulated products appear on the market in the United States. In the meantime, chlorofluorocarbons-propelled metered dose inhalers will continue to be the mainstay of asthma and COPD therapy.

Federal Excise Tax on Ozone-Depleting Chemicals

In 1989, Congress imposed a federal excise tax on ozone-depleting chemicals. This tax contained no exemption for the chlorofluorocarbons used in metered dose inhalers. The 1992 Energy Policy Act increased the tax rate for most ozone-depleting chemicals but specifically exempted chlorofluorocarbons destined for metered dose inhalers usage from the increase. By freezing the tax rate for these chlorofluorocarbons, Congress recognized that metered dose inhalers should be treated differently from other sues of ozone-depleting chemicals.

As a result of the 1992 freeze in the tax rate, the chlorofluorocarbons used in metered dose inhalers are currently subject to an excise tax of $1.67 per pound. This tax generates revenues of only $6 to $8 million per year.

Conclusion and Recommendation

The American Lung Association does not believe that in passing the federal excise tax on ozone-depleting chemicals Congress intended to penalize the millions of Americans who suffer from asthma and other diseases treated with metered dose inhalers. Maintaining the tax for chlorofluorocarbons used in metered dose inhalers would represent poor tax policy because it (i) is a needless incentive, and (ii) has an unintended and regressive impact on patients. The American Lung Association therefore recommends that Congress repeal or suspend the tax on ozone-depleting chemicals used as metered dose inhalers propellants.

HARC HALON ALTERNATIVES RESEARCH CORPORATION

2111 Wilson Boulevard □ Suite 850 □ Arlington, VA 22201 □ (703) 524-6636
FAX: (703) 243-2874

July 26, 1995

Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Chairman Archer:

The Halon Alternatives Research Corporation (HARC) appreciates the opportunity to submit a written statement for the record of the July 12-13 Ways and Means Committee hearings. HARC supports modification of the excise tax on ozone-depleting chemicals to permit imports of recycled halons.

From 1991 to 1993, both imported and domestically produced new halons were taxed at the same rate, approximately 25 cents per pound. In 1994 the tax rate increased dramatically to a level where, for Halon 1301, it jumped to $43 50 per pound. However, by law, production of new halons had already ended in the U.S. This has led to the situation where domestically recycled halon is traded tax free, but imported recycled halon is taxed at a high rate (currently $53.50 per pound), effectively preventing its trade. In contrast the U S. supported Copenhagen Amendments to the Montreal Protocol encourage the free movement of recycled halons in international commerce, and this apparent anomaly is of growing concern to U.S. users who have critical needs for recycled halon. Also of concern is that this differing treatment will have the unintended effect of limiting the supply of recycled halon in the U.S., while at the same time possibly encouraging halon emissions in countries with a surplus but no market.

As previously stated, the current tax rate is so high relative to the price of halon that it serves as an effective ban on imports. In contrast, it is possible that the proposed modification will have a small positive revenue effect. By lowering the tax to 25 cents per pound, significant quantities of recycled halons subject to this tax are much more likely to be imported and thus taxed.

The application of the tax on recovered halons, whose production has been phased out, serves no environmental or tax policy purpose. The tax will not reduce

the production of halon. If anything, it will reduce the value of recycled halon and promote environmentally damaging emissive uses outside the U.S. A large percentage of the halon held in the world and the great majority held in North and South America was produced in the United States. The effect of the tax is to prohibit responsible use of this material by companies in the U.S.

Halons are halogenated hydrocarbons that exhibit exceptional fire fighting and explosion prevention/suppression effectiveness. They are electrically non conductive, dissipate quickly, leave no residue, and have proven remarkably safe for human exposure. This unique combination of properties has led to their selection as an agent of choice for many critical fire protection and explosion prevention situations such as: computer, communications, and electronic equipment facilities, hospitals, military/commercial ships and aircraft, ground protection of military/commercial aircraft, oil and gas production, nuclear and hydro power generation. Also, existing fire suppression measures for commercial aircraft, required by FAA Air Worthiness Regulations, are largely based on the use of halons.

The Halon Alternatives Research Corporation (HARC) was formed to focus efforts for finding suitable alternatives for the halon used in fire fighting. HARC operates as a non-profit corporation and is the major industry association that provides information to the user community on halon related issues. HARC is now in its fifth year, and during that time it has developed a unique, cooperative working relationship with government agencies concerned with the halon/CFC issue. HARC's members include major companies in the following industries: aircraft production and servicing, oil and gas production, and manufacture of halon alternatives and systems.

Thank you again for the opportunity to express our support for this tax modification. Please let us know if we can provide further information to the Committee on this issue.

Sincerely,

Steven D. Taylor

Steven D. Taylor
Chairman

HALON ALTERNATIVES RESEARCH CORPORATION - MEMBERSHIP LIST

3 M Specialty Chemicals
3H Taiwan Industries Corporation
AES-Ntron
Aguilera Extincion, S. L.
Alyeska Pipeline Service Company
American Pacific Corporation
Ansul Fire Protection
Arco Alaska, Inc.
AT & T
Automatic Suppresion Systems
Boeing Company
BP Exploration Alaska
Cease Fire (Hong Kong) Limited
Control Fire Systems, Ltd.
Defense Material Administration
Du Pont Fluoroproducts
East Australian Pipeline Limited
Edison Electric Institute
Engineered Fire Systems
Eurotunnel
Exxon Company, International
Exxon Company, U.S.A.
Figgie Fire Protection
Fike Protection Systems
Fire Suppression Systems Association
FRC International
Great Lakes Chemical Corporation
Grinnell Corporation
Hejung Industrial Company, Ltd.
Hi-Fog
Hughes Aircraft Company
Hughes Associates, Inc.
J.N. Johnson Sales & Service
King Dragon Consultant & Engineering, Ltd
Magnavox Electronic Systems Company
MCI Telecommunications Corporation
National Association of Fire Equipment Distributors
New Mexico Engineering Research Inst.
National Fire Protection Association
Nissho-Hayashi Technos Company
North American Fire Guardian
Overland Aviation Services
Pacific Scientific
Phillips Petroleum
Poweus Inc.
Pyrene Fire Security
Quantum Corporation
Reliable Fire Equipment Company
Saab Aircraft AB
Securiplex Technologies
Shell Internationale
Sivani Antincendi S.p.A.
Solvay Performance Chemicals, Inc.
Taylor/Wagner, Inc.
Union Camp Corporation
Walter Kidde Aerospace, Inc.
Yamato Protec Corporation

HALON
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July 26, 1995

Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Chairman Archer:

The Halon Recycling Corporation (HRC) appreciates the opportunity to submit a written statement for the record of the July 12-13 Ways and Means Committee hearings. HRC supports modification of the excise tax on ozone-depleting chemicals to permit imports of recycled halons. The existing tax, with high rates set to discourage new production, creates a major barrier to the free flow of recycled halons in international commerce. The U.S. supported Copenhagen Amendments to the Montreal Protocol encourage the free movement of recycled halons in international commerce in order to avoid unnecessary emissions and future, additional production. This apparent anomaly is of growing concern to U.S. users who have critical, long-term needs for recycled halon.

From 1991 to 1993, both imported and domestically produced new halons were taxed at the same rate, approximately 25 cents per pound. In 1994 the tax rate increased dramatically to a level where, for Halon 1301, it jumped to $43.50 per pound. However, by law, production of new halons had already ended in the U.S. This has led to the situation where domestically recycled halon is traded tax free, but imported recycled halon is taxed at a high rate (currently $53.50 per pound), effectively preventing its trade. This disparate treatment will have the unintended effect of limiting the supply of recycled halon in the U.S. for critical needs, while at the same time possibly encouraging halon emissions in countries with a surplus but no market.

The current tax rate is so high relative to the price of halon that it serves as an effective ban on imports. In contrast, it is possible that the proposed modification will have a small positive revenue effect. By lowering the tax to 25 cents per pound, significant quantities of recycled halons subject to this tax are much more likely to be imported and taxed.

The application of the tax on recovered halons, whose production has been phased out, serves no environmental or tax policy purpose. The tax will not reduce the production of halon. If anything, it will reduce the value of recycled halon and promote environmentally damaging emissive uses outside the U.S. A large percentage of the halon held in the world and the great majority held in North and South America was produced in the United States. The effect of the tax is to prohibit responsible use of this material by companies in the U.S.

Halons are halogenated hydrocarbons that exhibit exceptional fire fighting and explosion prevention/suppression effectiveness. They are electrically non conductive, dissipate quickly, leave no residue, and have proven remarkably safe for human exposure. This unique combination of properties has led to their selection as an agent of choice for many critical fire protection and explosion prevention situations such as: computer, communications, and electronic equipment facilities, hospitals, military/commercial ships and aircraft, ground protection of military/commercial aircraft, oil and gas production, nuclear and hydro power generation. Also, existing fire suppression measures for commercial aircraft, required by FAA Air Worthiness Regulations, are largely based on the use of halons.

We have been working closely with government agencies that have an interest in this issue, the Department of Treasury and the Environmental Protection Agency, and have enclosed relevant correspondence from these agencies. As you can see, the letter from Treasury reiterates the lack of revenue effect from this modification and the letter from EPA outlines the environmental benefits that this tax modification will provide.

The Halon Recycling Corporation (HRC) acts as a facilitating organization for the recycling of Halon 1301 by providing information services to match companies that have excess Halon 1301 with those that need the fire fighting agent for critical uses. HRC operates as a non-profit corporation with a Business Review clearance from the U.S. Justice Department. HRC is listed as the primary recycling and banking organization in the U.S. by EPA in their Halon Fact Sheet and by the United Nations Environment Program (UNEP). HRC's members include major companies in the following industries: aircraft production and servicing, oil and gas production, and production and servicing of (ground-based) military vehicles. HRC's listed buyers and sellers include most major U.S. recyclers.

Thank you again for the opportunity to submit a written statement supporting this modification to the tax code. Please let us know if we can provide further information to the Committee on this issue.

Sincerely,

Richard A. Shafer
Chairman

Enclosures

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

1995 MAY 17 AM 12: 02

SECRETARY OF THE TREASURY

May 15, 1995

The Honorabl^ Frank Murkowski
United State Senate
Washington, D.C. 20510-0202

Dear Frank:

Thank you for your letter regarding the excise tax on imported recycled halons. I understand your concerns about discouraging the recycling of halon. At the Department of the Treasury, we have been working closely with the Environmental Protection Agency and the Office of the U.S. Trade Representative to develop an appropriate response to foreign recycled halon. At this point, I think that these issues are best addressed through environmental and trade policy, and we are working toward that end. I would also note that the tax on imported recycled halons is expected to raise little, if any, revenue.

Thank you again for writing, and please let us know if we can be of further assistance.

Sincerely,

Bob Rubin

Robert E. Rubin

1995 MAY 24 AM 2:07

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

MAY 22 1995

OFFICE OF
AIR AND RADIATION

Honorable Frank Murkowski
United States Senate
Washington, D.C. 20510-0202

Dear Senator Murkowski:

Thank you for your letter of April 12, 1995, in which you posed several questions regarding the potential legislative solution to tax issues surrounding the importation of recycled foreign halon.

1) Q: Are there sufficient quantities of halon in the U.S. to meet essential domestic needs, absent any new U.S. production? What do you consider "essential domestic needs?"

A: While the Environmental Protection Agency (EPA) believes that substantial quantities of halons currently reside in existing equipment, the vast majority of this agent will remain in that equipment until it is used for a fire or the system is replaced at some future date. As a result, the amount of halon from the existing "bank" of halon in equipment in the U.S. is somewhat unpredictable as to both quantity and timing of its availability. As a result, to avoid the need for production of virgin halon for "essential use" requirements, when the Parties to the Montreal Protocol accelerated the phase-out of halon production they also took action to facilitate the trading of used halon worldwide.

EPA considers an "essential use" one for which no viable substitute chemical has been identified and for which great economic cost, risk to human health and safety, or threat to the environment would ensue should halon not be available. While it is difficult to list all such applications, examples include:

Onboard aircraft. The Federal Aviation Administration is working with the commercial and military aircraft industry to identify substitutes and develop design specifications for onboard aircraft. It is anticipated that halon will be needed to serve the current and near-term future fleet of aircraft for approximately 40 years.

North Slope Oil Production Operations. The North Slope of Alaska is an extreme weather environment requiring explosion inertion in its facilities. For technical, economic, environmental, and human safety reasons, halon is still required. The Operators of the North Slope facilities have been aggressive in funding research into potential substitutes, but those efforts are not expected to yield solutions for several years. Meanwhile, they are continuing to procure and use recycled halon.

Military Mission Critical Applications - Weapon System Readiness. The Department of Defense has been a world leader in phasing out their use of ozone-depleting substances; funding and conducting research into substitute agents and strategies; and implementing banking programs for weapon platforms requiring halons. Nonetheless, halon is required for weapon system readiness. The Defense Logistics Agency has been instructed to maintain a reserve of halon and other ODSs, and is planning to procure additional recycled halon 1301 in the near future.

2) Q: How does the current U.S. certification process for domestic and imported halon work and describe the certification processes of other Protocol signatories.

A: EPA has established an extensive regulatory program related to the production and importation of new and used halon. Recently published regulations require pre-approval of all imports of used halons with extensive supporting documentation demonstrating that the halons were in fact used, where they were used, and how they were recovered. These new requirements were put in place to deal with the extensive illegal importing of CFCs but will also apply to recycled halons.

It is our understanding that, in Canada, importers and exporters must register with the Canadian Ministry of the Environment.

3) Q: Is it possible for EPA to develop a system to identify imported recycled halon?

A: While it is not possible to chemically determine whether a container of halon is newly produced or recycled, it is possible to implement requirements for certifying its origins by importers. The recently initiated regulations discussed above provide such safeguards.

4) Q: Do you believe that the current excise tax on imported recycled halon is inconsistent with the goal of encouraging the use of recycled halon?

A: It is EPA's opinion that the current excise tax on imported recycled halon discourages its use. The Copenhagen agreements of the Montreal Protocol included an accelerated production phaseout date for halon of 1994, fully two years before CFCs. It was

recognized that sufficient recycled halon was available world-wide to serve existing uses, and that encouraging an international market in recycled halon would be able to serve any needs.

If quantities of recycled halon are inadequate for mission critical and other essential needs, the U.S. might be in a position where it would have to request additional production under the Montreal protocol. Importation of used halon from abroad would be an environmentally superior way of meeting these needs until alternatives become available.

To be equitable, a tax of $0.25 per pound on imported recycled halons would be appropriate given that virgin halon production in the U.S. was taxed at this rate for several years prior to the production phase-out.

Based on the concerns discussed above, we believe that modifying the current tax to the same level at which it was taxed during production in the U.S. would substantially smooth the transition out of halons and possibly even have a net environmental benefit without imposing any revenue loss.

If you have any further questions, please call me at 233-9161.

Sincerely,

Paul M. Stolpman, Director
Office of Atmospheric Programs

HALON RECYCLING CORPORATION - MEMBERSHIP LIST

Alyeska Pipeline Service Company

Arco Alaska, Inc.

B.P. Exploration Alaska

Hughes Aircraft Company

Pacific Scientific

Walter Kidde Aerospace

July 27, 1995

Written Statement By ISO Corporation
In Support Of Proposed Reform Of
The Excise Tax On Ozone-Depleting Chemicals

ISO Corporation ("ISO") is a small chemical company that specializes in the importation of chemicals and materials into the United States. ISO strongly supports the proposal before the House Ways and Means Committee ("Committee") to exempt "imported recycled ozone-depleting chemicals" from the excise tax imposed by Section 4681 of the Internal Revenue Code. As explained below, the proposal would conform U.S. tax law to the international and domestic regulatory policies favoring recycling and beneficial reuse of ODCs, would provide imported recycled ODCs with the same tax-free status now afforded used ODCs imported into the U.S. for domestic recovery and recycling, would help ensure an orderly phaseout of the production and consumption of virgin ODCs, and would ease the transition to substitute chemicals by small businesses and consumers without requiring the premature and costly retirement/retrofitting of older equipment and consumer goods.

The proposed modification to Section 4681 would serve to conform U.S. tax law to the international and domestic regulatory policies that encourage the recycling and beneficial reuse of ODCs. These policies provide special incentives for the importation of used ODCs irrespective of whether the ODCs are recycled domestically or recycled overseas. The Parties to the Montreal Protocol on Substances that Deplete the Ozone Layer ("Montreal Protocol"), as amended, have agreed that the public and the environment can best be served by encouraging the recycling and reuse of ODCs. To that end, the Parties have excluded all used and recycled ODCs from the international system of consumption allowances that controls the quantities of ODCs that may be imported by member countries. Decision IV/2 of the Fourth Meeting of the Parties (Copenhagen, November 1992). The Environmental Protection Agency ("EPA") has amended its regulations implementing Title VI of the Clean Air Act Amendments of 1990 to bring the regulations into conformity with the above international policy. In a regulation that issued on May 10, 1995, EPA established a program to permit the continued importation of used or recycled ODCs beyond January 1, 1996, the date the U.S. ban on production and importation of virgin ODCs takes effect. 60 Fed. Reg. 24,970.

The proposed modification of the tax code would place imported recycled ODCs on an equal footing with used ODCs imported into the U.S. for domestic recovery and recycling. Under current tax law, used ODCs imported from foreign sources that are recovered in the United States are exempt from the excise tax (as are ODCs that are used and recovered in the United States). Imported recycled ODCs should be afforded the same tax-free status. To the extent Congress is concerned that virgin ODCs may fraudulently enter the U.S. as recycled material, or that imported recycled refrigerants may not meet U.S. standards, these concerns are fully addressed by the EPA regulations. EPA has instituted a petition process that requires importers to establish, and EPA to confirm, that the materials that will enter the U.S. have in fact been used or recycled overseas. For refrigerants that are recycled overseas, the EPA regulations require that the importer document the foreign recycling site. Moreover, the EPA regulations specify that all refrigerants consisting wholly or in part of used ODCs, whether recovered domestically or recovered overseas, must meet stringent EPA standards of purity. There thus is no sound environmental rationale for treating imported recycled ODCs differently under the tax law.

The proposed modification to Section 4681 also would serve to ensure an orderly phaseout of the production and importation of virgin ODCs. The phaseout of the production and importation of virgin ODCs for most emissive uses has been sharply accelerated and a total ban is scheduled to take effect on January 1, 1996. Domestically

recycled ODCs have played, and will continue to play, an important role in reducing the burdens on industry and the public caused by the accelerated phaseout. By permitting recycled ODCs to enter the U.S. without excise tax, the proposal before the Committee will further ease these burdens by insuring that ODCs recycled abroad are also made available to consumers during the phaseout period.

With the impending January 1, 1996 ban on the production and importation of virgin ODCs for most emissive uses, severe shortages of ODCs are anticipated. The tax-free status afforded domestically recycled ODCs will ensure that this material remains available for domestic use. On the other hand, the tax imposed on imported recycled ODCs has hindered its availability. The anticipated demand by small businesses and consumers are expected to exceed supply and prompt Congressional action is required to prevent a shortfall. Small businesses can ill afford the cost of replacing/retrofitting older equipment to accommodate the expensive new substitute chemicals. Indeed, for certain uses, no practicable substitutes are currently available. The problems faced by consumers are more pressing. The only economically feasible option for consumers in many instances is to continue to service older consumer products with recycled ODCs until the product's useful lives have ended. In short, lifting the excise tax on imported recycled ODCs will serve to guard against the significant economic dislocations that may occur if supplies of domestically recycled ODCs fall short of demand after January 1, 1996.

For the foregoing reasons, ISO strongly supports the proposed modification to Section 4681 of the Internal Revenue Code and urges the Committee to adopt the proposal.

Respectfully submitted,

William H. Barlen
President
ISO Corporation

TESTIMONY OF THE NATIONAL LIMOUSINE ASSOCIATION
AND THE
LIMOUSINE INDUSTRY MANUFACTURER'S ORGANIZATION
Before the Committee on Ways and Means
July 11, 1995

REINSTATE THE GAS GUZZLER TAX EXEMPTION FOR COACHBUILDERS

Section 4064 of the Internal Revenue Code imposes the "gas guzzler" excise tax on the sale by the manufacturer or importer of any automobile that does not meet statutory standards for fuel economy. The amount of the tax depends on the fuel economy of the model type of the automobile: the tax begins at $1,000 and increases to $7,000 depending on the mileage per gallon of the particular model.

The gas guzzler tax was enacted as part of the Energy Tax Act of 1978. The Tax Reform Act of 1986 amended the gas guzzler tax to exempt from the tax small manufacturers (generally manufacturers of fewer than 10,0000 vehicles annually) who lengthen existing automobiles into stretch limousines. This "coachbuilders exemption" was repealed by the Revenue Reconciliation Act of 1990, effective January 1, 1991.

Congress should reinstate the coachbuilders exemption. Generally, coachbuilders purchase from the original manufacturer (e.g., General Motors) vehicles that exceed the mileage standards of the gas guzzler tax and therefore would not be subject to the tax. After lengthening, however, the vehicles fail to satisfy the mileage standards. Although the tax is actually imposed on and paid to the government by the coachbuilders, it is uniformly passed through to limousine operators (who lease or purchase the lengthened automobiles from the coachbuilders). The limousine operators, therefore, bear the economic burden of the gas guzzler tax.

Recognizing that the gas guzzler penalty would be ineffective in encouraging energy savings when applied to customized vehicles such as limousines, there was never any intention to include commercial limousines. Nevertheless, the base models used by the coachbuilders have significantly improved their fuel efficiency. For example, the Cadillac base model in 1986 had a fuel efficiency rating of 18 mpg; the 1990 base model was rated at 22.5 mpg. The Ford base model in 1993 had a fuel efficiency rating of 20.1 mpg; the 1994 base model was rated at 20.4 mpg; and the 1995 base model is rated at 21.8 mpg.

The limousine operator industry is small business. There are approximately 2,500 operators nationwide. The limousine operation industry is concentrated in the mid-Atlantic region (roughly from Washington, D.C. to Boston), Chicago, California and Florida. The typical operator owns five vehicles and replaces one vehicle about every year or 18 months.

During 1988 and 1989 (before repeal of the coachbuilders exemption), there were approximately 35 coachbuilders, who lengthened approximately 8,000 to 9,000 cars annually. Now there are only 12 coachbuilders who lengthen approximately 1,200 to 1,400 vehicles annually. These vehicles bear an average tax of $2,000 per automobile.

The repeal of the coachbuilders exemption effective on January 1, 1991, clearly has had a devastating effect on the coachbuilders and limousine operators. The coachbuilders exemption should be reinstated. Reinstatement would have a negligible revenue impact, would increase job creation in the small business sector, and would redress the inequity of imposing a tax that has essentially crippled these small industries.

TESTIMONY OF FRED A. MEISTER
DISTILLED SPIRITS COUNCIL OF THE UNITED STATES

The following statement is submitted on behalf of the Distilled Spirits Council of the United States, Inc. (DISCUS). DISCUS is the national trade association which represents U.S. producers and marketers of distilled spirits. We welcome the opportunity to present our statement on two tax issues affecting the distilled spirits industry. Enactment of these proposals will simplify and improve the business efficiencies of distilled spirits companies and at the same time end unnecessarily burdensome and complicated regulations.

1. ALLOW IN-BOND TRANSFERS OF BOTTLED DISTILLED SPIRITS AMONG COMMONLY OWNED DISTILLED SPIRITS PLANTS.

Current Federal law discriminates between distilled spirits and beer and wine. Bulk and bottled beer can be transferred "in-bond" between commonly owned breweries, that is, beer and be transported either in bulk or in cases to another brewery of the same ownership without triggering payment of the Federal excise tax. Wine can go even further and can be transferred in bulk or in bottles between commonly owned bonded wineries, as well as to any other bonded winery premise. In contrast, while bulk distilled spirits may be transferred in-bond between bonded premises without payment of the tax, distilled spirits cannot be transported in bottles, even between commonly owned distilled spirits plants (DSPs) without triggering payment of the Federal excise tax.

The discrimination against bottled distilled spirits is simply a historical anomaly based upon no historic, legal or other rational reason. Simply put, there is no reason why bottled distilled spirits should be treated differently than beer or wine.

The benefits of our proposal to permit the transfers in bond of bottled case goods between commonly-owned distilled spirits plants (DSPs) and between DSPs where one is operating under contract as a bottler for the other, and to allow imported case goods to be transferred in bond from a Customs bonded warehouse (CBW) are two-fold.

First, our proposal is not viewed by distillers as a means to change the way business is done, but rather a means to effect greater cost efficiencies in delivering product to the market. In that regard, our proposal is narrowly drawn to apply to industry members that qualify for a DSP permit.

> The current tax code sets out stringent requirements to qualify as a DSP. (See 26 U.S.C. §§ 5171-5182; see also 26 U.S.C. §§ 5201-5244.) For example, 26 U.S.C. § 5171(a) provides that "[e]xcept as otherwise provided by law, operations as a distiller, warehouseman, or processor may be conducted only on the bonded premises of a distilled spirits plant by a person who is qualified under this subchapter." 26 U.S.C. § 5002 defines the terms "distiller," "processor," and "warehouseman." Under that provision of the tax code, the term "distiller" includes any person who produces distilled spirits from any source or substance. The term "processor" means any person who manufactures, mixes or otherwise processes distilled spirits, and includes in that term a bottler. The term "warehouseman" means any person who stores bulk distilled spirits. The Federal Alcohol Administration Act also requires these entities to obtain a permit to do business (27 U.S.C. §§ 203-204), and the Bureau of Alcohol, Tobacco and Firearms has extensive regulations concerning qualifying for a DSP permit (see 27 C.F.R. Part 19).

The critical point behind this "thumbnail sketch" of what constitutes a DSP is to underscore that our proposal pertains to only those entities whose operations would qualify as a DSP. Under current law, the "distilled spirits operations" conducted at such bonded premises relate to the production, manufacture, processing, aging, and bottling of distilled spirits products. Our proposal does not change these requirements.

Second, our proposal would eliminate the discrimination that now exists between distilled spirits and beer and wine. Bulk and bottled beer can be transferred in bond between commonly-owned breweries, i.e., beer can be transported either in bulk or in bottles to another brewery of the same ownership, without triggering payment of the federal excise tax. Wine can go even further and can be transferred in bulk or in bottles between commonly-owned bonded wineries, as well as to any other bonded winery premise. In contrast, while bulk distilled spirits may be transferred in bond between bonded premises without payment of tax, distilled spirits cannot be transported in bottles, even between commonly-owned DSPs, without triggering payment of the federal excise tax. This discrimination against bottled distilled spirits is a historical anomaly based upon no legal or other rational reason. Simply put, there is no basis why bottled distilled spirits should be treated differently than bottled beer and wine.

If such limited transfers could be made in-bond, it would reduce the complexity of the records system and internal controls required to maintain segregated inventories. This proposal greatly would simplify the audit trail for future BATF inspections and verifications, and obviously would maximize business efficiencies and competitive conditions for the distilled spirits industry.

2. DRAWBACK OF DISTILLED SPIRITS TAX ON SPIRITS USED IN NON BEVERAGE PRODUCTS.

Distilled spirits manufacturers are faced with a burdensome and unnecessarily complicated regulation when filing drawback for non beverage alcohol claims. The Internal Revenue Code authorizes "drawback" for those products which contain distilled spirits that are unfit for beverage purposes.

Presently, a company can only obtain drawback by processing a claim and paying the government $13.50 per proof gallon of the distilled spirits used in its products, and, upon processing its claim, the company then is remitted $12.50 per proof gallon. Drawback is due and payable monthly or quarterly upon filing a claim with the Secretary of the Treasury (Bureau of Alcohol, Tobacco and Firearms, (27 Code of Federal Regulations, Part 197).

The current regulations cover the allowance of drawback of tax on distilled spirits used in the manufacture or production of medicines, food products, flavors, or flavoring extracts which are unfit for beverage purposes.

A much more efficient way to accomplish "drawback" is to permit a company to pay the $1.00 fee (rather than filing a drawback claim for $13.50 and being refunded $12.50) and thus eliminate the intermediate paperwork and financial transaction in a straightforward manner unencumbered by the present method of payment. If this simplification procedure for filing drawback claims, distillers would still be paying $1.00 and fully meeting the requirements of the law.

Such a system would eliminate the present requirement for the processing of the claim, and the drawback could be verified by BATF on a post-audit basis. The economies and efficiencies of this proposals are self-evident.

In summary, the Distilled Spirits Council of the United States commends Chairman Archer for reviewing ways to simplify and improving current tax laws while fundamentally reforming our nation's tax laws. Enactment of these provisions will result in increased fairness and better business efficiency for the distilled spirits industry.

COMMITTEE ON WAYS AND MEANS

HEARINGS ON MISCELLANEOUS TAX REFORMS

STATEMENT OF GENZYME CORPORATION

DRAWBACK OF DISTILLED SPIRITS TAX ON SPIRITS USED IN NONBEVERAGE PRODUCTS

Genzyme Corporation is a biotechnology company based in Cambridge Massachusetts. Genzyme strongly supports the proposal listed in the July report of this Committee that would allow nonbeverage companies that pay an excise tax on alcohol and then apply for a drawback (refund) to simply pay the net tax.

We believe the current drawback system is unnecessarily bureaucratic. As a manufacture of medicines, Genzyme can claim a drawback of the excise tax it has paid on the alcohol used in the manufacture our biotherapeutic products. Under present law, we pay an excise tax of $13.50 per proof gallon when we purchase the alcohol and then apply for a $12.50 refund. Not only does this require staff resources from our company to comply with the paperwork necessary to claim a drawback, it also requires staff resources of the Bureau of Alcohol, Tobacco and Firearms (BATF) to process the refund requests.

Also, the current drawback system withholds money that is vital to our industry. According to a report by Ernst and Young published last year, fifty percent of the publicly held biotechnology companies do not have sufficient capital to survive more than two years. This analysis does not include privately held companies, which typically have less cash. Each year, BATF returns approximately $230 million under the drawback provision, a portion of which goes to the biotechnology industry. Last year, Genzyme paid $175,000 in excise taxes for use of alcohol and had $162,000 refunded. For small biotech companies, money held by the BATF is needed to pay its employees. For larger biotechnology companies, this money could be used for research and development.

The proposal being considered by this Committee is to allow companies that can claim a drawback to pay just the net amount between the excise tax and the refund, or $1 per proof gallon.

We do not expect that this proposal would be a cost for the government. The BATF has estimated that the loss to the government for use of the money during the interval between the payment of the excise tax and refunding the drawback claim to be roughly $3.5 million. Such a nominal cost could be offset by eliminating the BATF staff resources to process the refund requests.

The primary concern of the BATF on this proposal has been, as we understand it, that the government's position would be weakened by not being able to deny or deduct from a drawback claim if a company were found to be using the alcohol for unauthorized (beverage) purposes. While withholding money is one method to ensure compliance, we believe there are other less draconian enforcement methods available to the BATF that are as effective. Under current law, if the BATF were to find unauthorized use of alcohol it could withdraw the alcohol permits which allow us to claim a drawback or issue fines provided for under 26 U.S.C. §5603.

Genzyme commends Chairman Archer and this Committee for undertaking this effort to review this and other tax provisions. We thank you for your consideration of this proposal to remove for those nonbeverage industries the unnecessary and burdensome requirements for obtaining a drawback of alcohol excise taxes.

Statement of Stanley F. Hugenberg, Jr.
On Behalf Of The James Graham Brown Foundation, Inc.
Committee On Ways And Means
July 11, 1995

I am Stanley F. Hugenberg, Jr., a trustee of the James Graham Brown Foundation, Inc. ("Foundation"), a Kentucky nonprofit corporation exempt from Federal tax under § 501(c)(3) of the Internal Revenue Code and classified as a private foundation under § 509. My statement is to urge adoption of the proposal to amend the Internal Revenue Code to provide that costs of a private foundation in investigating, remediating or removing hazardous substances should be treated as qualifying distributions under § 4942.

§ 4942 of the Code requires that charitable foundations make qualifying distributions equal to 5 percent of the fair market value of the foundation's assets for the year, reduced by certain amounts. Qualifying distributions include expenditures for charitable purposes and grants to public charities or private operating foundations.

The amendment being considered by the Committee provides that certain costs incurred to voluntarily investigate, remove, or take other remedial action in regard to hazardous substances released at facilities owned or operated by the charitable foundation, shall qualify under § 4942 as a qualifying distribution. I stress that this amendment would only apply to hazardous substance removal costs incurred voluntarily by the foundation.

The amendment has previously passed both houses of Congress and was included in H.R. 11, which passed Congress in 1992 but was vetoed.

The amendment addresses the problem that charitable foundations face in choosing to voluntarily engage in hazardous substance clean-up efforts, the potentially enormous cost of which can threaten to deplete the corpus of the trust. This amendment recognizes that clean up efforts voluntarily undertaken by a foundation effectively advance a charitable purpose, and provide a strong incentive for such foundations to come forward and begin clean up efforts.

The amendment will encourage early intervention and cooperation with Federal and State entities, and ultimately will forward the goal of Superfund clean up. This provision will not let such foundations off the hook, nor recognize efforts made pursuant to nonconsensual order or judgements. It will, however, allow those responsible foundations which voluntarily engage in clean up efforts to remain in the business of supporting charitable causes.

In 1969, the Brown Foundation was bequeathed the majority of its assets, including the stock in three wood treating plant facilities. The foundation dissolved the companies and liquidated the assets. Nearly 15 years later, the foundation was notified by the Environmental Protection Agency of a hazardous substance clean up problem at one of its sites.

Consistent with the Foundation's charitable purpose, and reflecting the integrity and responsible character of its benefactor, Mr. James Graham Brown, the trustees entered into a voluntary consent order with EPA to clean up the site. That effort is virtually complete. The Foundation is also in the remediary process at the two other former wood treating sites.

These substantial clean up costs, incurred voluntarily, coupled with the requirements of § 4942, threaten to deplete the corpus of the foundation and jeopardize the ability of the foundation to continue its substantial support of so many charitable causes.

The Brown Foundation, and other responsible foundations that find themselves in a similar situation, deserve relief. I thank the Committee for their interest in this matter and for the opportunity to express our views.

Representative Dave Camp
United States House of Representatives
137 Cannon House Office Building
Washington, D.C. 20515

July 25, 1995

The Honorable Bill Archer
Chairman
House Committee on Ways and Means
1105 Longworth House Office Building
Washington, D.C. 20515

Re: Prohibition Against Tax on Agricultural Organization Associate Member Dues (H.R. 783)

Dear Mister Chairman:

This letter is submitted for the record of the July 11 through 12 Committee on Ways and Means hearings on miscellaneous tax reform proposals.

The tax treatment of associate member dues is critical to agricultural organizations across the country.

Agricultural organizations have been tax exempt since the beginning of the Federal income tax. Such organizations have long been composed of at least two types of members: (i) farmer/rancher members and (ii) non-farmer/rancher or "associate" members. The former class, as its name implies, is limited to those engaged in agricultural production. Other individuals who are interested in agriculture may join as associate members.

Both classes of members of agriculture organizations generally pay the same dues and enjoy virtually the same rights and privileges of membership. However, generally only farmers and ranchers are permitted to vote and hold positions on the boards of directors to insure that decisions ultimately are made by those with the greatest practical experience and personal stake in agriculture. Associate members, nevertheless, may actively participate in the organizations and often hold executive positions.

Both classes of members are also typically entitled to purchase various goods and services, including insurance, through entities related to the agriculture organization. Membership, however, is not a prerequisite to buy many of the insurance products made available to organization members, which are sold by taxable organization affiliates at the same cost to members and non-members.

For decades, associate memberships were an accepted part of agriculture organizations practice. Dues from associate members, like any other dues, were universally treated as tax-exempt income. In fact, the IRS officially endorsed this treatment in two rulings issued in the early 1980s. Tech. Adv. Mem. 8302010 and 8302009 (the "1983 TAMs").

That longstanding position, however, was turned on its head last year when the IRS asserted for the first time that the associate member dues of one state Farm Bureau were taxable income. In Technical Advice Memorandum 9416002, under facts virtually identical to those addressed in the 1983 TAMs, the IRS took the position that dues paid by the associate members of the state Farm Bureau are, in fact, payments for insurance and, therefore, unrelated business taxable income ("UBTI") to the state Farm Bureau.

Even a cursory examination of Farm Bureaus reveals that their associate member dues could not simply be payments for insurance as the IRS is contending. First, as the IRS recognized in the 1983 TAMs, associate and producer members have essentially identical rights and benefits. Second, a material number of associate members do not have <u>any</u> Farm Bureau related insurance and the rates of participation in the insurance programs are comparable for associate and producer members. Third, if associate members were only interested in obtaining insurance, they could do so at a lower cost from unaffiliated insurers without joining the Farm Bureau and paying any dues. Fourth, a significant proportion of associate members have made voluntary PAC contributions above and beyond their annual dues payments. All of these facts confirm that associate members join Farm Bureaus to support their exempt functions and not, as the IRS claims, as a means of simply obtaining insurance. Despite this clear evidence, Farm Bureaus are the subject of time-consuming and expensive IRS controversies around the country.

I, Congressman L.F. Payne of Virginia, and many others have worked diligently over the last year to bring this issue to the attention of the Department of Treasury and IRS in the hopes of finding an appropriate resolution that would not require legislation. That effort apparently resulted in the issuance earlier this year of Revenue Procedure 95-21, which simply lays out a new facts-and-circumstances test for determining when associate member dues are taxable.

Unfortunately, this approach is not a satisfactory solution. In fact, the central problems remain unchanged: aggressive IRS agents remain unchecked to assert that an agriculture organization's legitimate actions and statements are only a cover for "hidden" money-making purposes. At the extreme, the Revenue Procedure could require each of the some 2,750 Farm Bureaus to establish the appropriateness of their associate memberships for <u>every</u> taxable year.

While agriculture organizations should ultimately prevail in these actions, the controversies are expensive (for both the organizations and the government) and unpredictable, and they otherwise distract the organizations from accomplishing their important exempt purposes.

This is why on February 1, 1995, along with Congressman Payne (and to date 114 other bipartisan cosponsors), I introduced H.R. 783, the Tax Fairness for Agriculture Act of 1995.

H.R. 783 was drafted specifically to avoid the problems of vagueness and continued wasteful audits that characterize the recent IRS approaches. H.R. 783 has two components:

(i) For prior years, agricultural organizations that reasonably relied on the 1983 TAMs would be shielded from unwarranted and potentially devastating audits; and

(ii) A prospective safe harbor would be provided for annual dues paid by members of agricultural organizations of $100 or less. This would preclude wasteful and costly disputes in cases involving relatively nominal dues.

Moreover, the staff of the Joint Committee on Taxation has estimated that H.R. 783 "would result in a negligible loss of Federal budget receipts over the six fiscal years 1995 through 2000" (please see enclosed March 13, 1995, letter from Ken Kies to L.F. Payne). In other words, the current regime of uncertainty and potentially endless disputes could be resolved at essentially no cost to the American taxpayer.

H.R. 783 would simply confirm the appropriate treatment of associate member dues at no material cost to the government. Moreover, ending these expensive and ultimately unproductive disputes would free-up the limited resources of both the government and taxpayers for more productive uses.

Sincerely,

DAVE CAMP
Member of Congress

DLC:mdl
Enclosure

Congress of the United States

JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

MAR 13 1995

Honorable L.F. Payne
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Payne:

This is a partial response to your letter of March 7, 1995, requesting revenue estimates for a number of tax provisions. This letter provides a revenue estimate for H.R. 783, the "Tax Fairness for Agriculture Act of 1995".

H.R. 783 would provide that annual dues of less than $100.00 paid to agricultural or horticultural organizations described in section 501(c)(5) would not constitute unrelated business income to such organizations, regardless of any benefits or privileges provided to the members. This provision would be effective for taxable years beginning after December 31, 1994. For taxable years beginning after calendar year 1995, the $100.00 amount would be indexed to changes in the Consumer Price Index.

The bill also would provide transitional relief to agricultural or horticultural organizations that had a reasonable basis for not treating membership dues received prior to January 1, 1995, as unrelated business income. In such cases, no portion of such dues would constitute unrelated business income.

For the purpose of preparing a revenue estimate for H.R. 783, we have assumed that enactment will occur during fiscal year 1995. We estimate that this bill would result in a negligible loss of Federal budget receipts over the six fiscal years 1995 through 2000.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

/S/

Kenneth J. Kies

WRITTEN STATEMENT

by

JAMES A. JOSEPH
President and CEO
Council on Foundations

Hearings on
Miscellaneous Tax Reforms July 11-13, 1995

MR. CHAIRMAN, members of the Committee on Ways and Means, my name is James A. Joseph, and I am President and CEO of the Council on Foundations, an organization of 1400 members representing grantmaking foundations and corporate giving programs from every state and several foreign countries. Our members currently manage over $110 billion in assets and make grants in excess of $6 billion annually to address a wide array of pressing needs such as medical research, disaster relief, low-income housing, drug abuse and illiteracy.

This testimony will offer comment on three issues listed in your Hearing Announcement under the heading "Exempt organizations." The three issues we would like to address are:

- Common investment fund for private and community foundations.
- Modifying rules for private foundation grants to non-U.S. organizations.
- Extending the due date for first quarter estimated tax by private foundations.

I. Common Investment Fund -- currently H.R. 734

We are very indebted to Committee members David Camp (R-MI) and Andy Jacobs (D-IN) for taking the lead in introducing this legislation to the 104th Congress. To date, six additional Committee members have signed on as co-sponsors. This legislation has been introduced in the past three Congresses as well. It is worth noting that:

-- It was the subject of positive hearings before the Select Revenue Subcommittee on May 21, 1992.

-- It passed Congress twice in 1992 as part of the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210) and The Revenue Act of 1992 (H.R. 11). Both of these major tax bills were vetoed by President Bush.

I stress these events primarily to point out that this important legislation to private and community foundations has been carefully developed with the Committee on Joint Tax and has a long history of bi-partisan support and no opposition.

What is a Common Fund for Investments?

The general term "common fund" is used to describe a nonprofit, tax-exempt membership corporation organized and operated by and for its members. The purpose of such a fund is to provide investment management and related advisory services for its members with the goal of enhancing return on their invested assets. Such a fund for foundations would be governed by a board of directors elected by the private and community foundations comprising the membership.

Since 1971 there has been a similar organization called The Common Fund located in Fairfield, Connecticut. It has been very successful but its membership is limited by law -- IRC Section 501(f) -- to educational institutions. Total assets under management at The Common Fund now exceed $11 billion, and over 1000 schools participate.

Simply stated, the Council on Foundations is not trying to re-invent any wheel. We are merely asking Congress to permit private and community foundations to duplicate what has been such a successful program for educational institutions.

In many ways, a common fund resembles a group of mutual funds. The governing board of the common fund hires professional staff who are experts in the area of investment management. The primary function of the board (in consultation with the staff) is to select the investment managers for each different fund (such as a bond fund or an equity fund), monitor their performances, and make changes when warranted. The board of the common fund does not make decisions about which individual stock, bond or other investment to purchase. Each fund within the common fund is likely to have multiple outside managers.

Any member may have all or any portion of its endowment managed by the common fund, and ongoing decisions may be made as to how much of the investment should be allocated between the various types of funds available.

Research Demonstrates Need for Foundation Common Fund

The more foundations are successful in managing their endowments, the more funds will be directly available to combat a wide variety of problems in our society. The Council on Foundations is committed to helping improve investment performance in any way we can.

How well have foundations performed in managing their assets? To help answer this question, the Foundation Center published a study in 1989 entitled Managing Foundation Assets, by Lester M. Salamon of The Johns Hopkins University and Kenneth P. Voytek, an economist with the Center for Local Economic Competitiveness with the Michigan Department of Commerce. This report looked at foundation investment performance for the five-year period of 1979-83.

Based on this comprehensive five-year analysis, the authors reached several important conclusions. They compared foundation performance to a "control portfolio" that assumed a traditional asset mix of 60 percent common stocks, 30 percent high-grade, long-term corporate bonds and 10 percent short-term paper. They then compared actual foundation investment performance to the performance of this "control portfolio." In general, their findings included the following:

1. As a total group, foundations exceeded market returns. For all foundations combined, the annual rate of return on investment assets exceeded the comparable return rate for the market (or control portfolio). Thus, as a group, foundations were doing well in managing their assets for they were exceeding the results of the market.

2. Excellent results of a few larger foundations make the difference. This overall success story was made possible primarily because of the excellent performance of a relative handful of larger foundations who made use of an active investment management approach.

3. Most foundations performed below the results of the market. While the larger, more experienced foundations have adopted strategies for investment management that are working very well, the same is not true of smaller foundations. Most small to mid-size foundations did not match the returns of the market. To quote the authors of this study:

   > While our data indicated that a number of foundations have developed fairly sophisticated approaches to the management of their investments, they also indicated that the majority have not.
   >
   > [I]t is critically important to continue the improvement in foundation investment behavior that is already underway and extend it to the considerable number of foundations that still seem to be lagging behind.

A follow-up study extended this same analysis for three additional years so that we now have an eight-year comprehensive overview of foundation investment performance -- 1979 through 1986. This update by Lester M. Salamon is entitled Foundation Investment and Payout Performance: An Update (1991).

This follow-up study echoed many of the same findings of the initial analysis. In particular it found a significant difference between the performance returns of large foundations (over $50 million in assets) and small foundations (under $10 million). During the eight-year period studied, the larger foundations achieved a median total rate of return that was 2.5 percent higher than smaller foundations. At first glance, this 2.5 percent difference may not seem that important; however, it equals half the minimum payout required for each private foundation.

Based on this extensive research, the author recommends the creation of a common fund for foundations:

> The continued evidence of systematic difference in performance between large and small foundations, and between foundations pursuing more carefully designed and more ad hoc investment operations, suggests a continued need for some kind of "common fund" that would allow small and mid-sized foundations to pool their assets and manage them jointly. Such an approach could afford these foundations the professional management that is increasingly required in today's investment world.

How Will a Common Fund Help Smaller Foundations?

There are roughly 500 foundations with assets over $50 million. Generally, it is foundations within this group that have the most sophisticated investment management. Often, because of their size, they are able to employ a full-time financial officer whose primary task is the oversight of investments and the monitoring of their independent, outside investment managers. Almost without exception, these larger foundations employ outside managers to make the day-to-day investment decisions.

Needless to say, the vast majority of the 33,000 other foundations (with assets less than $50 million) cannot afford this luxury. Limited resources make it impossible to hire a sophisticated, professional financial officer to oversee the investment program. Without this assistance on staff, many boards are not sure how to hire outside managers nor how to monitor their performance. A common fund for foundations can help with all these problems.

A Common Fund Provides Access. Many of the investment managers with the best track records may be retained only if the foundation is able to meet a minimum account level. These minimum levels are sometimes as high as $5 to $20 million. By pooling assets in a common fund, even the smallest foundation can have access to the best money managers.

A Common Fund Can Reduce Fees. Investment managers charge fees based on the amount of principal under management or, in the case of commercial banks on income earned (or on some combination of the two). In almost every case, the fees are based on a percentage that declines as the size of the funds under management increases. By pooling assets in a common fund, smaller foundations may take advantage of these lower percentage fees charged on larger accounts.

A Common Fund Can Help In Choosing Managers. For the governing boards of many small and medium-sized foundations, the task of choosing the best investment managers is difficult. Many foundations have volunteer boards who lack the necessary time, sources of information, and/or expertise to make these important selection decisions. By using a common fund, the selection of managers is delegated to the common fund board of foundation experts who are assisted by highly specialized professional staff with the necessary expertise to identify, choose and evaluate investment managers.

A Common Fund Facilitates Use of Multiple Managers. By pooling assets in various funds, a common fund is able to use multiple managers to handle investment decisions. Smaller foundations often do not have enough assets to make feasible the use of multiple managers. Experienced managers of large endowments (pensions, universities, foundations) have found that the use of multiple managers with complementary investment styles can help obtain a diversified approach in an economy and securities market which is often volatile.

A Common Fund Can Assist in Asset Allocation Decisions. To maintain its purchasing power and keep up with inflation, a foundation must be fairly aggressive in its approach to investments. Perhaps the most crucial decision in such a strategy is how to allocate the endowment assets among stocks, bonds, cash and other investment options. Again, the boards of many foundations often lack the time and/or expertise to make these ongoing important allocation decisions. A common fund can provide a valuable educational component by providing advisory services to individual member foundations so that they can be better informed for making optimal asset allocation decisions.

II. Grants to Non-U.S. Organizations -- part of H.R. 733

Roughly four percent of private foundations grants are made to organizations outside the United States for such purposes as disaster relief and strengthening democratic development. Grants to non-U.S. organizations are made with great care to insure that the grant is used solely for charitable purposes and thus avoiding a penalty under Section 4945. In addition, the U.S. foundation is anxious to make sure the grant will count in meeting its five percent minimum distribution requirement under Section 4942.

From time to time in making grants to non-U.S. charities, the grantor foundation must treat the grantee as the "equivalent" of a private foundation. Grants from one private foundation to another require that the grantor "exercise expenditure responsibility" under Section 4945(d)(4)(B). Unfortunately, when a private foundation makes a grant to another private foundation, even the perfect exercise of expenditure responsibility will not guarantee that the grant will count toward meeting the minimum distribution requirement. This difficult result stems from a technical tax law provision known as the "out of corpus" rule.

The "out of corpus" rule requires that any grant from one private foundation to another must be spent by the grantee private foundation no later than twelve months after the close of the taxable year in which it received its funds. In other words, one private foundation cannot use grants to endow another; the grant funds must be taken "out of corpus" and spent within the required period of time.

The policy behind the "out of corpus" rule is to make sure that private foundation grants benefit the public and are not simply used to build another private foundation's investment portfolio. Unfortunately, this otherwise laudable policy creates severe problems for private foundations that want to fund non-U.S. charities that can satisfy the requirements of Section 501(c)(3), but, for whatever reason, cannot demonstrate that they are the equivalent of a public charity. It is not enough for the grantee to demonstrate that the grant was, in fact, expended for charitable purposes by the end of the required period.

The grant will be treated as "out of corpus" only if the grantee provides records to the private foundation grantor showing that: 1) the grantee met its five percent minimum payout requirement for the year before it received the grant, and 2) in addition to spending the full grant, the grantee satisfied its minimum payout requirement for the year in which the grant was received. If the grant is not fully expended in the year received, the minimum payout must also be satisfied for the year after the grant is received.

Most non-U.S. charities are unfamiliar with the minimum payout requirement and do not keep the records necessary to compute it. Thus, satisfying the "out of corpus" in most cases is impossible.

Proposed change. The proposed legislation provides that a nonoperating foundation grant to a foreign organization treated as a private foundation may qualify as a "qualifying distribution" without regard to the "out of corpus" requirement if: (a) the grantee is not controlled, directly or indirectly by the grantor foundation or its disqualified persons, (b) not later than the close of the first taxable year after the year in which the grant is received, the grantee makes expenditures for one or more charitable purposes equal to the amount of the grant, and (c) the grantor exercises "expenditure responsibility" with respect to its grant.

III. Extending the due date for first quarter estimated tax -- part of H.R. 733

Since 1969, private foundations have paid an excise tax on net investment income (Section 4940). Starting in 1987, the estimated tax rules required of corporations were applied to private foundations. Unfortunately, when the corporate estimated tax rules were applied to private foundations, no one noticed that different tax return dates applied. Corporate tax returns are due the 15th day of the fourth month after the end of the tax year and private foundation returns are due the 15th day of the fifth month. As a result, the first estimated tax due from private foundation under Section 6655(I) is due one month before the tax return is due, making calculating the tax unnecessarily difficult.

Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of the prior year's liability, as shown on the foundation's Form 990-PF, or, for taxable years beginning after 1992, 95 percent of the foundation's current year tax liability -- Section 6655(d). However, while the amount of the first quarter estimated tax liability may thus depend on the foundation's prior year tax liability as shown on the foundation's Form 990-PF, that return is normally not prepared at the time the estimated tax is due since the tax return is not due for another 30 days.

Proposed change. The proposed legislation would amend paragraph (3) of Section 6655(g) to provide that a calendar year foundation's first quarter estimated tax payment is due on May 15, the same day that its Form 990-PF for the preceding tax year is due. Section 6655(I) would automatically make the corresponding change for fiscal year foundations.

COUNCIL ON FOUNDATIONS
1828 L STREET NW WASHINGTON, DC 20036 (202)466-6512

July 25, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Re: Hearings on Miscellaneous Tax Reforms -- Encouraging Contributions of Closely-Held Stock

Dear Mr. Archer:

As part of your hearings held July 11-13, 1995, you requested comments under the section on Exempt Organizations with respect to the issue referred to as follows:

> Permit tax-free liquidation of certain closely held corporations whose stock is given to charity and exempt certain assets from section 514(c)(2) debt financed rules.

On behalf of the Council on Foundations, I am writing to express the support of our organization for this provision which we believe will encourage many donors to contribute significant wealth for charitable purposes -- particularly in the formation and growth of family foundations.

I am President and CEO of the Council, an organization of 1400 members representing grantmaking foundations from every state and several foreign countries. Our members currently manage over $110 billion in assets and make grants in excess of $6 billion annually to address a wide array of pressing needs such as scientific research, disaster relief, low-income housing, drug abuse and illiteracy.

Over the past few years we have seen a significant increase in the formation of family foundations. To cite one example of this, our annual conference of family foundations has grown from 50 participants to over 300 in the past six years. These foundations typically involve donors who wish to make major contributions to charity during their lifetime by transferring wealth to a private foundation where their traditions of charitable giving can be shared with the family and handed down to their children.

In our efforts to promote the growth of philanthropy, the Council supports any effort that will responsibly encourage a donor to contribute to a family foundation a controlling interest in a closely held corporation.

However, under current law, for such a gift to be of true benefit to the foundation, the corporation must be liquidated soon after the gift is made (in fact, if given to a private foundation, the excess business holdings rules in Section 4943 would require divestment within five years). Unfortunately, such a liquidation today (and since 1986) results in a taxable event whereby as much as 34 percent of the value of the corporation must be paid in tax, thus substantially reducing the value of the charitable gift.

Based on our exposure to the growing interest in family philanthropy, we are convinced that more donors could be encouraged to contribute substantial assets for charitable purposes if the implications of this liquidation tax could be removed.

We urge your favorable treatment of this important amendment to the tax code.

Sincerely,

James A. Joseph

James A. Joseph
President and CEO

July 27, 1995

Statement of
The Coalition for Fair Corporate Sponsorship Rules
Before the
Committee on Ways and Means
United States House of Representatives

Prepared for Hearings on
Miscellaneous Tax Proposals
July 11 and 12, 1995

The Coalition for Fair Corporate Sponsorship Rules, a voluntary association of tax exempt organizations which, among other things, support and organize public events which raise funds which are devoted to tax exempt functions, are pleased to submit the following written testimony in connection with the Committee on Ways and Means hearing on miscellaneous tax proposals. The Members of the Coalition are listed at the end of this testimony.

For the reasons stated in this testimony, the Coalition enthusiastically supports H.R. 1161, legislation to provide an exclusion from unrelated business taxable income for certain corporate sponsorship payments, and applauds the legislation's sponsors and co-sponsors for their leadership on this issue.

As the Committee is aware, legislation virtually identical to H.R. 1161 was adopted by Congress as part of H.R. 11, the Revenue Bill of 1992. However, as a result of President Bush's veto of that legislation on unrelated grounds, the Coalition's members once again find it necessary to ask Congress to adopt fair and uniform rules to resolve uncertainties in the law relating to the tax treatment of corporate sponsorship payments.

BACKGROUND

As the Committee knows from its previous consideration of this issue in 1992, little attention was paid to the treatment of corporate sponsorship payments until the late 1980's, when the Internal Revenue Service issued a series of rulings in this area. Under these rulings IRS took the position that it could subject such payments to the unrelated business income tax (the "UBIT") in cases in which its agents concluded that the corporate sponsor was receiving valuable services, including advertising services, in exchange for its support.

Not surprisingly, these rulings presented an extraordinary threat to tax exempts at a time when reductions in federal, state, and local government support for their activities had begun to decline, and they in turn, had begun to rely more and more on the private sector for support. After all, the imposition of UBIT on sponsorship payments would have the effect of reducing by as much as one third funds which are used to support tax exempt functions, including many charitable and educational activities, and a variety of activities which help our local communities.

Moreover, IRS' rulings, which were issued in the absence of any new statutory authority in the UBIT area, were at variance with the basic definition of unrelated business taxable income upon which tax exempts had come to rely in their fundraising activities. Unrelated business taxable income is income derived by a tax-exempt

organization from a trade or business that is not substantially related to its exempt purpose and which is "regularly carried on." In particular, tax exempt organizations had relied on the UBIT exceptions relating to activities which are "not regularly carried on" and with respect to activities which are substantially carried out by volunteers. A large percentage of the tax exempt fundraising activities which are organized by the undersigned take place only once a year, for a short period time, and are run by volunteers.

The interpretation of these rules that exempt organizations have come to rely on is supported by the legislative history, Treasury regulations, and the courts. The legislative history to the Tax Reform Act of 1969 makes clear that income derived from an annual athletic exhibition is not "regularly carried on." (S. Rep. No. 552, 91st Cong., 1st Sess. 67-68 (1969); Staff of Jt. Comm. on Internal Revenue Taxation, 91st. Cong., 1st Sess., Summary of H.R. 13270 (Tax Reform Act of 1969.) Furthermore, Treasury's longstanding regulations provide that intermittent income producing activities will not be considered "regularly carried on," even if they occur on an annual recurrent basis. Regulations 1.513-1(c)(2)(iii). Finally, the Tenth Circuit Court of Appeals in NCAA v. Commissioner, 914 F.2d 1417 (10th Cir. 1990) held that the sale of advertising in the game program for the Final Four basketball tournament was not "regularly carried on." However, the IRS failed to acquiesce in the result of the NCAA case and continued to pursue the fundraising events of exempt organizations. Had IRS agreed to the result in that decision, most if not all of the events which are organized by the undersigned would be protected from UBIT.

We submit that the "regularly carried on" test, which IRS has chosen not to follow, is consistent with the general purpose of the UBIT to prevent exempt organizations from competing unfairly with for profits. Brief once a year events organized for the purpose of raising funds for tax exempt causes simply cannot and do not pose any threat to ongoing commercial businesses. This coupled with the participation of volunteers in many of the fundraising activities emphasizes the non-commercially competitive nature of these events.

A LEGISLATIVE SOLUTION IS NEEDED

We are not unmindful that the Treasury Department has made an effort over the past several years to address some of our concerns through their proposed regulations in the corporate sponsorship area. Nevertheless, these regulations have been outstanding for several years with major issues still to be resolved. We believe it is important to codify rules in this area in order to bring certainty to the exempt community in their fundraising efforts.

For one thing, the state of law absent a legislative solution is and will continue to be uncertain. Since the early 1990's Treasury and IRS have issued a series of rulings and guidance in the form of audit guidelines and proposed regulations which in the aggregate, present a confusing picture as to what activities would, or would not, pose the threat of the imposition of UBIT. While the proposed regulations alleviate the problem to a certain extent, in our view, even if they were finalized, the law still would be confusing.

In this regard, we must emphasize that while uncertainty in the law poses difficulties for all taxpayers, it poses special difficulties for tax exempts. Private support for exempts is a voluntary practice, and while many individuals and corporations are generous, in uncertain economic times, contributors are easily discouraged by concerns that the money they are donating is as likely to go to the government than to be used for tax exempt purposes. Contributor uncertainty reduces the amount of

contributions and, in turn, the ability of tax exempts to do their job.

H.R.1161 presents clear and simple rules to evaluate whether a corporate sponsorship contribution would be subject to the UBIT, and as a result, its enactment would end much of the uncertainty which is of current concern to the tax exempt community. Moreover, these rules merely restate the existing principles of UBIT upon which the Nation's tax exempts have relied.

Another aspect of the proposed regulations which raises concerns about potential uncertainty in the law is the so-called "tainting rule" under which the presence of any "advertising" element, as defined by IRS, however small that element might be, in a public tax exempt event would cause the entire corporate sponsorship payment to be subject to UBIT. By its nature, a "tainting rule" causes uncertainty. Moreover, the "tainting rule" turns the UBIT into a punitive measure, something Congress surely could not have intended when these rules were enacted into law.

The approach taken by H.R.1161, by contrast, would settle the law for tax exempts and their sponsors, encourage critically needed private sector giving, and minimize the need to expand substantial government resources to evaluate which contributions are subject to UBIT and which are not. Two simple questions, originating in existing law, would control that issue under H.R 1161 -- (1) was the event substantially related to the exempt purpose of the organization, or (2) was the event "regularly carried on."

CONCLUSION

The debate in Congress and at the Treasury Department over the tax treatment of corporate sponsorship contributions has made the job of raising funds to support tax exempt functions even harder over the past several years. Because public policy is moving in the direction of placing even greater reliance on private sources to support charitable and other exempt functions, it is imperative that clear, simple, sensible and effective rules be established. H.R.1161 accomplishes that result by making clear that the existing principles in the UBIT area should control.

While certainty in the law, especially in this area, is a very good reason to support H.R.1161, there is another reason which is equally important and which we ask the Committee to keep in mind as it considers H.R.1161.

The debate over corporate sponsorship is focused solely on the tax treatment of funds which are raised and devoted to the furtherance of exempt functions ranging from supporting local hospitals, community centers, disaster relief, education, and a host of other activities which benefit our town and communities, and in the final analysis, people. Funds related to these events which ultimately are received by individuals and business who supply non-exempt support, such as suppliers of equipment used in such events, <u>are taxed</u> as income to those persons.

In other words, the entire focus of the debate over corporate sponsorship contributions has been over whether money devoted to support exempt functions should be taxed -- pure and simple.

We the undersigned organizations who are tax exempts and who support many important public causes, respectfully submit that this debate should be resolved by Congress enacting sensible rules to protect and encourage our ability to raise funds for these purposes. H.R.1161 will accomplish this and we urge the Committee to support its enactment.

Respectfully submitted,
The Coalition for Fair Corporate Sponsorship Rules

The International Festivals Association
Zia Gipson (206) 246-6389

The Football Bowls Association
Bruce Bernstein (214) 741-8686

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The PGA Tour *
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* While The PGA Tour filed a separate statement with the Committee in support of H.R. 1161, it wishes to express its support for this statement as well.

THE PGA TOUR
112 TPC Boulevard
Ponte Vedra Beach, FL 32082

July 27, 1995

**Statement of The PGA Tour
Before the
Committee on Ways and Means
United States House of Representatives**

**Prepared for Hearings on
Miscellaneous Tax Proposals
July 11 and 12, 1995**

The PGA Tour is grateful for the opportunity to submit the following written testimony relating to H.R. 1161, legislation to provide an exclusion from unrelated business taxable income for certain charitable sponsorship payments, in connection with the Committee on Ways and Means hearing on miscellaneous tax proposals.

For the reasons stated in this testimony, the PGA Tour enthusiastically supports H.R. 1161, and applauds the legislation's sponsors and co-sponsors for their leadership on this issue.

In that regard, we want to emphasize that while this testimony is being filed by the PGA Tour, a non-stock membership organization which is exempt from tax under Section 501(c)(6), the true beneficiaries of the legislation are the charities nationwide who sponsor the more than 120 professional golf tournaments which we sanction.

In effect, the corporate sponsorship funds which are donated to the sponsors of tournaments sanctioned by the PGA Tour directly benefit charities such as the Eisenhower Medical Center, the Cancer Fund, the Texas Children's Hospital, local scouts and Big Brothers and Sisters chapters throughout the Nation, and national charitable organizations such as the American Cancer Society and the March of Dimes. A full listing of the charitable organizations which benefitted from PGA Tour sanctioned events in 1994 is attached.

BACKGROUND

Like many of the organizations which support the legislation, the PGA Tour had hoped that the tax treatment of corporate sponsorship funds would have been resolved several years ago. As the Committee is aware, legislation virtually identical to H.R. 1161 was adopted by Congress as part of H.R. 11, the Revenue Bill of 1992. However, as a result of President Bush's veto of that legislation on unrelated grounds, the PGA Tour, on behalf of the many charities which sponsor these tournaments, again finds it necessary to ask Congress to adopt fair and uniform rules to resolve serious uncertainties in the law which persist in this area.

As the Committee knows from its previous consideration of this issue in 1992, little attention was paid to the treatment of corporate sponsorship payments until the late 1980's, when the

Internal Revenue Service issued a series of rulings in this area. Under these rulings IRS took the position that it could subject such payments to the unrelated business income tax (the "UBIT") in cases in which its agents concluded that the corporate sponsor was receiving a benefit in the form of "advertising" in exchange for its support.

Not surprisingly, these rulings presented an extraordinary threat to charities and their supporters at a time when reductions in federal, state, and local government support for their activities had begun to decline, and they in turn, had begun to rely more and more on the private sector for support. After all, the imposition of UBIT on sponsorship payments would have the effect of reducing by as much as one third funds which are used to support charitable activity.

Moreover, IRS' rulings, which were issued in the absence of any new statutory authority in the UBIT area, were at variance with exceptions to the UBIT upon which charities had come to rely on in their fundraising activities. In particular, charitable organizations had relied on the UBIT exceptions relating to activities which are "not regularly carried on" and with respect to activities which are substantially carried out by volunteers. Each PGA Tour event sponsored by a charitable organization takes place only once a year for a period of approximately one week and is run by volunteers.

One of the major reasons why charities have come to rely on these statutory exceptions to the UBIT is that the federal courts have agreed with them. IRS' announcement that it would not follow the decision in NCAA v. Commissioner, 914 F.2d 1417 (1990) (holding that the sale of advertising for programs used in connection with the NCAA's "Final Four" basketball tournament did not result in UBIT because the three week long event was not regularly carried on), a central issue in the debate over the proper treatment of corporate sponsorship payments, is a primary reason why this issue remains unresolved. Had IRS agreed to the result in that decision, corporate sponsorship payments to charities sponsoring PGA Tour events would be protected from UBIT.

We submit that the "regularly carried on" exception, which IRS has chosen not to follow, is consistent with the general purpose of the UBIT to prevent exempt organizations from competing unfairly with for profits. Brief once a year events organized for the purpose of raising funds for charitable causes simply cannot and do not pose any threat to ongoing commercial businesses. This coupled with the fact that the events are primarily staffed by volunteers emphasizes the non-commercially competitive nature of these events.

A LEGISLATIVE SOLUTION IS NEEDED

We are not unmindful that the Treasury Department has made an effort over the past several years to address some of our concerns. Nevertheless, we favor the legislative proposal now before the Committee.

For one thing, the state of law absent a legislative solution is and will continue to be uncertain. Since the early 1990's Treasury and IRS have issued a series of rulings and guidance in the form of audit guidelines and proposed regulations which in the aggregate, present a confusing picture as to what activities would, or would not, pose the threat of the imposition of UBIT. While the proposed regulations alleviate the problem to a certain extent, in our view, even if they were finalized, the law still would be confusing.

For example, under the proposed regulations, IRS agents would be empowered to distinguish between events which contain elements of "advertising," and those which contain nothing more

than mere "acknowledgements" of the sponsor's generosity. While some guidance is provided, it is unlikely to be sufficient in practice to address many of the circumstances which may be present in any particular charitable fundraising event.

In this regard, we must emphasize that while uncertainty in the law poses difficulties for all taxpayers, it poses special difficulties for charities. Charitable giving is a voluntary practice, and while many individuals and corporations are generous, in uncertain economic times, contributors are easily discouraged as a result of concerns over the tax treatment of their donations. Contributor concerns, in turn, reduce the ability of charities to do their job.

H.R.1161 presents clear and simple rules to evaluate whether a corporate charitable sponsorship contribution would be subject to the UBIT, and as a result, its enactment would end much of the uncertainty which is of current concern to the tax exempt community. Moreover, the legislation merely restates the existing principles of UBIT upon which the Nation's charities have relied.

Another aspect of the proposed regulations which raises concerns about potential uncertainty in the law is the so-called "tainting rule" under which the presence of any "advertising" element, as defined by IRS, however small that element might be, in a charitable event would cause the entire corporate sponsorship payment to be subject to UBIT. By its nature, a "tainting rule" causes uncertainty. Moreover, the "tainting rule" turns the UBIT into a punitive measure, something Congress surely could not have intended when these rules were enacted into law.

The approach taken by H.R.1161, by contrast, would settle the law for charities and their sponsors, encourage charitable giving, and minimize the need to expand substantial government resources to evaluate which contributions are subject to UBIT and which are not. Two simple questions, originating in existing law, would control that issue under H.R 1161 -- (1) was the event substantially related to the exempt purpose of the charity, or (2) was the event "regularly carried on."

CONCLUSION

The debate in Congress and at the Treasury Department over the tax treatment of corporate sponsorship contributions has made the job of raising funds for charity ever harder over the past several years. Because public policy is moving in the direction of placing even greater reliance on private sources to support charities, it is imperative that clear, simple, sensible and effective rules be established. H.R.1161 accomplishes that result by making clear that the existing principles in the UBIT area should control.

While certainty in the law, especially with respect to charitable giving, is a very good reason to support H.R.1161, there is another reason which is equally important and which we ask the Committee to keep in mind as it considers H.R.1161.

The debate over corporate sponsorship is focused solely on the tax treatment of funds which are raised and devoted to the furtherance of charitable functions ranging from supporting local hospitals, community centers, disaster relief, education, and a host of other activities which benefit towns and communities across the Nation, and in the final analysis, people. We ask the Committee to bear in mind that any part of a corporate sponsorship payment which is not used for charity, such as a payment for services, is taxed to the ultimate recipient.

In other words, the entire focus of the debate over

corporate sponsorship contributions has been over whether money destined for charity should be taxed -- pure and simple.

The PGA Tour submits that the only reasonable way to resolve this debate is by Congress enacting sensible rules to protect and encourage charitable fundraising. H.R.1161 will accomplish this well and we urge the Committee to support its enactment.

Respectfully submitted,

The PGA TOUR
Edward L. Moorhouse
Executive Vice President,
Legal & International Affairs

(904) 273-3300

Charities Served

... from PGA TOUR, Senior PGA TOUR and ... tournaments, including the following in 199...

PGA TOUR

Anheuser Busch Golf Classic
Th... ...ngs Daughter
...
Wm... ... Health ... Hospital
...
William ...burg Fire Department
...
American Heart Association
Boy Scouts
...
American Cancer Society
USO
Child Development Resources
Virginia Home for Boys
Virginia State Golf Association

AT&T Pebble Beach National Pro-Am:
...
Alzheimer's Association
American Cancer Society
American Red Cross
... Pebble Beach ... Golf Association
AT&T Telephone Pioneers
Annual Prayer Breakfast
...
Boys & Girls Club of the Monterey Peninsula
...
Carmel High School
Carmel Valley Community Youth Center
...
Community Hospital Foundation
...
Food Bank for Monterey ...
Foundation for Monterey County Free Libraries
...
Hospice of the Central Coast
...
John XXIII AIDS Ministry
Joseph ... Memorial for Education
...
Meals on Wheels of the Monterey Peninsula
Meals on Wheels ... Salinas ...
...
Monterey County Agricultural & Rural Life Museum
...
Monterey County Sheriff's Advisory Search & Rescue
...
Monterey High School
Monterey History & Art Association
Monterey Institute of International Studies
Monterey Peninsula Museum of Art
...
Northern California Golf Foundation
Notre Dame High School
...
St. Angela's Children's Center
St. Dunstan's Episcopal Church
Salinas ... Schools
Salvation Army
Salvation Army Christmas Program
San Carlos Parent's Club
Scottsdale Christian Academy
Society for the Prevention of Cruelty to Animals
Soledad Community Hospital District Foundation
Soledad Local Development Corporation
Spreckles Union Educational Foundation
Stanford Golf Club Fund
Stanton Endowment

Tassajara Zen Center
United Way of the Monterey Peninsula
United Way of the Salinas Valley
Visiting Nurse Association
Volunteer Center of Monterey County
... Foundation Plan ...
World Golf Village Foundation
YMCA of the Monterey Peninsula
YWCA Monterey Peninsula
... School
Youth Music Monterey

B.C. Open
...
Appalachian Library
Binghamton ...
Broome ... College Foundation
Binghamton University Foundation
Broome County Head Start
... Special Olympics
Camp ... Days and Special Times
Toys for Tots
...
Catholic Charities Portfolio Cafe
Cider Mill Playhouse
...
Endicott Lions
Endicott Rotary
Endwell Rotary
Endicott Kiwanis
Vestal Rotary
... Club of Western Broome
...
... Health Services Foundation
...
Lourdes Hospital Foundation
Meals on Wheels Western Broome
...
... Association for Retarded Children
Oswego Rotary
...
Samaritan Counseling Center
... Boys and Girls
Southern Tier ... Foundation
...
... Boys and Girls Club
Town of Union Volunteer Emergency Squad
... Cultural Center
Rehabilitation Services, Inc.
Vestal ...
...
Handicapped Children's Association
West Corners Fire Department
West Corners Lions

Bell Canadian Open
Canadian Golf Foundation
United Way of Oakville
Knights of Columbus
St. John's Ambulance
Big Brothers Association
Kids Help Phone

BellSouth Classic
... Children ... at Emory University
Atlanta ... Golf Association
Georgia State Golf Foundation
Boy Scouts of America
...
Georgia Sheriff's Boys Ranch
Cobb County Fellowship of Christian Athletes
... Clinic
... Middle School
Johnson Ferry Baptist Church

Bob Hope Chrysler Classic
A.B.C. Recovery Center
Alano Club of the Desert
American Red Cross
Angel View Children's Foundation
Assistance League of Palm Desert
Boys & Girls Club of Coachella Valley
Boys & Girls Club of Desert Hot Springs
Boys & Girls Club of Palm Springs
Braille Institute of the Desert
Coachella Valley Boxing Club
Coachella Valley Firemen's Association
Coachella Valley Parents United
Coachella Valley Rescue Mission
Community Blood Bank Center
Desert Area Meals on Wheels
Desert Blind Association
Desert Rehab Services, Inc.
Desert Rehab Sunshine Program
Eisenhower Medical Center
Family Service of Coachella Valley
Family YMCA of the Desert
FISH of the Lower Coachella Valley
Food in Need of Distribution
Foundation for the Retarded
Guide Dogs of the Desert

HDS Foundation
Desert Palm Springs Youth Center
Palm Springs Child Development Center
Palm Springs Stroke Activity Center
Pathfinder Ranch
Oasis Riding Academy
San Gorgonio Girl Scout Council
Shelter from the Storm
United Cerebral Palsy of California
Variety Boys & Girls Club of Cathedral City

Buick Classic
United Hospital Medical Center
Foundation of Hudson Valley Hospital
Lawrence Hospital
The Mount Vernon Hospital
New Rochelle Hospital Medical Center
Northern Westchester Hospital Center
Phelps Memorial Hospital Center
Putnam Hospital Center
St. Agnes Hospital & Children's Rehabilitation Center
St. John's Riverside Hospital
St. Joseph's Medical Center
St. Vincent's Hospital
White Plains Hospital Center
American Diabetes Association NY Downstate Affiliate, Inc.

Buick Invitational of California
Baseball for Sports (? S)
San Diego County Junior Golf Association
Assistance League of San Diego
Boys & Girls Club of East County
Boys & Girls Club of San Diego
Boys & Girls Club of San Dieguito
San Diego State University Golf Program
University of San Diego Golf Program
University of California San Diego Golf Program
San Diego Hall of Champions
La Jolla YMCA
Armed Services YMCA
San Diego County Golf College Superintendents Association
Serve San Diego
Seau Foundation

Buick Open
Easter Seal Society
American Red Cross
Whaley Children's Center
Flint Institute of Arts
Flint Institute of Music
Genesee County Association of Retarded Citizens
Flint Osteopathic Hospital Fund
St. Joseph Hospital Auxiliary
McLaren Regional Medical Center Auxiliary
Evans Scholars Foundation
Flint Junior Golf Association
Michigan School for the Deaf PTA
American Lung Association
Detroit Police Athletic League
Boy Scouts
Grand Blanc Community Schools
March of Dimes
Detroit Children's Hospital Burn Unit
Detroit Public Schools Golf Program

Buick Challenge
Boys Club of Columbus
Boys & Girls Club of Lee County
Carpenter's Way Ranch
Chattahoochee Council of Boy Scouts of America
Christian Service Center
Columbus College Foundation/G. Gunby Jordan Endowment Fund
Columbus College Foundation/Music Department
Columbus Symphony
Concharty Council of Girl Scouts, Inc.
Coweta Special Olympics
Emory University Robert Jones Scholarship Fund
Girls Club of Columbus
PGA TOUR Charities
Seniors for Kids
Twin Cedars Youth Services, Inc.
United Way of Barnesville
Warm Springs Roosevelt Development Fund

Canon Greater Hartford Open
Urban League of Greater Hartford
Mi Casa Family Service and Educational Center
The Bridge Family Center Inc.
Ramon E. Betances Elementary School
Hartford Consortium for Higher Education
Connecticut Community Care Inc.
Project Hope, Inc.
Hartford Public Schools Inc.
School of The Hartford Ballet
Youth Challenge of Greater Hartford, Inc.
Network Against Domestic Abuse of N. Central Connecticut, Inc.
Felician Adult Day Care
Greater Hartford Jewish Community Center
Paul & Lisa Program Inc.
Glastonbury Boys Club Inc.
Chamber Music Plus Inc.
Christmas Renewal Team of Greater Hartford, Inc.
The Legal Aid Fund Inc.
Hartford Area Habitat for Humanity
Hartford Area Training Center Inc.
United Cerebral Palsy Association of Greater Hartford
Leadership Greater Hartford Inc.
Connecticut Pre-Engineering Program Inc.
Prudence Crandall Center for Women
West Hartford Seniors Job Bank Inc.
Greater Hartford Jaycees Soccer Inc.
Jaycee Challenger Baseball League
Jaycee Houses I and III
Catholic Charities Catholic Family Services, Inc.
Connecticut Community Care Inc.
Hartford Interval House Inc.
Greater Hartford Transit District
Loaves & Fishes
YMCA of Greater Hartford
American School for The Deaf
Children in Placement Connecticut, Inc.
Connecticut T.B.I.
Felician Adult Day Care
Wheeler Clinic Inc.
American Cancer Society
Sammy Davis Jr. Memorial Scholarships
Jackie Robinson Scholarship
Habitat for Humanity
Barbour School
Asylum Hill Neighbors
Hartford Stage Company
Very Special Arts Connecticut
Connecticut Women's Legal & Education Fund
Interim Communications/Connecticut
West Hartford Interfaith Coalition

Colonial National Invitation
All Church Home for Children
American Heart Association
Because We Care
Big Brothers Big Sisters of Tarrant County
Boys & Girls Clubs of Greater Fort Worth
Camp Sanguinity
Child Advocates of Tarrant County
Child Study Center
Citizens Crime Commission
First Texas Council of Camp Fire
Fort Worth Hebrew Day School
Girl Scout Council
Happy Hill Farm
Harris Methodist Health Foundation
Hill School
Junior Achievement
Lena Pope Home
Liberation Community
Lighthouse for the Blind
Parenting Center
Ronald McDonald House
Tarrant Council on Alcoholism and Drug Abuse
Tarrant County Cancer Care Services
Tarrant County Mental Health and Mental Retardation Services
Texas Wesleyan University
Union Gospel Mission
United Negro College Fund
The WARM Place
YMCA of Metropolitan Fort Worth
Youth Orchestra of Greater Fort Worth
Good Fellows
Paschal High School Golf/Tennis

Deposit Guaranty Golf Classic
Boy Scout Troop No. 22
Food Effort for Emergency Distribution Inc.
Guiding Summit Home for Girls Inc.
The Guardian Shelter for Battered Families
Madison County Sheriff's Department
March of Dimes
Mississippi Special Olympics
North Jackson Exchange Club
The Palmer Home for Children
St. Catherine's Village
UMC Children's Hospital

Doral Ryder Open.
American Cancer Society
Boys Club of Miami
Dade County Schools
New World Symphony
Cities in Schools
PGA TOUR Hall of Fame
Arthur Ashe Foundation
Baptist Hospital of Miami

FedEx St. Jude Classic:
St. Jude Children's Research Hospital

Franklin Funds Shark Shootout:
National Childhood Cancer Foundation
Casa Pacifica

Freeport McMoRan Classic
St. Michael's Special School
Louisiana Children's Research Center
Camp Challenge
Boys Hope
Bright School
Girl Scouts
Covenant House
Child's Wish
Special Olympics
Parenting Center
Methodist Home
Cystic Fibrosis
Boys & Girls Club
Sunrise Bridge
Odyssey House
American Cancer Society
Children's Hospital
Alcohol & Drug Abuse
Easter Seals
Leukemia Society
March of Dimes
United Christian Charities
Juvenile Diabetes
Ronald McDonald House

Greater Milwaukee Open:
Athletes for Youth
Big Brothers Big Sisters of Wisconsin
Boys & Girls Clubs
Childhood Abuse Prevention Fund
Children's Hospital
Continental Youth Band
Curative Workshop
Easter Seals
Four Lakes Council Boy Scouts
Franklin Medical Center
Golf Foundation of Wisconsin
GMO Charities
Greendale Lions Club
Habitat for Humanity
Hales Corners Lutheran Church
Lombardi Cancer Clinic
Midwest Athletes Against Childhood Cancer
Messmer High School
Muscular Dystrophy
Partners Advancing Value in Education (PAVE)
Penfield Children's Center
Ronald McDonald House
Southwest YMCA
St. Aemilian Lakeside
St. Luke's Medical Center
Telephone Pioneers
TOUR Wives Golf Tournament
United Community Center
United Performing Arts Fund
University of Wisconsin Children's Hospital
University of Wisconsin Hospital & Clinics
Variety Club of Wisconsin
Whitnall Area Sports Association
Wisconsin Junior Golf Association

GTE Byron Nelson Classic.
Salesmanship Club Youth and Family Centers

Quad City Classic
Arrowhead Ranch
Skip-A-Long Day Care Center
Junior Achievement
Tri-County Pork Producers Scholarship Fund
Iowa PGA Section Golf Scholarship Fund
Boy Scouts of America
Family Resources, Inc.
Visiting Nurses and Homemakers Association
Mississippi Valley Special Olympics
Y's Men
Quad Cities Jaycees Chapters
R.I. and Scott County Councils on Alcohol and
Substance Abuse
Bethany Home, Inc.
Metropolitan Youth Program
Big Brothers Big Sisters
Salvation Army
Girl Scouts of America
CrimeStoppers
Handicapped Development Center
Valley Shelter Homes, Inc.
East Area Special Olympics
Shriners
Lions Club
Access Center
American Cancer Society
American Heart Association
American Little League
American Red Cross
Arthritis Foundation Iowa Chapter
Association for Retarded Citizens of Rock Island
County
Association for Retarded Citizens
Assumption High School
Bettendorf Children's Museum Foundation
Bettendorf Knights of Columbus
Bettendorf Optimist Club
Bettendorf Schools Parents and Athletic Boosters
Boys & Girls Clubs of the Mississippi Valley
Bright Beginnings Childcare, Inc. of Aledo, IL
C.A.S.I. Adult Day Center
Cassandra Manning Ballet Theatre
Central Little League
Children's Miracle Network
Christ the King General Fund
Christian Family Care Centres
Christian Friendliness Association
Clinton Big Brothers/Big Sisters
Clinton County Special Olympics
Clinton Humane Society
Clinton Symphony Orchestra
Cloverleaf Ridgewood Schools
Coal Valley Boy Scout Troop 118
Coal Valley Lions
Colonel Davenport Historical Foundation
Community Health Care
Crippled Children's Foundation
Dads Club
Davenport Izaak Walton League
Davenport Jaycee Foundation
Davenport Junior Theatre
Davenport Noon Host Lions Club
Davenport Schools PTA
Davenport Soccer Foundation
Davenport YMCA
Diamond Softball Team ASA
Durant Athletic Boosters
Durant Lions
East Moline Lioness Club
Easter Seal Foundation
Faith Academy Christian School
Family Resources, Inc.
Family YMCA of Muscatine, IA
Fellowship of Christian Athletes
First Day Fund
Friendly House
Friends of BHS Theatre
Friends of East Moline Library
Friends of New Parents Program
Friends of the Davenport Museum of Art
Friends of the Davenport Public Library
Geneseo Community Chest
Geneseo Lioness
Genesis Health Services Foundation
H.E.L.P. Legal Aid
Habitat for Humanity of Knox County, IL
Hearts & Hammers Q.C.A.
Henry County Youth Services Bureau
Humane Society of Rock Island County
Illinois Special Olympics
Immanuel Lutheran School
Iowa East Central TRAIN
Iowa Quad Cities Rotary
Jordan Catholic Schools
Just Kids Child Care, Inc.
Kahl Home for the Aged and Infirm
Kaleidoscope Art Classes Augustana College
Kiwanis Club of Kewanee
Lowden Charitable Trust
Lutheran Social Services of Illinois
Marriage & Family Counseling Center
Martin Luther King Community Center
Maternal Health Center
Meals on Wheels
Milan Aces ASA Softball
Milan Rotary Club
Miss Iowa Scholarship Program
Mississippi Valley Girl Scout Council
Moline Breakfast Optimist Club
Moline Jaycees
Moline Kiwanis Foundation
Moline Little League
Moline Public Schools Foundation
Moline YMCA
Monroe School Dad's Club
Muscatine Lutheran Homes
Neighborhood Housing Services
New Kingdom Trailriders
North High School Athletic Boosters
North Scott Jaycees
Orion Booster Club
Orion Lions Club
Our House Preschool
PACT Protect All Children Together
Playcrafters Barn Theatre
Pleasant View Elementary School PTA
Project NOW
Putnam Museum of History & Natural Science
Quad Cities Alzheimer's Association
Quad Cities Chapter American Red Cross
Quad City Arts
Quad City Composite Squad CAP, Moline, IL
Quad City Juvenile Diabetes Association
Quad City Kids and Company
Quad City Music Guild
Quad City Osteopathic Foundation
Quad City Symphony
RJCCA A Bridge to a New Beginning

Richmond Health [illegible]
River Valley Foundation
Rock Island County Council on Addictions
Rock Island [illegible] Scholarship Fund
Rock Island [illegible]
Rock Island Humane Society [illegible]
Rock Island [illegible] Kiwanis Club
Rockridge Athletic Boosters
Ronald McDonald House
[illegible] Student [illegible] Fund
[illegible] Special Olympics
[illegible] Club
[illegible]
[illegible] Eagle Nature Center
[illegible] Group
[illegible] Scholarship Fund
St. Katharine's St. Mark's College
St. Paul's [illegible]
The Compassionate Friends
The Easter Seal Society of Iowa, Inc.
The [illegible] Connection
The Youth Agenda, Inc.
[illegible] Fund Kaaba & Mohammed Temples
[illegible] Jewish Center
[illegible] Children's Hospital
[illegible] Health Foundation
United Cerebral Palsy Association
United Cerebral Palsy of Mississippi Valley
United Way
Valley Sunrise Rotary Club
[illegible]
[illegible] School, Ltd.
Volunteer Center of the Greater Quad Cities
[illegible] TV
Young Life
Youth for Christ
Youth Service Bureau of Rock Island County
YMCA

Honda Classic
Boys & Girls Club of Broward County
Ronald McDonald Children's Charities of South Florida
South Florida Council Boy Scouts of America
Florida Parks & Recreation
Lutheran Ministry in Christ Youth
[illegible]
Broward County Junior Golf Association
[illegible] High School Band Parents
Coral Springs High School Band Parents
Coral Springs Basketball
[illegible]
[illegible]
Downtown Lions Club
Make A Wish
Community [illegible]
St. Andrew's Catholic Church Auxiliary
Southern Chapter [illegible]
Children's Cardiac Research Foundation

JCPenney Classic
[illegible] of Florida
[illegible] Center Foundation
Big Brothers Big Sisters of Tampa Bay
Boys & Girls Club of Tampa Bay
[illegible] Memorial Hospital
[illegible] of Pinellas
[illegible] Foundation
Junior Achievement
[illegible] Foundation of America
[illegible] Cancer Center Foundation
[illegible] Plant Hospital Foundation
[illegible] Youth Foundation
[illegible] Hospital Auxiliary
[illegible] Hospital Foundation

Kemper Open
Boys & Girls Clubs
[illegible] Syndrome
[illegible] Organization
Museum of Science and Industry
Special Olympics Golf [illegible]
[illegible] Golf Scholarships
Association for Retarded Citizens of Montgomery County
Bethesda Chevy Chase Rescue Squad
Boy Scouts National Capital Area Council
Cabin John Volunteer Fire Department
Children's Inn at NIH
Columbia Lighthouse for the Blind
Easter Seal Society
Girl Scout Council for the National Capital Area
[illegible] Cares
Greater Washington Boys & Girls Clubs
[illegible] Inc.
Juvenile Diabetes
Make A Wish Foundation
Navy Relief Society
[illegible] Kids
Suburban Hospital
The Army Emergency Relief Organization
U.S. Capitol Historical Society
Washington Regional Alcohol Project (WRAP)

Kmart Greater Greensboro Open:
Adult Center for Enrichment
African American Atelier
[illegible] Association
[illegible]
Bennett College
[illegible] Emergency [illegible]
[illegible]
[illegible] Inner City
[illegible] League Baseball
Camp [illegible]
[illegible]
[illegible]
[illegible] Arts African American Arts
Central North Carolina School for the Deaf
[illegible]
[illegible]
Community Theatre of Greensboro
[illegible] Center
[illegible]
[illegible] Basketball
[illegible]
[illegible]
Exchange Club Welcome Baby
Expanding Horizons
Family Life [illegible]
[illegible]
Greensboro Cerebral Palsy
[illegible]
[illegible] Waste Facility (Recycling)
Greensboro Holiday Parade (High School Bands)
[illegible]
Greensboro [illegible] Academy
Greensboro Opera Company
Greensboro [illegible] Commission
[illegible]
Greensboro Young Woman of the Year
[illegible] High School Jazz Band
[illegible] Partnership
[illegible] County Emergency Services
Guilford County [illegible] Rescue
Guilford County Sheriff Department
Human Relations Community [illegible]
Jaycee Scholarships for High School Seniors
[illegible] Center for Multiple Sclerosis
Junior Achievement
[illegible] Youth Sports Program
Natural Science Center
[illegible] Enforcement
North Carolina Shakespeare Festival
North Carolina Special Olympics
North Carolina State Highway Patrol
North Carolina Young Woman of the Year Scholarship
[illegible] Shelter of High Point
[illegible] Caddies
Randolph County Senior Adults
[illegible] Food Pantry
Salvation Army Boys Girls Club
[illegible] Duke University Medical Center
[illegible] House
[illegible] Family Effects
[illegible] Girl Scout Council
[illegible] Aid
[illegible] Health Project
United Cerebral Palsy
[illegible] Services for Older Adults
[illegible] Recreation Center
Greensboro Urban Ministry
[illegible]
Greensboro Beautiful
[illegible]
[illegible] Library
[illegible] Association
[illegible]
[illegible]
[illegible] Speech
Child Care Ministry
Randolph County Senior Adults
[illegible] Meals on Wheels
[illegible] Program for Children
[illegible] Home for Children
[illegible]
[illegible] Theatre Ensemble
[illegible]
[illegible] of North Carolina
Greater Piedmont Teen Challenge
Bell House
Guilford Extension Advisory
Greensboro Pregnancy Care Center
Hospice for Randolph
Our Children's House
[illegible]
Greensboro Urban Ministry
North Carolina Alliance for Mentally Ill
[illegible] Festival
Forward Guilford
[illegible]
Friend of Animal Foundation
Shepherd's Center of Greensboro
North Carolina Society to Prevent Blindness
Guilford County Fire Prevention Society
Children's Flight of Hope
Greensboro Episcopal Housing Ministry

Moonlight Basketball
Grassroots Production Ltd
Reading Connections
Guilford County Junior Miss Scholarship
North Carolina Junior Miss Scholarship

Las Vegas Invitational
West Charleston Lions Club
Las Vegas Junior League
Las Vegas Junior Golf Association
WestCare
Boy Scout Explorers
Nevada Dance Theater
YMCA
Las Vegas Founders Golf Foundation

Lincoln Mercury Kapalua International:
J. Walter Cameron Center

MCI Classic
Arts Council of Northern Beaufort County
Beaufort Area Caregivers Support Group
Beaufort Lions Club
Big Brothers Big Sisters of Beaufort Co.
Boys & Girls Club of Beaufort
Boys & Girls Club of Hilton Head
Boys & Girls Club of Jasper
Clemson University College of Architecture
Child Abuse Prevention Association
Citizens Opposed to Domestic Abuse
Deep Well
Family Resources Inc
Foundation for the Multihandicapped, Blind & Deaf of SC
Friends of Caroline Hospice
Greenbrier Children's Center, Inc.
Hilton Head Regional Habitat for Humanity
Hospice Volunteers of the Low Country
[illegible]
Literacy Volunteers of the Low Country
Low Country Habitat for Humanity
Low Country Human Development Center, Inc
Meals on Wheels Bluffton Hilton Head, Inc.
MUSC Children's Hospital
Orangeburg Family Health Centers, Inc.
Palmetto Chapter of the American Red Cross
Rotary Club of Columbia Foundation
Rape Crisis Center of the Low Country
Second Helpings Inc
South Carolina State Museum Foundation
Tara Hall Home for Boys
The Chamber/Museum Partnership
The Cultural Council of Hilton Head
The Free Medical Clinic, Inc
The Museum of Hilton Head Island
Town of Hilton Head Fire & Rescue Division
United Communities for Child Development
Volunteers in Medicine Clinic
Wexford Golf Village
Benedict College
Claflin College
Morris College
South Carolina State University
Technical College of the Low Country
Voorhees College
Boy Scout Troop 245
Hilton Head Christian Academy
Hilton Head High School
Hilton Head Preparatory School
The Citadel
Hilton Head Island Rotary Club
Island Beautification Association
The Stadium Club Inc
Island School Council
Hilton Head Lions Club
Sea Pines Montessori School
Hilton Head Gators
Island Recreation Center
Rotary Club

Memorial Tournament
Children's Hospital of Columbus
Dispatch Charities
Arthur James Cancer Clinic
Aladdin Protest (Shriners Burns Unit)
Heinzerling Foundation
Hospice at Riverside
St. Ann's Hospital

Mercedes Championships
National Women's Hall of Fame
San Diego Symphony Orchestra
Magdalena Ecke Family YMCA

Motorola Western Open
Evans Scholars

NEC World Series of Golf
Women's Board of Children's Hospital
Beacon Journal Charity Fund
APOB Educational Fund
Akron Jaycee Foundation
Say Yes to Tennis
Mobile Meals
Akron Symphony Orchestra
Summit Education Partnership
Boy Scouts
Pregnancy Care
Haven of Rest
Interval Brotherhood Home
Tri County Independent Living
Let's Grow Akron

New England Classic
Worcester Area Association for Retarded Citizens
American Lung Association
Cerebral Palsy Association
Dana Farber Inc
Telephone Pioneers
Boy Scouts of America
VNA of Worcester Home Health Systems, Inc.

Nestle Invitational
Arnold Palmer Hospital for Children and Women
University High School Golf Team
Dr. Phillips High School Golf Teams

Nissan Los Angeles Open
L.A.'s Best
Heart of L.A. Youth
Educational Resource & Service Center
Museum of Contemporary Art
Los Angeles Junior Chamber of Commerce Projects

Northern Telecom Open.
20/30 Club
3A High School Golf
American Cancer Society
American Legion Baseball
Amphitheater Girls Softball Team
Amphitheater Summer Basketball
Arizona Cats
Arizona Children's Home
American Express Softball
Arizona Fencing Academy
Arizona Lil Cats
Arthritis Foundation
BCI All Star Team
BCI Boys Basketball
BCI Girls Basketball
Big Brothers & Big Sisters
Bobby Sox
Bonvicini Basketball Camp
Boy Scouts Catalina Council
Boys & Girls Club
Candlelighters of Tucson
Catalina High School Basketball
Club Cactus Juniors
Copper Bowl Foundation
Educational Enrichment Foundation
Fan Kane Flippers
Fleet Feet Striders Track Club
Gymnastics Support Organization
Jacobs Park Soccer Club
Junior Golf Association of Arizona
LPGA Junior Girls Golf Club
Little League
Los Indios Baseball Team
McConnell Basketball Camp
Perimeter Bicycling Association
Pima County Parks & Recreation
Pima County Special Olympics
Ricks Ranch Golf Program
South Tucson Sports League Project YES
Southside Day Care Center
Southside Family Life Center
Speed Pacer
Sporting Chance Youth Basketball, Inc.
Sunnyside High School
Tucson Association of the Deaf
Tucson Awards Committee
Tucson Aztecs
Tucson Bandits
Tucson Community Tennis Program
Tucson Hockey Club
Tucson Parks & Recreation Tennis
Tucson Pony League
Tucson Pop Warner
Tucson Roadrunners
Tucson Royals
Tucson Scramblers
Tucson Sunrays
Tucson Synchro
University of Arizona Golf Program
University of Arizona Indian Programs
University of Arizona Rugby Team
University of Arizona Scholarship Development
University of Arizona Sports O Rama
Wildcat Basketball Camp
YMCA Triangle Y Ranch Camp
Youth On Their Own

Phoenix Open
Thunderbird Youth Fund
Arizona Special Olympics
United Way

Boys & Girls Clubs Metro Phoenix
Boys & Girls Clubs East Valley
Boys & Girls Clubs, Scottsdale
Area High School Golf Teams
Grand Canyon State Games
Arizona State University
Grand Canyon College
Phoenix Community College
Scottsdale Community College
Arizona Panhellenic Council
Make A Wish Foundation
Arizona Law Enforcement Torch Run
American Indian Christian Mission
Coaches Care
Pop Warner Scholar Awards
USGA Women's Public Links Championship
Athletes in Action
"Never Say Never"
Arizona Track Coaches Association
National Prep All American Golf Tournament
Jane Wayland Family Center
Thunderbird Junior Senior Golf Classic
Arizona Women's Golf Association
Arizona Marlins Swim Team
Academic Decathlon
Phoenix Zoo
Foundation for the Blind
Latch School
Ronald McDonald House
Arizona Science Center
Phoenix City Library
YMCA Urban Youth Services Center
Mountain View Teen Center
Save the Family Foundation
Friends of the Chandler Library
Ninos Adelante Day Care
Mountain Park Health Center
Phoenix Day Child Development Center
Glendale Youth Center
Chicanos Por La Causa
Centro de Amistad
Indian Community Health Services
Friends of Scottsdale Library
Southwest Community Network
Cardinal Charities
Boy Scouts
Junior Golf Association of Arizona
Dan Majerle Honda Celebrity Charity Golf Tournament
Phoenix Boys & Girls Club
Foundation for Blind Children
United Fire Fighters Local 493
Phoenix District Tennis Association
Arizona Interscholastic Association
Active 20/30 Club Annual Golf Classic
Phoenix Suns Charities
Arizona Hook A Kid On Golf
Annual Juvenile Diabetes Fundraiser
Pilot Parent Partnership
Arizona Stars Youth Basketball Association
North Valley Juniors Volleyball Club
Phoenix District Tennis Association
Jesse Owens Memorial Track Club
Bang the Boards Tournament/Superstar Basketball Event
ASU Wings of Gold
Northern Arizona University
Ville de Marie Academy
Arizona Baseball
Phoenix Boys Choir
Desert Mashie Golf Foundation
Garden of Gears
MLK Golf Classic
Maricopa County Sports Authority
Sound of America
Athletes International Ministries Youth Program
Arizona Heat All Stars
Second Annual Budweiser Golf Tournament
Arizona Silverbelle Championship
National Youth Sports Coaches Association
Pit Vipers Soccer Team
Esperanza Junior Golf Association
P.W. Brookmire Memorial Golf Tournament
The Vinns
Santos Soccer Club
Fiesta Classic Arizona Juniors Volleyball
American Youth Soccer Organization
National Minority Junior Golf Scholarship Association
Fiesta Bowl Golf Classic
Maricopa County Sheriff's Office

THE PLAYERS Championship
Alden Road Exceptional Student Center
Alzheimer's Association NE Florida
American Diabetes Association
Association for Retarded Citizens/St. Johns
Baker County Special Olympics
Beaches Council on Aging
Beaches Emergency Assistance Ministry (BEAM)
Big Brothers/Sisters of Greater Jacksonville
Boys Home Association
Camp Tracey
Cerebral Palsy of Jacksonville, Inc.
Children's Haven
City Rescue Mission
Clara White Mission Inc
Down Syndrome Association of Jacksonville
Dreams Come True
Elizabeth Edgar Hall Inc
FCCJ Bosom Buddies
FCCJ Golf Program
Fellowship of Christian Athletes (NGM)
Fellowship of Christian Athletes, Jacksonville
Flagler College
Florida Theatre Performing Arts Center
Girls Inc. of Jacksonville
Greenwood School
Grove House of Jacksonville, Inc.
Harbor House of Jacksonville
Hospice of NE Florida Inc
H. Warner Webb Center Independent Living
Jacksonville Urban League
Junior Achievement of Jacksonville, Inc.
JU Athletic Department Golf Scholarship
Learn to Read Inc
Learn to Read/St. Johns
MADD
Morning Star School
NE Florida Exchange Center/Prevent Child Abuse
Otis Smith Foundation
Our House (Alzheimer's Day Care)
PAL St. Johns
Physically Adaptive Recreation & Sports Inc.
PLAYERS Championship Scholarship
Police Athletic League of Jacksonville
Prisoners of Christ Inc
PACE Center for Girls
Quigley House Inc
Riverside Tradition House
Ronald McDonald House
Safe Harbor Boys Home
Speech and Hearing Center, Inc.
St. Gerard House
St. Johns Public Education Foundation
Temple Sisterhood Braille Group
THE LIFE CENTER, INC. (TLC)
THEATREWORKS INC
Travelers Aid Society of Jacksonville
Nancy Reagan TPC Village
University of Florida Golf Program
US Naval Sea Cadet Corps Beaches
Westside Christian Outreach (WSCO)
World Golf Village
YMCA Camp Immokalee
YMCA Nassau County
Youth Leadership Jacksonville

The Presidents Cup
Boys Town of Florida
Fred Meyer Children's Charity
Challenge Cancer Support Network
Leukemia Society for Lymphoma Research
Big Brothers of King County
Fred Hutchinson Cancer Research Center
Overlake Hospital Foundation
Washington Junior Golf Association
Inner City Golf
O'Dea High School Foundation and Annual Fund
Make A Wish Foundation
South African Police Widows and Orphans Fund
St. Jude Children's Hospital
Trinity Christian Academy
UNC Medical School Foundation
Arnold Palmer Children's Hospital
Victorian AIDS Council
Chi Chi's Kids Foundation
St. Louis Children's Hospital
The International Foundation
Safe Harbour
Texas Children's Hospital
Montgomery County Youth Services
Zimbabwe Junior Golf Association
ZimCare Trust
Zimbabwe Golf
Special Olympics
Heather Farr Endowment
New Zealand Golf Foundation
Starlight Foundation
Edgewood Children's Ranch
Big Brothers & Big Sisters
Tennessee Golf Foundation
Mid South Junior Golf Association
Royal Brisbane Children's Hospital Foundation
Freedom from Suffering
Rwanda Relief Fund
Princess Takamatsu Cancer Research Fund

Shell Houston Open
The Chinquapin School
Boys & Girls Country
Boys & Girls Clubs of Houston
Boys & Girls Harbor
Interfaith Center of The Woodlands
Drug Abuse Resistance Education

Junior Golf
The Lighthouse of Houston
YMCA of Greater Houston
United Way of the Texas Gulf Coast
Metropolitan Day Care Center
Friends of Retarded
Montgomery County Youth Services
Star of Hope
The John Cooper School
The Children's Assessment Center
Neighborhood Center Inc Rusk Settlement
Texas Children's Hospital
Research for Science & Engineer Library
The American Heart Association
Big Brothers and Big Sisters of Houston
Houston Achievement Place
Interfaith Child Development
All American Youth Football
Alpha Sigma Phi
Knights of Columbus
Lake Conroe Republican Women
Oak Ridge Lions Club
Mental Health Association of Houston
Newcomers Club
Pathfinders Republican Club
River Plantation Lions Club
Soroptimist Club
Telephone Pioneers
Woodlands Amateur Golf Association
Woodlands Area Republican Women
Xi Upsilda Omicron
Montgomery County Flood Victims
Houston School for Deaf Children

The Skins Game:
Leukemia Society of America Lymphoma Research Center
Big Brothers of King County
Fred Hutchinson Research Center
Washington Junior Golf Association
Inner City Golf Program
Retinitis Pigmentosa
Children's Mercy Hospital of Kansas City

Sprint International
Havern Center Inc
Colorado Golf Foundation
Boys & Girls Club
Denver Area Council/Boy Scouts of America
Golf 4 Fun
Castle Pines Home Association
Woodside Priory School
Elizabeth High School Cardinal Club
Colorado Golf Hall of Fame
Colorado Sports Council
Easter Seals
US West Seniors
Castle Rock Senior Center
Elbert County 4H
Castle Rock Chamber of Commerce
Castle Rock Jaycees
Castle Rock Rotary
Douglas County Child Abuse Association
League of Women Voters
Douglas County High School Student Council
Northridge/Sedalia Elementary
Seratoma
Visiting Nurses Association
Women's Crisis Center
Friends of the Library
Elway Foundation/Celebrity Auction
Colorado Head Injuries Foundation
Plain & Fancy Ball/Metro College
University of Southern Colorado $1 Million Shootout
Denver Nuggets Tournament/Auction
Leukemia Society of America
Woodburn Alumni Golf Charity
American Diabetes "Sandbaggers"
Mile High United Way
American Cancer Society/Jonquil Ball
Evans Scholars Par Club
Colorado Springs Chamber of Commerce
Japan American Society/Fifth Annual
Design Center for Conflict Center
March of Dimes/Wyoming Chapter
Juvenile Diabetes Foundation
Ronald McDonald House
Colorado Business Hall of Fame
Denver Advertising Federation
AMC Cancer Center/Evening Augusta
Cystic Fibrosis Foundation
Colorado University Cancer Center
Court Appointed Special Advocates
Special Olympics Colorado
Make A Wish Foundation
University of Northern Colorado
Colorado Junior Golf
TOUR Wives Golf Classic
National Sports Center for Disabled
Jeffco Early Childhood PTA
Graland Country Day School
Zonta Club of Denver
Diana Price Fish Foundation
Boy Scouts Sports Awards
Colorado Sports Hall of Fame
Colorado Sportswomen Hall of Fame
Tiny Tim Dev Pre School
Bal Swan Celebrity Sports Classic
Channel Six Auction
Colorado Sports Council
Junior Symphony Guild
Medical Care & Research Foundation
NFL Alumni for Children's Hospital
Mile Hi Optimist Club of Denver
Denver Ear Institute
Wichita State University Alumni Association
Colorado Academy
Dutch Creek Elementary School
KVRH Early Birdie Open
National Sports Center for Disabled
The Pueblo Symphony
Canon City Lions Club
Lasley Elementary School
Denver Dumb Friends League
Colorado School of Mines
Denver Zoo
Parents Awareness League
Labor's Community Agency
Denver Metropolitan Convention Bureau
Elizabeth School
Big Brothers of Denver
Aspen Art Museum
Young Audiences Inc
Association for Community Living
Red Rocks Community College
National Kidney Foundation of Colorado
The Rocky Mountain Adoption Exchange
Kmart Greater Greensboro Open
Havern Center's 10th "Chip In
Aspen Susan G. Komen Foundation
University of Denver
Arthritis Foundation
University of Colorado School of Dentistry
Information Handling Services
American Cancer Society/Boulder
Junior Golf Tournament
Buckingham Square Optimist Club
Arvada Jefferson Kiwanis
Presbyterian/St Luke Medical Center
The Harmon Foundation
Hale Irwin Junior Golf
Havern Golf Tournament
Lundquist/Walker Tournament
Castlewood Fire Department
Muscular Dystrophy/Day in May
Easter Seals 24 Hour Relay
20-30 Children's Foundation

LaCantera Texas Open
San Antonio Children's Foundation
High School "Save Our Sports" Program
Youth Alternatives
San Antonio Junior Golf
Rotary Diploma Plus Program

THE TOUR Championship
American Lung Association
American Red Cross
Aragon High School
Bay Area Sports Hall of Fame
Boys and Girls Club of Oakland
Breast Cancer Fund
CASE
Catholic Charities
Center for Handicapped Children and Teenagers
City of San Francisco
Community Impact
Coyote Point Museum Association
Daly City Police Athletic Fund
Delancey Street Foundation
Family Service Agency of San Francisco
Free Wheelers Association
Glide Memorial
Guardsmen
Hospice of the Valley
Interplast, Inc
Jefferson High School
Kidney Foundation
Larkin Street Youth Center
Lincoln Child Center
Leukemia Society of America
Judah L. Magnes Museum
March of Dimes Birth Defects Foundation
Mariposa Youth Leadership and Education Services
Notre Dame High School
Peninsula Humane Society
Riordan High School
Sacred Heart Cathedral Preparatory
Salesian Boys Club
San Francisco Beautiful
San Francisco Unified School District
San Francisco Society for the Prevention of Cruelty to Animals
St Anthony Foundation
St Ignatius College Preparatory
St Lukes Foundation

St. Mary's Medical Center
[illegible]
[illegible]
[illegible] San Francisco
[illegible]
[illegible] High School
[illegible] Peninsula Oral School for the Deaf
[illegible]
[illegible] Village

United Airlines Hawaiian Open:
Bobby Benson Foundation
[illegible]
[illegible] Family Service
[illegible]
Hawaiian Humane Society
Institute for Human Services, Inc.
[illegible]
Police Activities League Booster Club
[illegible] Foundation
[illegible]
[illegible] Comprehensive Health Center
[illegible] Morale Welfare & Recreation

Walt Disney World/Oldsmobile Classic:
Heart of Florida United Way Serving Orange, Osceola and Seminole Counties

SENIOR PGA TOUR

Ameritech Senior Open
Habitat for Humanity Uptown
[illegible]
[illegible]
[illegible] Educational Foundation

Bank of Boston Senior Golf Classic:
Emerson Hospital
Concord Carlisle Boosters
Lincoln Sudbury Booster
3rd [illegible]
GWARC (Greater Waltham Association for Retarded Citizens)
Hanscom AFB Project
Boys & Girls Club of Boston

Bank One Classic
Youth Development Foundation
UK Markey Cancer Center
Friends of the Parks
Gary Player Foundation
Tates Creek High School Band Boosters

Bell Atlantic Classic:
St. Christopher's Children's Hospital

BellSouth Senior Classic at Opryland:
Middle Tennessee Council of Boy Scouts of America
Success by Six
Cumberland Museums
Y Cap

Brickyard Crossing Championship
Big Brothers of Greater Indianapolis
Big Sisters of Central Indiana
Jewish Federation of Greater Indianapolis
Riley Hospital for Children

Bruno's Memorial Classic:
[illegible]
[illegible] Episcopal [illegible] School
Alabama [illegible] Reading [illegible] Network
Alabama [illegible] Foundation
Alabama Head Injury Foundation
Alabama Institute for Deaf and Blind
Alabama School of Fine Arts
Alabama Sheriffs Boys and Girls Ranches
Alabama Sports Writers Association
Alabama Youth Home
All Saints Episcopal Day School
American Cancer Society
American Heart Association Jefferson Shelby Division
American Lung Association of Alabama
American Red Cross Disaster Fund
American Sports Medicine Institute
Angelo Bruno Research Laboratory
Arnold Palmer Hospital
Auburn University Foundation
Be an Apostle of Christ (BAC) Foundation
Big Brothers Big Sisters of Greater Birmingham
Big Oak Ranch, Inc.
Birmingham Ecological Association
Birmingham Festival of Arts Association, Inc.
Birmingham Path Program
Boy Scouts of America Birmingham Area Council
Boy Scouts of America Horseshoe Bend District
Boys & Girls Clubs Central Alabama, Inc.
Boys & Girls Clubs Montgomery
Boys & Girls Clubs Tuscaloosa County, Inc.
Brett Starr Memorial Fund
[illegible] Scholar Athlete Program
[illegible] Charity
[illegible] Cancer Research & Youth Outreach [illegible]
[illegible] Society
[illegible] A Mile
[illegible]
Catholic [illegible]
Center for Urban [illegible]
[illegible] Concessions
[illegible] Charity Fund
[illegible]
[illegible]
[illegible] Hospital [illegible]
[illegible] Hospital [illegible] Alabama Magic Moments
[illegible] Alabama Violence Prevention
[illegible] Missionary Sisters
[illegible] Center
[illegible] Foundation of America Alabama [illegible]
[illegible]
Developing Alabama Youth (DAY) Program
[illegible]
Epilepsy Foundation
[illegible] Community Health Center
[illegible]
[illegible] Shelter for the Homeless
Gary Player Foundation
[illegible] Council
Girls Incorporated of Central Alabama
[illegible] Elementary
Helen Keller Eye Research Foundation
Historical Society of Birmingham
[illegible] Shelby County
[illegible] Spring
[illegible] Explorer [illegible]
[illegible] River [illegible] Concessions
[illegible] Band Association Concessions
[illegible] Athletic Boosters Concessions
James [illegible] Golf
Jefferson County Auburn Club
Jefferson County Easter Seals of Alabama
[illegible] Athletic Booster Concessions
John Carroll Scholarship Fund Standard Bearers
Junior Achievement of Greater Birmingham, Inc.
Ladies Birmingham Golf Association
Lakeshore Foundation
Larry Laoretti Kids Classic
Leukemia Society of America
Literacy Council of Central Alabama
[illegible]
March of Dimes Birth Defects Foundation
Meals on Wheels Birmingham
[illegible] Athletic Boosters Concessions
[illegible] High Athletic Boosters Concessions
Myasthenia Gravis Foundation, Inc.
National Kidney Foundation of Alabama
National Multiple Sclerosis Society Alabama Chapter
Oak Mountain Elementary Concessions
Pelham High Band Boosters Concessions
Pioneers for The American Dream, Inc.
Prescott House
Retired Senior Volunteer Program of Shelby County (RSVP)
SafeHouse of Shelby County, Inc.
Saint Vincent's Hospital
Salvation Army
Salvation Army Adult Rehabilitation Center
SRLT [illegible] by the Tracks
Service Guild Early Intervention Program
Shelby County Educational Foundation Buddies for Books
Shelby Emergency Assistance, Inc.
Shelby Medical Shelby County Healthcare Authority
Special Equestrians, Inc.
[illegible] Bifida Association
St. Jude Children's Research Hospital
[illegible] Foundation
[illegible] Quarterback Club Concessions
UAB Comprehensive Cancer Center
United Cerebral Palsy of Greater Birmingham, Inc.
United Methodist Children's Home
United Negro College Fund, Inc.
United Way of Central Alabama
WJOX Challenge Fore Charity
Youth Extension Clubs [illegible] Kiwanis
YMCA Birmingham

Burnet Senior Classic
Fairway Foundation
Abbott Northwestern [illegible] Auxiliary
[illegible] Foundation
Abbott Northwestern United Hospital Foundation

Cadillac NFL Golf Classic
Tomorrow's Children's Fund
NFL Charities
[illegible] Boys & Girls Club
Gertrude Herbert Art Institute

Chrysler Cup
SAHIB Temple
YMCA (Sarasota Family)

Dallas Reunion Pro Am
- [illegible] Foundation
- [illegible] Economic Development Foundation
- [illegible]
- [illegible] Foundation of Texas
- Juliette Fowler Homes
- Way Back House
- The Jeffries Street Learning Center
- [illegible] Audience
- [illegible] Ministries
- YWCA of Texas

Doug Sanders Celebrity Classic:
- Betty Ford Center
- Easter Seals Society of the Gulf
- [illegible] Foundation
- [illegible] Children's Center
- The Sunshine Kids
- Make A Wish Foundation
- Texas Special Olympics
- Ronald McDonald House
- Doug Sanders International Junior Golf

First of America Classic
- [illegible] Boys & Girls Club
- [illegible] Fund
- [illegible] College
- [illegible]
- [illegible]
- Boy Scouts of America

FORD SENIOR PLAYERS Championship:
- American Red Cross S.E. Michigan Chapter
- [illegible]
- [illegible] Hospital for Children
- [illegible] of America Detroit Council
- [illegible]
- [illegible] Management Services, Inc
- [illegible] for Children
- [illegible] Foundation
- [illegible] Wayne County
- [illegible] Animal Shelter
- Greenfield Congregational Church
- Henry Ford Estate [illegible]
- Henry Ford Health System
- Hook A Kid On Golf
- [illegible] Southeastern Michigan
- [illegible]
- [illegible] Junior Golf Program of Detroit)
- Leukemia Research Life [illegible]
- [illegible]
- [illegible] Research Foundation
- Michigan Cancer Foundation
- Michigan [illegible] Council
- Michigan Parkinson Foundation
- Michigan Special Olympics
- [illegible] Association Inc
- [illegible] Head Injury Foundation Inc.
- [illegible] Hospital Foundation
- [illegible] Inc
- Paralyzed Veterans of America MI Chapter
- [illegible] for Blind Children
- Salvation Army [illegible] Center
- [illegible] Services of Metro. Detroit
- University of Michigan Dearborn
- [illegible]
- William Beaumont Hospital
- [illegible] Village [illegible]
- YMCA [illegible] Family Branch

GOLF MAGAZINE SENIOR TOUR Championship:
- United Way of Horry County
- [illegible] Environmental Education Center
- The Children's Museum of South Carolina
- The Horry Georgetown Technical College Foundation, Inc
- Disabled American Veterans
- Hook A Kid On Golf

GTE Northwest Classic
- YWCA of Seattle
- The Neutral Zone
- Everett Public Schools Foundation
- Boys & Girls Clubs of King County

GTE Suncoast Classic
- Abilities of Florida Inc
- The Hospice of the Florida Suncoast
- Metropolitan Ministries
- Senior Care at University Community Hospital
- OASIS Older Adult Services
- United Cerebral Palsy of Tampa Bay
- Urban Junior Golf Association
- Seminole Rotary Club
- Tampa Police Athletic League
- Tampa Emergency Medical Services

GTE West Classic
- The C.R.E.W.
- Ojai Education Foundation
- Interface (Ventura County)

Hyatt Regency Maui Kaanapali Classic:
- Hale Makua

The IntelliNet Challenge:
- Boy Scouts of America
- The Conservancy
- Youth Haven

Kroger Senior Classic
- Kroger Scholarship Program
- Johnny Bench Scholarship Fund

Las Vegas Senior Classic:
- Las Vegas Founders Club Golf Foundation
- Westcare

Liberty Mutual Legends of Golf
- VIVA Foundation

Nationwide Championship
- Cystic Fibrosis Foundation
- March of Dimes Birth Defects Foundation
- Georgia Baptist Health Care Foundation
- Chattahoochee Booster Club
- Fulton County Sheriff's Reserve
- Scottish Rite Children's Festival

Northville Long Island Classic
- Schneider Children's Hospital/Jewish Medical Center
- St. Paul The Apostle [illegible]
- St. Mary's Children's Hospital
- Consolation Residence

Paine Webber Invitational:
- The Charlotte Jaycees
- Mecklenburg Aquatic Club

Quicksilver Classic
- Greater Pittsburgh Guild for the Blind
- Epilepsy Foundation of Western Pennsylvania
- [illegible] Athletic Association
- [illegible] Athletic Association
- McDonald VFD
- [illegible] Park Fund
- McDonald Library
- D.A.R.E.
- Troop 1322

Raley's Senior Gold Rush
- Junior Golf Association of Northern California
- Northern Nevada Junior Golf Association
- [illegible] Golf
- Junior Golf [illegible] High Schools
- [illegible] for Families
- Easter Seal Society of Superior California
- Wellspring Women's Center
- Stanford Settlement Neighborhood Center
- Youth Guidance Connection
- Victory Outreach Program
- Goodwill Industries of Sacramento Valley, Inc.
- Sierra Adoption Service
- Sacramento Children's Home
- Heart to Heart
- Cystic Fibrosis
- Sacramento Sports Foundation
- Guide Dogs for the Blind
- Heart Association
- U.C.D. Medical Center/Pediatrics
- Senior Gleaners
- Leukemia Society of Sacramento
- [illegible]
- The [illegible] Place
- Salvation Army
- New Helvetia River Oaks
- D.A.R.E.
- California Leadership Program
- Raley's Dental Clinic

Ralphs Senior Classic:
- Fennnela Children's Fund

Royal Caribbean Classic:
- The Miami Project to Cure Paralysis
- MAST Academy
- Project NEWBORN (Miami and Coral Gables)
- Metro Dade County's Adopt A Park
- Easter Seal Society of Dade County

Senior Skins Game
- Arnold Palmer Hospital for Women & Children
- Miami Children's Hospital
- Christina's Smile Children's Dental Clinic
- St. Jude Children's Hospital
- PGA Junior Golf Foundation

Southwestern Bell Colonial:
- Crittenton in Kansas City

The Tradition Presented by Scotts:
- Scottsdale Memorial Health Foundation
- Scottsdale Charros
- Telephone Pioneers of America
- Child Help USA
- United Way

The Transamerica
Boys & Girls Clubs of Napa, CA
Queen of the Valley Foundation
Community Projects Inc

Vantage at The Dominion
San Antonio Junior Golf
Senior TOUR Association Dental Clinic
Ronald McDonald House
Make A Wish Foundation
Oak Hills Rotary Club
Christian Heritage Schools Inc.
Newport News Fire Department
A.L. Murphy VA Hospital
Bexar County Battered Women's Society
San Antonio Golf Association
Ft. Sam Houston Commander Invitational
Purple Heart Chapter #1507 ROA
San Antonio Symphony
Dustoff Association
Ft. Sam Houston Women's Club
San Antonio Junior Golf Association
United States Air Force
Leon Springs Fire Department
Elf Louise Golf Tournament
VA Hospital Kerrville
San Antonio Junior Forum
Child Abuse Prevention Network
Northern Hills Lions Club
Lone Star Superintendents Association
Golf Louise
Operation THAANKS
USO
Ft. Sam Houston Appreciation Day
Pepsi Challenge (Junior Golf)
Air Force Sergeants Association
The Ecumenical Center
Texas CASA
Gary Player Golf
JFK High School
Chamber of Commerce
Central Catholic Scholarship Foundation
Special Olympics Texas
Youth Alternatives Inc
PLAZA Club Blue Santa
San Antonio World Trade
Boysville
I Have A Dream Foundation
Kiwanis Boysville
Children's Habilitation Center

Vantage Championship
Forsyth County Tanglewood Park
Winston Salem Jaycees
Greensboro Swim Association
Forsyth Tech Community College
Gumtree Volunteer Fire Department
O.E.S. Oldtown Chapter
Pfafftown Jaycees
Clemmons Jaycees
Winston Lake YMCA
Best Choice Center
Clemmons Civic Club
Walkertown Volunteer Fire Department
AT&T Telephone Pioneers
Professional Secretaries International
Tanglewood Golf Association
King Volunteer Fire Department
Special Operations Response Team
Grandview Men's Association
Winston Salem Enrichment Center
Salem Chapel Volunteer Fire Department
Tobaccoville Crossing Volunteer Fire Department
Triangle Volunteer Fire Department
Lewisville Civic Club
Clemmons United Methodist Church
Kingswood United Methodist Church
Winston Salem Sertoma
Stratford Kiwanis
Forsyth County Sheriff Reserves & Explorers

NIKE TOUR

NIKE Alabama Classic:
Huntsville Hospital Foundation

NIKE Boise Open:
Rocky Mountain Tumor Institute
Rocky Mountain Section-PGA Scholarships

NIKE Carolina Classic:
Boys & Girls Clubs

NIKE Central Georgia Open:
Multiple Sclerosis Society

NIKE Cleveland Open:
Cleveland Plain Dealer Charities
United Way

NIKE Dakota Dunes Open:
Ronald McDonald House of Sioux City

NIKE Dominion Open:
American Red Cross
YMCA
American Lung Association

NIKE Gateway Classic:
St. Louis Children's Hospital

NIKE Greater Greenville Classic:
Jaycees-"Camp Hope"

NIKE Inland Empire Open:
Children's Fund
Special Olympics
United Way

NIKE Knoxville Open
Boys & Girls Clubs

NIKE Louisiana Open
Louisiana Open Charities

NIKE Miami Valley Open
Hipple Cancer Research Center
Miami Valley Cultural Alliance

NIKE Mississippi Gulf Coast Classic:
Salvation Army

NIKE Monterrey Open:
Nuevo Amanecer
Cerebral Palsy Institute

NIKE New Mexico Charity Classic
Rotary Club
YMCA
Literacy Programs
Del Norte Foundation
Habitat for Humanity
McDonald's Children's Charities

NIKE Ozarks Open
Ronald McDonald House of the Ozarks

NIKE Panama City Beach Classic:
Shaddai Temple Children's Transportation Fund
American Red Cross

NIKE Pensacola Open:
Pensacola Sports Association
United Way

NIKE Permian Basin Open
Medical Center Development for Pediatrics ICU

NIKE Shreveport Open:
Shreveport Open Charities

NIKE Sonoma County Open:
Schools Plus
Junior Achievement

NIKE South Carolina Classic
McLeod Children's Hospital
Boy Scouts of America

NIKE Texarkana Open
Opportunities Inc.

NIKE TOUR Championship
Inner City Golf

NIKE Tri-Cities Open:
American Cancer Society

NIKE Utah Classic:
Utah Special Olympics

NIKE Wichita Open:
American Diabetes Association
Boothe Foundation

* The Boys & Girls Clubs are a charitable beneficiary of each NIKE TOUR event.

SEIM, JOHNSON, SESTAK & QUIST
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TOM H. SCHNACK, C.P.A.

July 25, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Miscellaneous Tax Reform Hearings of
July 11, July 12, July 13, 1995
Written Statement Submitted for the Record

Dear Mr. Moseley:

I wish to submit this statement for the Miscellaneous Tax Reform Hearings of July 11, July 12 and July 13, 1995 for exempt organizations Item #6 "Repeal 1986 Extension of UBIT to Games of Chance".

The Internal Revenue Service has contended that UBIT includes income generated from the sale of pickle cards (pull-tab).

Section 511 of the Internal Revenue Code imposes a tax at corporate income tax rates on the unrelated business taxable income of certain taxable exempt organizations. Unrelated business taxable income generally means the income derived from any unrelated trade or business that is regularly carried on. Internal Revenue Code Section 513 provides that the term "unrelated trade or business means any trade or business the conduct of which is not substantially related to the expressed purpose of the organization's charitable or other exempt purposes".

The Internal Revenue Service interprets Code Section 511, 512 and 513 to say that UBIT does apply to the income generated from the sale of pickle cards.

I do not believe that original congressional intent intended UBIT would stretch to reach the income generated from the sale of pickle cards by tax exempt organizations. The pickle cards are sold only by licensed charitable organizations in the State of Nebraska. Pickle card charities are not engaged in a trade or business covered by the UBIT because under Nebraska law only tax exempt, nonprofit organizations may be licensed pickle organizations; therefore, these organizations cannot legally be in competition with taxable organizations. To apply the UBIT to them would be beyond the scope and policy of the UBIT.

The problem at which the UBIT, enacted in 1950, was directed was primarily that of unfair competition. See H.REP.NO.2319, 81st CONG., 2nd Session, Page 36, SEN.REP.NO.2375, 81st CONG., 2d Session, Page 28, relating to the Revenue Act of 1950. The tax reform of 1969 indicates that Congress' purpose continued to be curbing unfair competition. Although Congress expanded the UBIT in 1969 to certain additional tax exempt organizations:

- It stated that the reason for expansion is because many exempt organizations have engaged in substantial commercial activity. Of the dozen or so illustrations of commercial activities, neither gambling nor pull-tab fundraising was mentioned. SEN.REP.91-552, 1969-3 CB467

- It stated that the amendments provided that the UBIT was not to apply to certain religious orders or educational institutions if it was established to the satisfaction of the secretary that rates and other charges and services provided by such business were fully competitive with and did not exploit similar businesses operating in the same general area. In such case, the report stated there were no competitive advantages obtained by the business by the exemption, in which the exempt organization had for a long time depended on this income, to make it forego approximately half of it would constitute a serious hardship. SEN.REP.NO.91-552, 1969-3 CB469

- Congress had repeatedly rebuffed IRS attempts to expand the UBIT into areas lacking unfair competition. See Clarence LaBelle, INFRA, 580F#2d at 279-281.

- In the Revenue Act of 1978, Congress placed bingo on a tax exempt status. In House Report No.95-1608 stated that "in general the unrelated business income tax was imposed to prevent tax exempt organizations from having an unfair competitive advantage over taxable businesses. In situations where for-profit organizations are not caring on the same activities, the basic rationale does not apply. Similarly, in states where political organizations are allowed bingo games and they do not compete with for-profit organizations, it appears inappropriate to subject the proceeds of these games to tax".

- In the Tax Reform Act of 1969, with regard an amendment to Code Section 513(c) dealing with when advertised activities would be subject to the UBIT, House Report No. 91-513 stated "(the 1967 Treasury regulations) specified that the carrying on of a business in competition with tax paying business would be subject to tax . . . Because of the ensuing controversy over this problem (relating to IRS attempts to tax advertising income) your Committee has decided to deal with this subject by legislation . . . Your Committee believes that a business competing with tax paying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function." 1969 U.S. CODE CONG. and ADMIN. NEWS, P.1695

- The 1978 Revenue Act made it clear that Congress never intended to tax bingo - if it could be legally operated only by tax exempts. Likewise, the 1984 Tax Reform Act (Section 311), is clarified by the 1986 tax act (Section 1834) and 1988 tax act (Section 6201) made it clear that pickle card activities in North Dakota were not subject to the UBIT tax if it could be legally operated only by tax exempts.

  - However, in neither instance did Congress say the UBIT applied to all other gambling activities - even if they could be legally operated only by tax exempts.

  - Instead, Congress was simply responding to two specific situations which had come up by clarifying the law in these two situations.

  - It has left to the IRS and the court to continue to find the scope of the UBIT in the future with regard to all other unclear areas not specifically addressed.

- I contend Congress in 1969, 1978, 1984, 1986 and 1988 has continued to show its inclination to exempt an activity when asked to do so in a specific area, where such activity could be legally operated only by tax exempts.

The above legislative history clearly indicates that the type of trade or business subject to the UBIT is one in which the likelihood of unfair competition could exist. Nebraska statutorily does not permit taxable organizations to compete with tax exempt charities in the pickle card area. Thus, the type of trade or business statutorily required by UBIT is not present. To tax the pickle card income effectively transfers a lawful charitable organization's expenditure to the federal government, i.e. a tax to carry on their activity. Good common sense demands that charity does not exist for the benefit of the federal government.

Nebraska charities do not bear a gambling risk. This risk is borne by the operator which sells the pickle card to the ultimate consumer. Nebraska pickle card regulations require that a charitable organization sell the pull tab device to an operator which is a licensed liquor retailer. The licensed liquor retailer then sells the pull tab to the general public and it is the licensed liquor retailer who bears the risk. When the Nebraska charities sell a pull tab to the licensed liquor retailer, the charity receives its defined profit at that point. The charity has no further responsibility for the pull tab. Nebraska law mandates that the licensed liquor retailer pay the charity at the time the delivery is made of the pull tabs.

I urge the Committee to repeal the 1986 extension of UBIT to games of chance that are carried on by licensed charitable organizations. The extraction of funds from a charitable organization in the form of a tax is not acceptable and merely depletes the organization's funds used for their charitable activity within the state of Nebraska. I understand that several other states have similar types of law and charitable organizations in those states equally need to be exempted from the UBIT on games of chance carried by a licensed charitable organization. I urge your immediate attention in clarifying the applicability of the UBIT to these organizations and permit the charitable organizations to continue on with its activities without incurring continuing substantial legal and accounting fees to litigate the matter in the courts.

Sincerely,

Wendell L. Quist

Wendell L. Quist, C.P.A.
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Omaha, Nebraska 68182
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MAVERICKS

July 21, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Gentlemen:

I am writing to call your attention to Miscellaneous Tax Reforms which would give much-needed relief to organizations such as ours which have been trying to fund their programs in ways which do not burden local or state governments.

In seeking creative, private solutions to our funding problems, we are now experiencing many other roadblocks to our progress.

For the University of Nebraska at Omaha, the difference could be as much as a half million dollars annually. In all likelihood, losing that amount would seriously threaten our existence. Were it not for funding of this nature, a severely tested tax base would be tested even further.

I have enclosed a copy of a letter that was sent in January on our behalf to Congressman Christensen.

Please consider this when you vote on Miscellaneous Tax Reforms.

Sincerely,

Dave Cox
Athletic Director

The Maverick Club

UNIVERSITY OF NEBRASKA AT OMAHA • OMAHA, NE 68182 • (402) 554-2305

January 19, 1995

Congressman Jon Christensen
1020 Longworth House Office Building
Washington D.C. 20515

Dear Congressman Christensen:

The Maverick Boosters Inc. is a non-profit organization established to raise funds for the University of Nebraska at Omaha (UNO) athletic department. As a Division II school, the UNO athletic department is not self supporting and must raise over $500,000 annually to remain competitive in the conference. Accordingly, numerous fund-raising activities have been employed with Pickle Cards as the most successful endeavor.

We have followed, with great interest, your predecessor's efforts to revise the Tax Reform Act of 1986, which would provide relief from Unrelated Business Income (UBI) Taxes for non-profit entities that use Charitable Gaming as a fund-raiser. Recently, we were advised that passing such a bill in the current political and economic climate has little hope of success without some type of companion legislation which provides the revenue offset. The purpose of this letter is to share some additional information regarding this situation.

First, we are not asking you to condone or support Charitable Gaming. Charitable Gaming is a state issue. What we are asking you for is parity on a Federal Tax issue. The Tax Reform Act of 1986 contained language which excluded organizations conducting Charitable Gaming from UBI implications if their state had enacted legislation on a specific date. The only state to which this applied was North Dakota. It was a Congressman from North Dakota on the Ways and Means Committee who placed this language into the act. The consequence of this action is that according to the IRS, every charitable organization in every state in the union, except North Dakota, must pay income taxes on the funds raised through Charitable Gaming.

Second, we are not aware of any non-profit organization that has actually paid these taxes. Therefore, we do not believe there is actually a revenue shortfall. Does the Federal Budget include estimates of revenue for this activity?

Third, the IRS has challenged our non-profit status due to the amount of funds raised through charitable gaming. It is their contention that Charitable Gaming is different from other types of fund raising activity and that we are actually a "for profit organization". Charitable

Gaming can only be conducted by non-profit organizations under Nebraska statutes; therefore, it seems unreasonable and contrary to state statutes to assert that we are a "For Profit" organization. Funds raised through Charitable Gaming are donated to the University of Nebraska at Omaha Alumni Association to support the Athletic program. Removal of our non-profit status by the IRS could cause the revocation of our state license to conduct Charitable Gaming.

The result of these issues is that we believe that we have been thrust into a situation which places us at odds with federal and state law. Our purpose is to provide funds for student athletes at the University of Nebraska at Omaha. Without these donations by our organization, it is feasible that the University's Board of Regents would have to request additional funding from the State. Our perception is that the Federal government is attempting to take funds out of Nebraska which the state will never see again and shortfalls would have to be made up through local taxes.

Regarding the specific legislation, it has been suggested that the language be broadened to cover all forms of Charitable Gaming, not just Bingo and Pickles (Pull Tabs). This would provide much more flexibility if State Legislatures were to allow other forms of gaming for non-profits to participate in. Members of our board would be interested in meeting with you or your Washington staff regarding these issues at your convenience. If this is at all possible, please contact Mr. Wendell Quist at (402) 330-2660 or Mr. Lynn Stephenson at (402) 554-2322.

Sincerely,

Jack Lewis, M.D.
Chairman, Maverick Boosters Inc.

PART I

JOHN D. and CATHERINE T. MacARTHUR FOUNDATION

Limited Expansion of Section 514(c)(9) of the Internal Revenue Code to Include Certain Foundations with Inherited Real Estate

Legislative Background

The Section 514 "debt-financed" income provisions were added to the Internal Revenue Service by the Tax Reform Act of 1969 in response to the *Clay Brown, University Hill Foundation*, and other cases. The problem to which Section 514 was directed involved leveraged acquisitions of assets by tax-exempt organizations. Typically, the exempt organization would purchase a corporate business, agreeing to pay the purchase price out of profits generated from the purchased assets. It would then liquidate the business and lease its assets back to the original seller. Rents would be used to make debt payments. The seller/lessee could deduct the rents in calculating its ordinary income and receive them back in the form of debt satisfaction on the original sale, with the gain portion of each installment taxable at lower capital gains rates. Eventually, the debt would be repaid and the exempt organization would own the assets, free of debt, at little or no out-of-pocket cost.

In 1980, Congress amended the debt-financed income rules by adopting an exception for leveraged real estate investments by qualified pension trusts, coupled with various restrictions to prevent abuses. This exception, Section 514(c)(9), was extended to educational institutions described in Section 170(b)(1)(A)(ii) and their supporting organizations in 1984, along with additional restrictions applicable to pension trusts, educational institutions and their supporting organizations.

History

In 1978, the John D. and Catherine T. MacArthur Foundation received all of the stock of Bankers Life and Casualty Company ("Company") from a trust created by John D. MacArthur during his lifetime. As part of an overall plan to comply with the divestiture requirements of the excess business holding rules under Section 4943 of the Internal Revenue Code, various real estate assets located throughout the United States with an aggregate value in excess of $1.4 billion were distributed by the Company to the Foundation in December of 1983 pursuant to a plan of partial liquidation approved by the IRS.

The real estate assets consisted of extensive holdings in New York (including in excess of 10,000 apartment units and 19 commercial and office buildings) and Florida. The Florida real estate assets included approximately 98,000 acres of vacant real estate in Southern Florida, and in particular, approximately 53,000 acres of vacant real estate in northeast Palm Beach and southeast Martin Counties. Following the 1983 distribution of real estate, approximately 86% of the Foundation's assets were invested in real estate, all of which was essentially inherited from John D. MacArthur.

Since 1983, the Foundation has disposed of the Company, and its sales of inherited real estate assets have exceeded $1.0 billion. Proceeds from these sales were invested in income-producing financial assets, such as stock and bonds (See Exhibit 1, which shows the Foundation's total asset allocations for the years 1983 through 1994.

Despite its continuing effort to reduce its real estate holdings, the Foundation continues to own 43,400 acres of unimproved real estate in Florida, concentrated in Palm Beach and Martin Counties (See Exhibit 2 which contains a map showing the location of the real estate). The Foundation has been advised by independent consultants to continue to take aggressive steps to reduce its remaining real estate holdings, and in particular, to significantly reduce the concentration of its vacant real estate holdings in Florida, but to do so in an orderly way so as to realize the full value of the assets and avoid adversely affecting the values of other properties in the surrounding areas.

Although the Foundation has made efforts to sell the Florida real estate, the economy in recent years, along with the regulatory environment, including an extensive comprehensive land use plan adopted by the State of Florida, has discouraged development and resulted in minimal sales. Moreover, the Foundation has been forced to take back, or participate in "work-out" arrangements for, several properties it sold because of problems experienced by buyers. As a result of all of these factors, the Foundation's real estate assets, in particular the Florida real estate, suffered a reduction in market value of over $300 million based on a 1992 reappraisal of such real estate.

Notwithstanding the decrease in value of its real estate assets, the Foundation has continued to increase its charitable giving. Grants totalling $763.3 million were made during the past five years, far in excess of the 5% minimum distribution requirement applicable to private foundations (See Exhibit 3, which shows the Foundation's actual charitable distributions and the minimum distribution requirements for the years 1984 through 1994.

Problem

The John D. and Catherine T. MacArthur Foundation finds that the income from its investment portfolio is not sufficient to maintain its existing charitable programs, because nearly 28% of its assets remain invested in real estate that does not generate significant cash income to fund the charitable programs. The non-real estate portion of the Foundation's investment portfolio alone does not generate sufficient income to continue to fund and maintain the desired level and quality of the Foundation's charitable programs.

Without additional income from the real estate holdings, the Foundation will have no alternative but to curtail its charitable programs.

The current income yield from the real estate is low because most of the properties are vacant. Selling the real estate is not feasible, due in particular to the limited marketability of the unimproved land and the present state to economic pressures, as well as a regulatory environment that discourages economic development by third-party developers. The economy in which the real estate is situated is stagnant, and it does not appear that revival is imminent. The Foundation needs to find ways to make the vacant Florida real estate either more productive or more saleable in today's market.

Real estate development activities are a necessary element in order to generate current income and create economic demand for the Florida real estate, which over the long term will generate sufficient revenues to fund its share of the Foundation's charitable programs. Absent such activity, the only alternative that the Foundation will have will be to reduce the level of its charitable programs, which would be to the disadvantage of various charitable organizations located all over the world, and their ultimate beneficiaries (See Exhibits 4 and 5, which show projections of future net income, approved charitable

distributions, and cumulative asset sales that will be required if additional revenue is not forthcoming.

The Foundation finds that it has no reasonable alternative for funding the development of the vacant Florida real estate other than to borrow funds. The principal alternative--liquidation of a significant portion of its current investment portfolio of stocks and bonds to fund the improvements--would be imprudent, irresponsible, and unreasonable. Such a liquidation would cause an immediate reduction in income available to fund the Foundation's existing charitable programs and commitments, and cause further concentration of the Foundation's assets in Florida real estate. The current and potential beneficiaries of the Foundation's programs would suffer immediately from the loss of funds to meet current obligations and face the risk of future losses associated with concentrating an even greater portion of the Foundation's endowment in real estate. In contrast, the use of debt to fund improvements to real estate is a traditional and accepted method of financing in the real estate sector and would allow the Foundation to maximize the productivity of its assets for the benefit of charity, both now and in the future.

The use of debt to fund the economic development of the Florida real estate, however, would cause the income generated from the property to be characterized under current law as "debt-financed" and to be taxable as unrelated business taxable income.

The income tax payable due to the application of the debt-financed income rules would make the additional investment to develop the Florida real estate uneconomical compared to other investments. Moreover, and most importantly, the taxes would further reduce the funds available to maintain and enhance the Foundation's charitable programs. Thus, under present law, the Foundation and the public loses regardless of whether the Foundation borrows to fund the development of its real estate or liquidates a portion of its portfolio of stocks and bonds.

Proposal

The special exception from the debt-financed income rules of Section 514(c)(9) currently applicable to pension trusts and educational institutions would apply to debt incurred by a private foundation (as defined in Section 509(a)) to improve any real property if --

(1) at any time since it was organized, more than half of the assets, determined by value, held by the Foundation and acquired, directly or indirectly, by gift or devise, consisted or improved and unimproved real property.

(2) immediately prior to the time the debt was originally incurred, real estate acquired, directly or indirectly, by gift or devise, exceeded 10% of the value of all investment assets held by the Foundation, and

(3) no member of the organization's governing body was a disqualified person (as defined in Section 4946) during the period the debt remains unpaid other than by virtue of being a "foundation manager."

To prevent any unintended abuses, the proposed changes would be subject to the same anti-abuse limitations that apply today to pension trusts and educational organizations.

Rationale

Where a private foundation has received by gift or devise non-charitable assets in the form of real estate that produces little or no current income, the Foundation must choose among these options: (1) reduce its charitable program; (2) sell income-

producing assets; (3) sell its real estate at "fire sale" prices in today's market, and for the foreseeable future; or (4) improve the real estate to make it income-producing. In order to improve its real estate, the Foundation will have to borrow. However, the penalties imposed by the debt-financed income rules will make an otherwise attractive investment unattractive.

As was true for pension trusts and educational institutions before the current law exception was adopted, the debt-financed income rules make many otherwise economically sound investments non-economic, The adverse impact of the tax is exacerbated by the following: (1) in a perverse fashion, as time passes, the portion of overall income that is made taxable increases even where the amount of debt is constant or falling; and (2) most, if not all, gain upon disposition is subjected to taxation if the property is sold while the acquisition indebtedness continues to be outstanding.

The proposed legislation is not limited to a "rifle shot" solely for the benefit of the Foundation. Based upon a limited survey, thirty-one (31) other foundations are eligible for the legislative relief (See Exhibit 6 for listing of eligible foundations). A more extensive inquiry will certainly find additional foundations eligible for the legislative relief. The revenue loss as estimated by the staff of the Joint Committee on Taxation is only $23.0 million (See Exhibit 7 for letter from Joint Committee on Taxation).

Finally, the proposed change would supplement the Administration's current attempts to restore vitality to the real estate sector. The Foundation's efforts to improve the productivity and marketability of its own real estate should be expected to enhance the economy of the surrounding community and produce ripple effects that benefit everyone as a result of the desired economic stimulation.

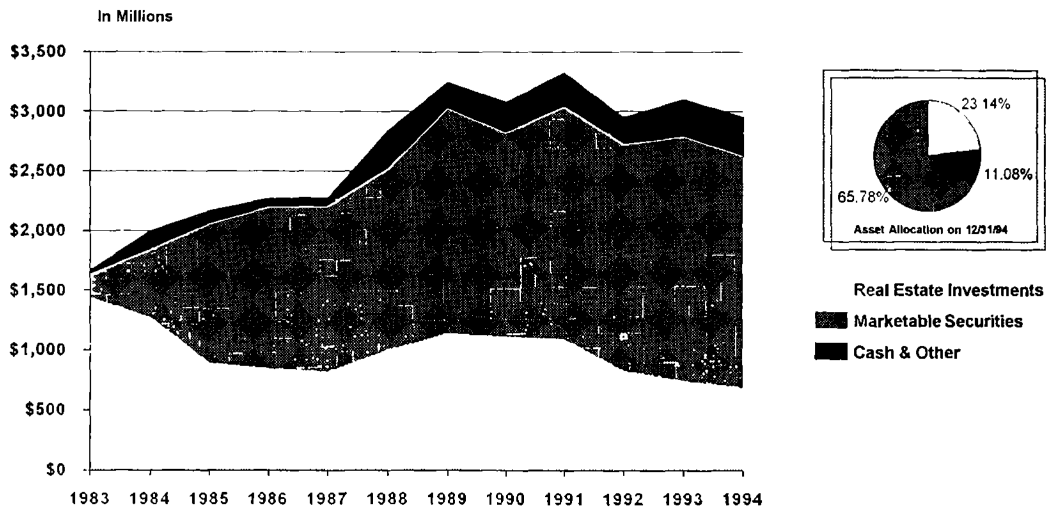
Board of Directors

The Board of Directors of the Foundation is completely independent of the family of John D. and Catherine T. MacArthur. No members of the Board of Directors is in any way related to the founders of the Foundation (See Exhibit 8 for listing of the present members of the Board of Directors).

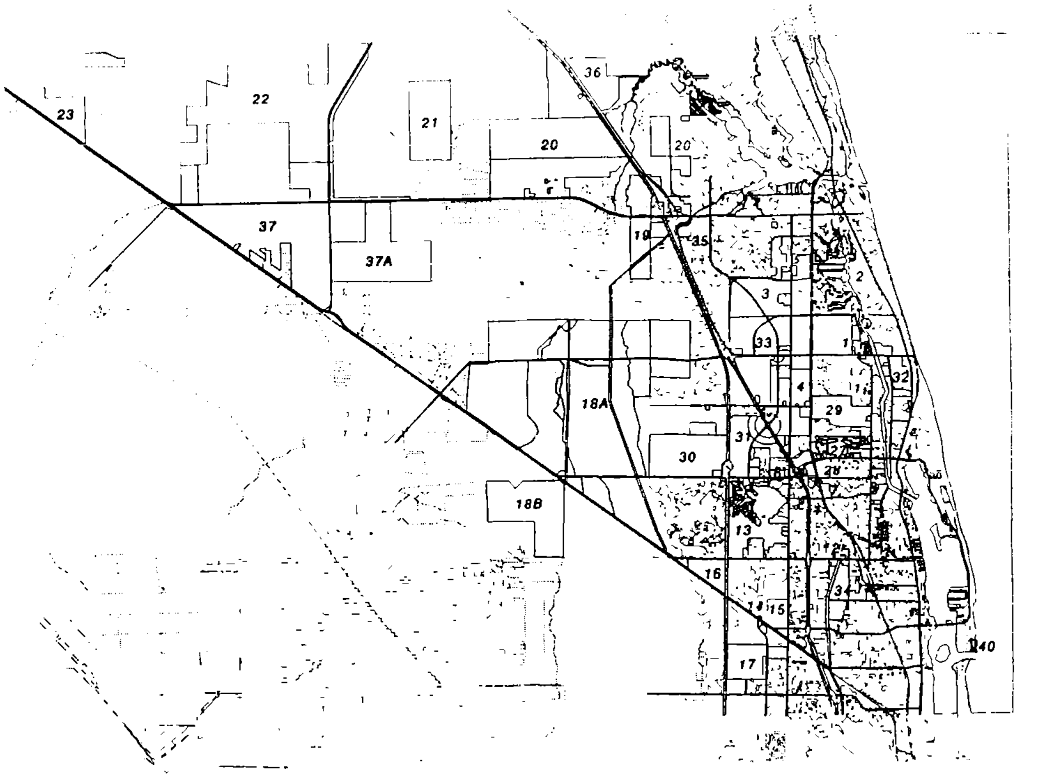
Conclusion

The Foundation seeks the same legislative relief currently available to retirement plans and educational institutions. There is no valid basis for according such relief to such organizations and not to the Foundation or other similarly situated charitable organizations.

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
Total Asset Allocation



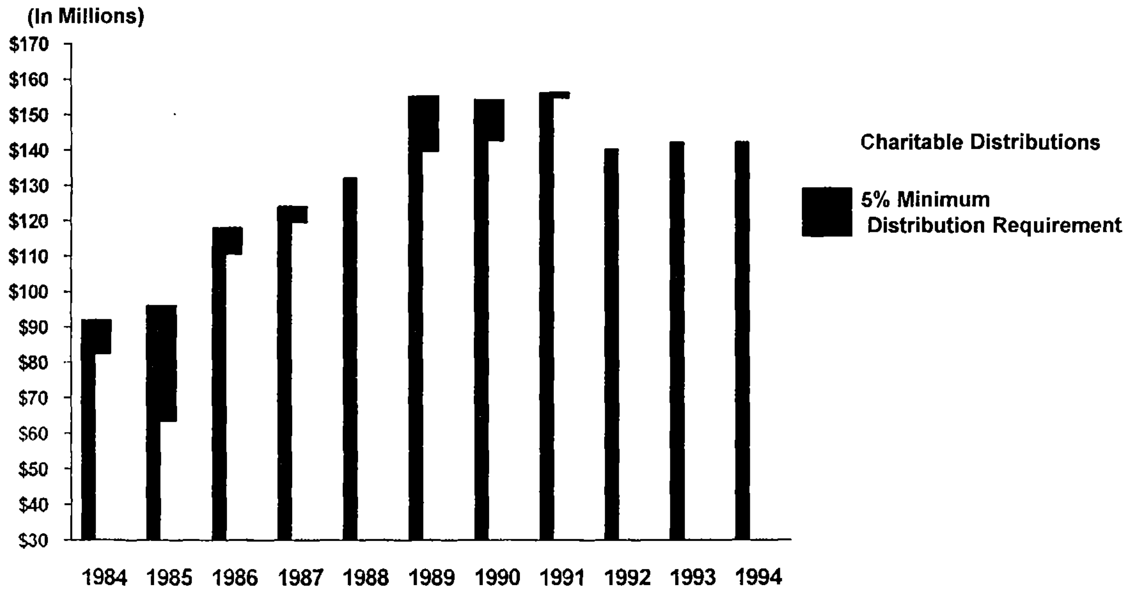
"EXHIBIT 1"



"EXHIBIT 2"

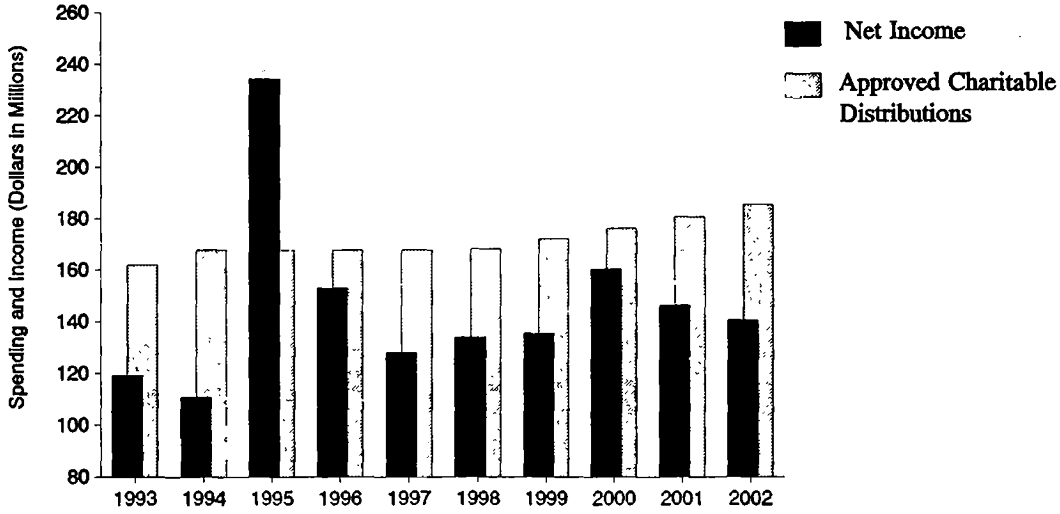
John D. & Catherine T. MacArthur Foundation Holdings Map

The John D. and Catherine T. MacArthur Foundation
Analysis of Distribution

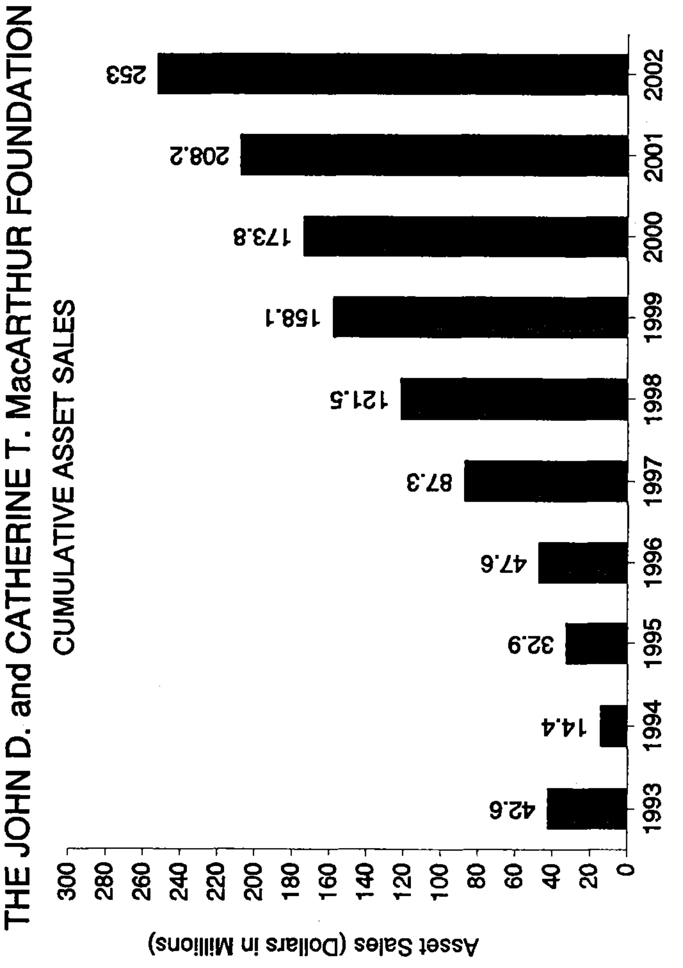


"EXHIBIT 3"

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
APPROVED CHARITABLE DISTRIBUTIONS vs. NET INCOME



"EXHIBIT 4"


THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
CUMULATIVE ASSET SALES
Asset Sales (Dollars in Millions)
0
20
40
60
80
100
120
140
160
180
200
220
240
260
280
300
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
42.6
14.4
32.9
47.6
87.3
121.5
158.1
173.8
208.2
253

"EXHIBIT 5"

PRIVATE FOUNDATIONS ELIGIBLE FOR RELIEF
UNDER THE PROPOSED AMENDMENT TO SECTION 514(c)(9)

			Value of Real Estate (A)
1.	(1)	John D. and Catherine T. MacArthur Foundation (IL.)	$885,465,074
2.	(3)	Liliuokalani Trust (HI.)	$106,038,193
3.	(5)	Fritz B. Burns Foundation (CA.)	$ 61,746,765
4.	(9)	S. H. Cowell Foundation Corp. (CA.)	$ 46,589,544
5.	(12)	Winkler Botanical Preserve (VA.)	$ 31,007,119
6.	(14)	G. Harold & Leila Mathers Charitable Foundation (NY.)	$ 29,671,431
7.	(15)	Emil Buehler Perpetual Trust (NJ.)	$ 29,629,000
8.	(18)	George Foundation (TX.)	$ 23,851,501
9.	(19)	TRW Foundation (OH.)	$ 21,720,121
10.	(22)	Temple Hoyne Buell Foundation (Co.)	$ 20,000,000
11.	(25)	J. L. Bedsole Foundation (AL.)	$ 16,531,321
12.	(28)	Herbst Foundation (CA.)	$ 13,850,961
13.	(35)	Caterpillar Foundation (IL.)	$ 10,570,000
14.	(36)	Mobil Foundation, Inc. (TX.)	$ 10,486,145
15.	(38)	M.S. Doss Foundation (TX.)	$ 9,333,445
16.	(46)	M.G. & Lillie A. Johnson Foundation, Inc. (TX.)	$ 7,780,390
17.	(48)	B. B. Owen Trust (TX.)	$ 7,500,000
18.	(62)	Ben May Charitable Trust (AL.)	$ 4,770,945
19.	(64)	Mary and Daniel Loughran Foundation, Inc. (D.C.)	$ 4,343,725
20.	(67)	Susan Lindsay Trust (CO.)	$ 4,129,924
21.	(71)	Baughman Foundation (KS.)	$ 3,297,430
22.	(77)	The Schowalter Foundation (KS.)	$ 2,753,800
23.	(78)	Apollos Camp & Bennet Humiston Trust (IL.)	$ 2,732,448
24.	(79)	Santa Fe Pacific Foundation (IL.)	$ 2,715,000
25.	(85)	Conn Memorial Foundation, Inc. (FL.)	$ 2,376,450
26.	(88)	Oldham Little Church Foundation (TX.)	$ 2,059,320
27.	(91)	Weller Foundation, Inc. (NE.)	$ 1,867,182
28.	(92)	Ed and Mary Heath Foundation (TX.)	$ 1,834,136
29.	(102)	Robert L. Howell Foundation (MS.)	$ 1,309,479
30.	(117)	Godfrey Thomas Foundation, Inc. (AR.)	$ 750,000
31.	(121)	Harry E. Griswold Trust (IL.)	$ 735,350
32.	(124)	Marietta Dyer Trust U/Will (MA.)	$ 675,525

(A) As reported on 1989 990-PF tax return

EXHIBIT 6

Congress of the United States

JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

OCT 28 1994

Honorable Sam M. Gibbons
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Gibbons:

This letter is in response to your request of April 6, 1994, for a revenue estimate of a modification to Internal Revenue Code (Code) section 514(c)(9). This proposal adds certain private foundations to the list of qualified organizations eligible for the real property exception from the debt-financed property rules.

Under present law, an organization that is otherwise exempt from Federal income tax is taxed on the income derived from debt-financed property in proportion to the amount of debt financing. An exception to this rule exists for qualified organizations, including pension trusts, educational institutions, and certain title-holding companies, if the conditions specified in Code section 514(c)(9)(B) are satisfied.

This proposal would add certain private foundations to the list of qualified organizations that are exempt from the debt-financed property rule. A private foundation would be treated as a qualified organization if (1) at any time, more than half of the foundation's total assets acquired by gift or devise consisted of real property; (2) real estate acquired by gift or devise exceeded ten percent of the value of all assets held by the foundation at the time the debt was incurred; and (3) no member of the organization's governing body was a disqualified person (as defined in Code sec. 4946) other than by virtue of being a "foundation manager" for the period that the debt was outstanding.

We have assumed for purposes of estimation that this proposal would be effective for taxable years beginning after December 31, 1994. The effect on Federal fiscal year budget receipts is shown below.

Fiscal Years [Millions of Dollars]					
1995	1996	1997	1998	1999	1995-99
*	-1	-3	-7	-12	

NOTE: Details do not add to total due to rounding.
* Loss of less than $500,000.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

/S/

John L. Buckley

'EXHIBIT 7'

JOHN D. and CATHERINE T. MacARTHUR FOUNDATION

Board of Directors

John E. Corbally, Former President of the University of Illinois

Robert P. Ewing, Retired Chairman of Bankers Life and Casualty Company

William H. Foege, M.D., Executive Director of the Carter Center of Emory University

James M. Furman, Retired Executive Vice President of the Foundation

Murray Gell-Mann, Millikan Professor of Theoretical Physics, California Institute of Technology, Nobel Laureate

Alan M. Hallene, Retired President, Montgomery Elevator International

Paul Harvey, News Commentator, American Broadcasting Company

John P. Holdren, Professor of Energy and Resources, University of California, Berkeley

Shirley Mount Hufstedler, Attorney-at-Law

Sara Lawrence Lightfoot, Professor of Education, Harvard Graduate School of Education

Margaret E. Mahoney, President, The Commonwealth Fund

Elizabeth J. McCormack, Associate, Rockefeller Family & Associates

George A. Ranney, Jr., Attorney-at-Law

Adele Simmons, President of the Foundation

Thomas C. Theobald, Partner and investor at William Blair Capital Partners, Former Chairman of Continental Bank.

No member of the Board of Directors is in any way related to John D. and Catherine T. MacArthur, founders of the Foundation

"EXHIBIT 8"

PART II

JOHN D. and CATHERINE T. MacARTHUR FOUNDATION

Limited Expansion of Section 514(c)(9) Exception

Overview

The John D. and Catherine T. MacArthur Foundation inherited the stock of Bankers Life & Casualty Company ("Company"). To comply with the excess business holdings requirements of the Internal Revenue Code, the Foundation exchanged the stock for the assets of the Company under a ruling obtained from the Internal Revenue Service. The Foundation has disposed of all the active trades or businesses that it received, and much of the real estate assets. However, approximately 30 percent of the Foundation's assets continues to be vacant real estate.

For the reasons described below, the only prudent course of action is for the Foundation to develop much of this real estate with borrowed money if the Foundation is to meet its commitments and maintain or increase its level of support of other charitable organizations. However, the existing debt-financed income rules cause this approach to be imprudent. The Foundation believes that the solution to this "Catch 22" situation is to extend to the Foundation and any similarly situated organization the same relief from the debt-financed income rules that Congress already has extended to pension plans and educational organizations and their supporting organizations, subject to the same limitations and anti-abuse rules that apply to those other organizations.

Legislative Background

The Section 514 "debt-financed" income provisions were added to the Internal Revenue Code by the Tax Reform Act of 1969 in response to the *Clay Brown, University Hill Foundation,* and other cases. The problem to which Section 514 was directed involved leveraged acquisitions of assets by tax-exempt organizations. Typically, the exempt organization would purchase a corporate business, agreeing to pay the purchase price out of profits generated from the purchased assets. It would then liquidate the business and lease its assets back to the original seller. Rents would be used to make debt payments. The seller/lessee could deduct the rents in calculating its ordinary income, and receive them back in the form of debt satisfaction on the original sale, with the gain portion of each installment taxable at lower capital gains rates. Eventually, the debt would be repaid and the exempt organization would own the assets, free of debt, at little or no out-of-pocket cost.

In 1980, Congress amended the debt-financed income rules by adopting an exception for leveraged real estate investments by qualified pension trusts, coupled with various restrictions to prevent abuses. This exception, Section 514(c)(9), was extended to educational institutions described in Section 170(b)(1)(A)(ii) and their supporting organizations in 1984, along with additional restrictions applicable to pension trusts, educational institutions, and their supporting organizations.

The current restrictions effectively require that (1) the purchase price must be fixed in amount; (2) the indebtedness must not be revenue-dependent; (3) the real estate must not be leased to the seller; (4) in the case of a qualified pension trust, the real estate must not be acquired from, or leased to, a person related to any plan with respect to which the trust was formed; (5) no seller financing may be provided; and, (6) in the case of real estate held in a partnership, either all of the partners are qualified organizations or certain other requirements are satisfied.

In its February 1993 "Revenue Proposals", the Clinton Administration has included several proposals designed to make it easier for "pension funds and others" to engage in a broader range of "legitimate leveraged acquisitions of real estate." The proposals appear to be limited to "qualified organizations" under current law -- i.e., pension trusts, educational institutions, and their supporting organizations. The proposals would permit (1) limited leasebacks of debt-financed real estate to sellers, (2) some seller financing, and (3) both partially contingent sales prices and participating loan arrangements in the case of some distressed real estate. These proposals, and others also included in both the Administration's package and the two major tax bills that Congress sent to President Bush in 1992, generally reflect a recognition of the depressed state of the real estate market and attempt to contribute to creating a climate that will restore its former vitality.

History

In 1978, the John D. and Catherine T. MacArthur Foundation received all of the stock of the Company from a trust created by John D. MacArthur during his lifetime. As part of an overall plan to comply with the divestiture requirements of the excess business holding rules under Section 4943 of the Internal Revenue Code, various real estate assets located throughout the United States with an aggregate value in excess of $1.4 billion were distributed by the Company to the Foundation in December of 1983 pursuant to a plan of partial liquidation approved by the IRS.

The real estate assets consisted of extensive holdings in New York (including in excess of 10,000 apartment units, and 19 commercial and office buildings) and Florida. The Florida real estate assets consisted of operating properties (such as hotels, golf courses, motels, country clubs, and utilities) and approximately 98,000 acres of vacant real estate in Southern Florida, and in particular, approximately 53,000 acres of vacant real estate in northeast Palm Beach and southeast Martin Counties. Following the 1983 distribution of real estate, approximately 86% of the Foundation's assets were invested in real estate, all of which was essentially inherited from John D. MacArthur.

Since 1983, the Foundation has disposed of the Company, and its sales of inherited real estate assets have exceeded $1.0 billion. Proceeds from these sales were invested in income-producing financial assets, such as stocks and bonds (See Exhibit 1, which shows the Foundation's total asset allocations for the years 1983 through 1994).

Despite its continuing effort to reduce its real estate holdings, the Foundation continues to own 43,400 acres of unimproved real estate in Florida, concentrated in Palm Beach and Martin Counties. The Foundation has been advised by independent consultants to continue to take aggressive steps to reduce its remaining real estate holdings, and in particular, to significantly reduce the concentration of its vacant real estate holdings in Florida, but to do so in an orderly way so as to realize the full value of the assets and avoid adversely affecting the values of other properties in the surrounding areas.

Although the Foundation has made efforts to sell the Florida real estate, the economy in recent years, along with the regulatory environment, including an extensive comprehensive land use plan adopted by the State of Florida, has discouraged development and resulted in minimal sales. Moreover, the Foundation has been forced to take back or participate in "work-out" arrangements for several properties it sold because of problems experienced by buyers. As a result of all of these factors, the Foundation's real estate assets, in particular the Florida real estate, suffered a reduction in market value of over $300 million based on a 1992 reappraisal of such real estate.

Notwithstanding the decrease in value of its real estate assets, the Foundation has continued to increase its charitable giving. Grants totalling $763.3 million were made during the past five years, far in excess of the 5% minimum distribution requirement applicable to private foundations (see Exhibit 2, which shows the Foundation's actual charitable distributions and the minimum distribution requirements for the years 1984 through 1994).

Problem

The John D. and Catherine T. MacArthur Foundation finds that the income from its investment portfolio is not sufficient to maintain its existing charitable programs, because nearly 28% of its assets remain invested in real estate that does not generate significant cash income to fund the charitable programs. The non-real estate portion of the Foundation's investment portfolio alone does not generate sufficient income to continue to fund and maintain the desired level and quality of the Foundation's charitable programs. Without additional income from the real estate holdings, the Foundation will have no alternative but to curtail its charitable programs.

The current income yield from the real estate is low because most of the properties are vacant. Selling the real estate is not feasible, due in particular to the limited marketability of the unimproved land and the present state of the economy. Further, the Florida real estate is subject to economic pressures, as well as a regulatory environment that discourages economic development by third-party developers. The economy in which the real estate is situated is stagnant, and it does not appear that revival is imminent. The Foundation needs to find ways to make the vacant Florida real estate either more productive or more saleable in today's market.

Real estate development activities are a necessary element in order to generate current income and create economic demand for the Florida real estate, which over the long term will generate sufficient revenues to fund its share of the Foundation's charitable programs. Absent such activity, the only alternative that the Foundation will have will be to reduce the level of its charitable programs, which would be to the disadvantage of various charitable organizations located all over the world, and their ultimate beneficiaries (See Exhibits 3 and 4, which show projections of future net income, approved charitable distributions, and cumulative asset sales that will be required if additional revenue is not forthcoming).

The Foundation finds that it has no reasonable alternative for funding the development of the vacant Florida real estate other than to borrow funds. The principal alternative--liquidation of a significant portion of its current investment portfolio of stocks and bonds to fund the improvements--would be imprudent, irresponsible, and unreasonable. Such a liquidation would cause an immediate reduction in income available to fund the Foundation's existing charitable programs and commitments, and cause further concentration of the Foundation's assets in Florida real estate. The current and potential beneficiaries of the Foundation's programs would suffer immediately from the loss of funds to meet current obligations and face the risk of future losses associated with concentrating an even greater portion of the Foundation's endowment in real estate. In contrast, the use of debt to fund improvements to real estate is a traditional and accepted method of financing in the real estate sector and would allow the Foundation to maximize the productivity of its assets for the benefit of charity, both now and in the future.

The use of debt to fund the economic development of the Florida real estate, however, would cause the income generated from the property to be characterized under current law as

"debt-financed" and to be taxable as unrelated business taxable income.

The income tax payable due to the application of the debt-financed income rules would make the additional investment to develop the Florida real estate uneconomical compared to other investments (See Exhibits 5 and 6 which illustrate the impact that the debt-financed income rules have on a hypothetical investment in a $20 million project where 70 percent ($14 million) is borrowed). Moreover, and most importantly, the taxes would further reduce the funds available to maintain and enhance the Foundation's charitable programs. Thus, under present law, the Foundation and the public loses regardless of whether the Foundation borrows to fund the development of its real estate or liquidates a portion of its portfolio of stocks and bonds.

Proposal

The special exception from the debt-financed income rules of Section 514(c)(9) currently applicable to pension trusts and educational institutions would apply to debt incurred by a private foundation (as defined in Section 509(a)) to improve any real property if--

(1) at any time since it was organized, more than half of the assets, determined by value, held by the foundation and acquired, directly or indirectly, by gift or devise, consisted of improved and unimproved real property,

(2) at the time the debt was originally incurred, real estate acquired, directly or indirectly, by gift or devise, exceeded 10% of the value of all investment assets held by the Foundation, and

(3) no member of the organization's governing body was a disqualified person (as defined in section 4946) at any time during the taxable year, other than by virtue of being a "foundation manager."

To prevent any unintended abuses, the proposed changes would be subject to the same anti-abuse limitations that apply today to pension trusts and educational organizations.

Rationale

Where a private foundation has received by gift or devise noncharitable assets in the form of real estate that produces little or no current income, the foundation must choose among these options: (1) reduce its charitable program, (2) sell income-producing assets, (3) sell its real estate at "fire sale" prices in today's market and for the foreseeable future, or (4) improve the real estate to make it income-producing. In order to improve its real estate, the foundation will have to borrow. However, the penalties imposed by the debt-financed income rules will make an otherwise attractive investment unattractive.

As was true for pension trusts and educational institutions before the current law exception was adopted, the debt-financed income rules make many otherwise economically sound investments non-economic. The adverse impact of the tax is exacerbated by the following: (1) the statutory formula causes much of the depreciation that is incurred in the early years of an investment to go unused; (2) in a perverse fashion, as time passes, the portion of overall income that is made taxable increases even where the amount of debt is constant or falling; and (3) most, if not all, gain upon disposition is subjected to taxation if the property is sold while the acquisition indebtedness continues to be outstanding.

The proposed legislation is not limited to a "rifle shot" solely for the benefit of the Foundation. Based upon a limited survey, thirty one (31) other foundations are eligible for the legislative relief (See Exhibit 7 for listing of eligible foundations). A more extensive inquiry will certainly find additional foundations eligible for the legislative relief. The revenue loss as estimated by the staff of the Joint Committee on Taxation is only $23.0 million (See Exhibit 8 for letter from Joint Committee on Taxation).

Finally, the proposed change would supplement the Administration's current attempts to restore vitality to the real estate sector. The Foundation's efforts to improve the productivity and marketability of its own real estate should be expected to enhance the economy of the surrounding community and produce ripple effects that benefit everyone as a result of the desired economic stimulation.

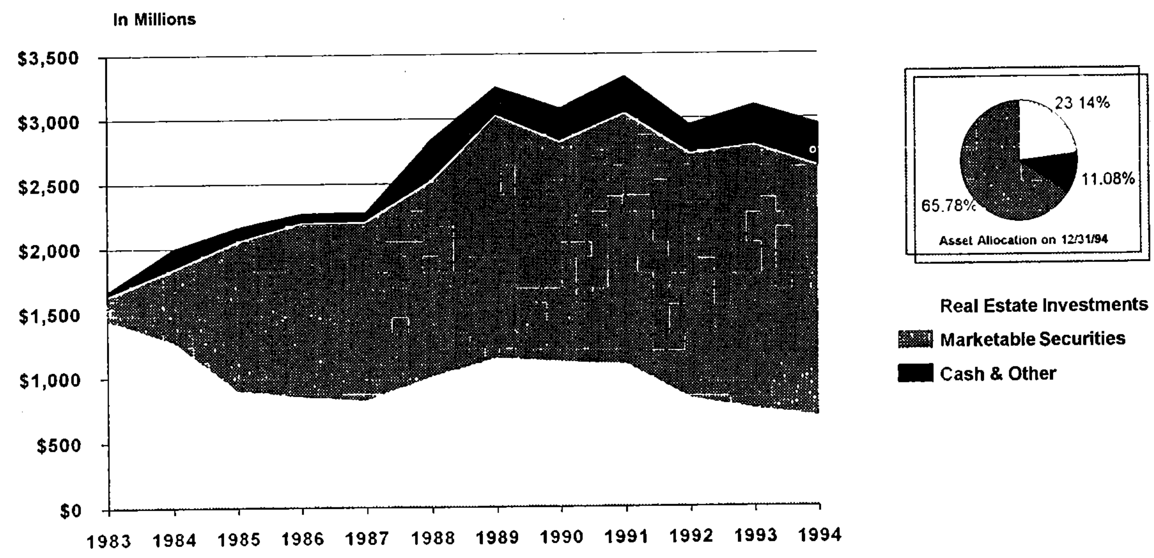
Board of Directors

The Board of Directors of the Foundation is completely independent of the family of John D. and Catherine T. MacArthur. *No* members of the Board of Directors is in any way related to the founders of the Foundation (See Exhibit 9 for listing of the present members of the Board of Directors).

Conclusion

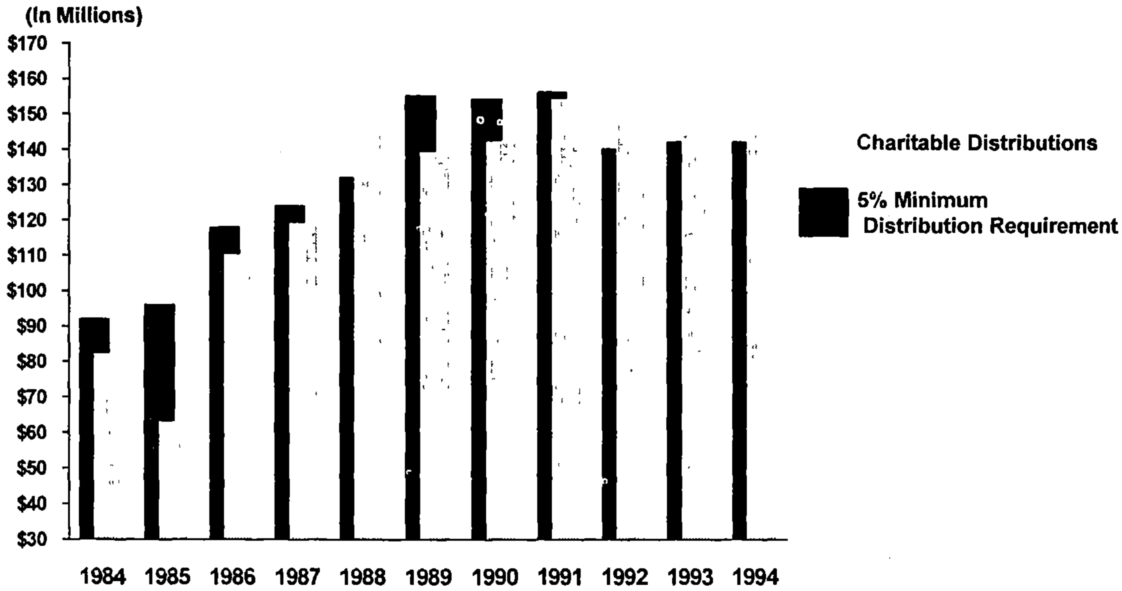
The Foundation seeks the same legislative relief currently available to retirement plans and educational institutions. There is no valid basis for according such relief to such organizations and not to the Foundation or other similarly situated charitable organizations.

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
Total Asset Allocation



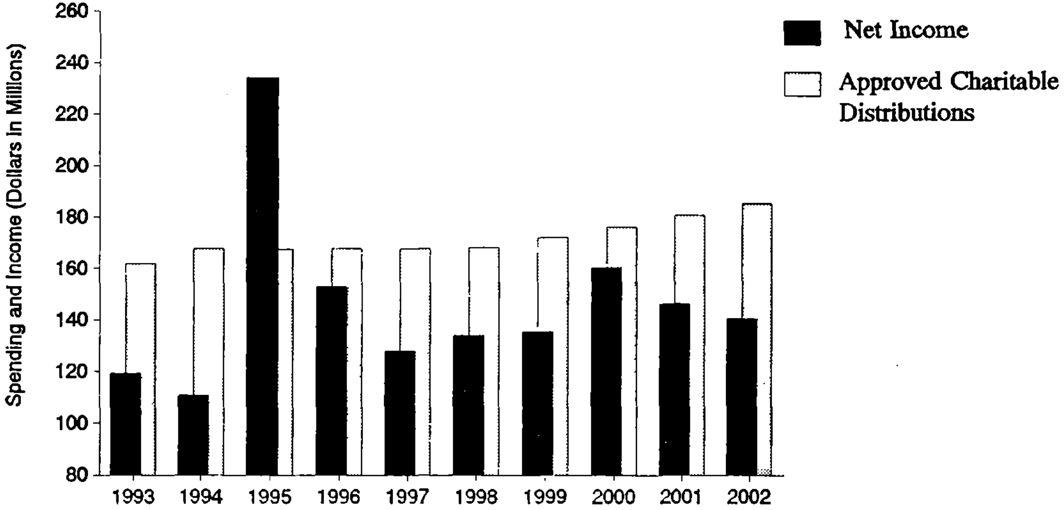
"EXHIBIT 1"

The John D. and Catherine T. MacArthur Foundation
Analysis of Distribution

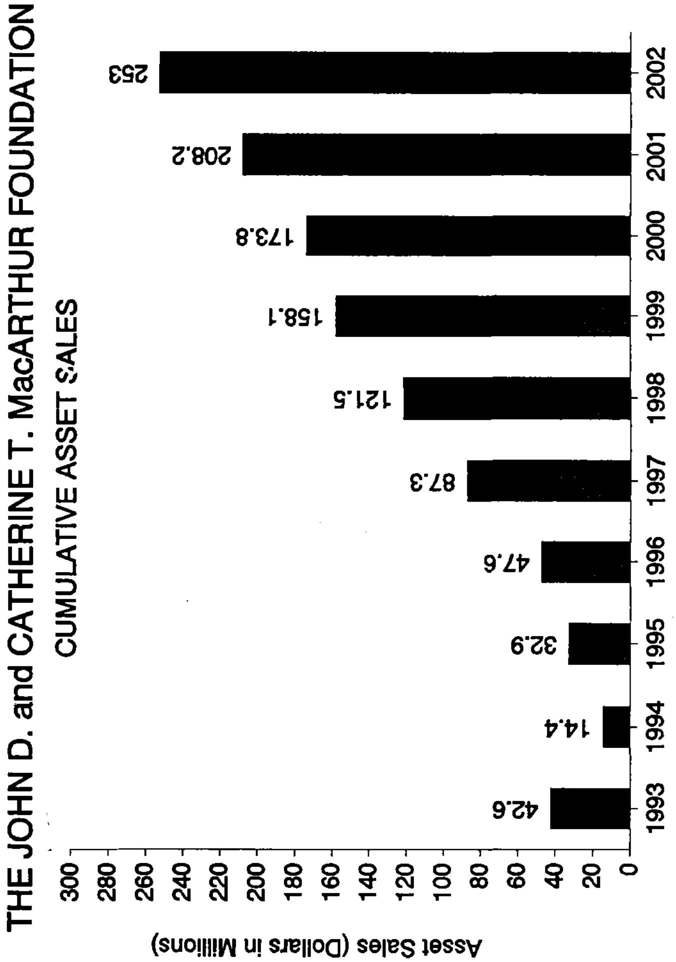


"EXHIBIT 2"

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
APPROVED CHARITABLE DISTRIBUTIONS vs. NET INCOME



"EXHIBIT 3"


THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
CUMULATIVE ASSET SALES
Asset Sales (Dollars in Millions)
300
280
260
240
220
200
180
160
140
120
100
80
60
40
20
0
42.6
14.4
32.9
47.6
87.3
121.5
158.1
173.8
208.2
253
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002

"EXHIBIT 4"

EXHIBIT 5: 70% DEBT FINANCING — NOT SUBJECT TO UBIT

YEAR	EQUITY INVESTMENT/ RETURN	AFTER TAX NET CASH FLOW	TOTAL CASH FLOW
	(6,000,000)	0	(6,000,000)
1		540,000	540,000
2		540,000	540,000
3		612,000	612,000
4		612,000	612,000
5		668,160	668,160
6		726,005	726,005
7		785,585	785,585
8		846,952	846,952
9		910,161	910,161
10	6,878,328	975,266	7,853,594
TOTAL	878,328	7,216,129	8,094,457

	Discounted Separately	Percent of Total	Component of Return
PRESENT VALUE - CAPITAL	6,878,328	48.8%	5.91%
PRESENT VALUE - CASH FLOWS	7,216,129	51.2%	6.20%
TOTAL	14,094,457	100.00%	12.10%

PRESENT VALUE DISCOUNT FACTOR 12.10%

YEAR	GROSS RETURN	INTEREST	DEPRE-CIATION	NET INCOME	UBTI	UBIT	AFTER TAX NET CASH FLOW	NET CASH ON DIS-POSITION
1	1,800,000	1,260,000	267,857	272,143	0	0	540,000	600,000
2	1,800,000	1,260,000	535,714	4,286	0	0	540,000	1,218,000
3	1,872,000	1,260,000	535,714	76,286	0	0	612,000	1,854,540
4	1,872,000	1,260,000	535,714	76,286	0	0	612,000	2,510,176
5	1,928,160	1,260,000	535,714	132,446	0	0	668,160	3,185,481
6	1,986,005	1,260,000	535,714	190,291	0	0	726,005	3,881,046
7	2,045,585	1,260,000	535,714	249,871	0	0	785,585	4,597,477
8	2,106,952	1,260,000	535,714	311,238	0	0	846,952	5,335,402
9	2,170,161	1,260,000	535,714	374,447	0	0	910,161	6,095,464
10	2,235,266	1,260,000	535,714	439,552	0	0	975,266	6,878,328

EXHIBIT 6: 70% DEBT FINANCING — SUBJECT TO UBIT

YEAR	EQUITY INVESTMENT/ RETURN	AFTER TAX NET CASH FLOW	TOTAL CASH FLOW
	(6,000,000)	0	(6,000,000)
1		470,489	470,489
2		538,875	538,875
3		591,396	591,396
4		590,787	590,787
5		630,209	630,209
6		669,766	669,766
7		709,343	709,343
8		748,803	748,803
9		787,983	787,983
10	3,732,064	826,692	4,558,756
TOTAL	(2,267,936)	6,564,343	4,296,407

	Discounted Separately	Percent of Total	Component of Return
PRESENT VALUE - CAPITAL	3,732,064	36.2%	2.88%
PRESENT VALUE - CASH FLOWS	6,564,343	63.8%	5.06%
TOTAL	10,296,407	100.00%	7.94%

PRESENT VALUE DISCOUNT FACTOR 7.94%

YEAR	GROSS RETURN	INTEREST	DEPRE-CIATION	NET INCOME	UBTI	UBIT	NET CASH FLOW	NET CASH ON DIS-POSITION
1	1,800,000	1,260,000	267,857	272,143	193,086	69,511	470,489	427,591
2	1,800,000	1,260,000	535,714	4,286	3,126	1,125	538,875	805,186
3	1,872,000	1,260,000	535,714	76,286	57,233	20,604	591,396	1,183,623
4	1,872,000	1,260,000	535,714	76,286	58,924	21,213	590,787	1,561,768
5	1,928,160	1,260,000	535,714	132,446	105,419	37,951	630,209	1,938,297
6	1,986,005	1,260,000	535,714	190,291	156,218	56,238	669,766	2,311,656
7	2,045,585	1,260,000	535,714	249,871	211,782	76,242	709,343	2,680,031
8	2,106,952	1,260,000	535,714	311,238	272,638	98,150	748,803	3,041,293
9	2,170,161	1,260,000	535,714	374,447	339,383	122,178	787,983	3,392,948
10	2,235,266	1,260,000	535,714	439,552	412,705	148,574	826,692	3,732,064

PRIVATE FOUNDATIONS ELIGIBLE FOR RELIEF
UNDER THE PROPOSED AMENDMENT TO SECTION 514(c)(9)

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1.	(1)	John D. and Catherine T. MacArthur Foundation (IL.)	$885,465,074
2.	(3)	Liliuokalani Trust (HI.)	$106,038,193
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18.	(62)	Ben May Charitable Trust (AL.)	$ 4,770,945
19.	(64)	Mary and Daniel Loughran Foundation, Inc. (D.C.)	$ 4,343,725
20.	(67)	Susan Lindsay Trust (CO.)	$ 4,129,924
21.	(71)	Baughman Foundation (KS.)	$ 3,297,430
22.	(77)	The Schowalter Foundation (KS.)	$ 2,753,800
23.	(78)	Apollos Camp & Bennet Humiston Trust (IL.)	$ 2,732,448
24.	(79)	Santa Fe Pacific Foundation (IL.)	$ 2,715,000
25.	(85)	Conn Memorial Foundation, Inc. (FL.)	$ 2,376,450
26.	(88)	Oldham Little Church Foundation (TX.)	$ 2,059,320
27.	(91)	Weller Foundation, Inc. (NE.)	$ 1,867,182
28.	(92)	Ed and Mary Heath Foundation (TX.)	$ 1,834,136
29.	(102)	Robert L. Howell Foundation (MS.)	$ 1,[illegible]9,479
30.	(117)	Godfrey Thomas Foundation, Inc. (AR.)	$ 750,000
31.	(121)	Harry E. Griswold Trust (IL.)	$ 735,350
32.	(124)	Marietta Dyer Trust U/Will (MA.)	$ 675,525

(A) As reported on 1989 990-PF tax return

EXHIBIT 7

103D CONGRESS 2D SESSION

SENATE

HOUSE

SAM M. GIBBONS, FLORIDA
ACTING VICE CHAIRMAN
DAN ROSTENKOWSKI, ILLINOIS
J.J. PICKLE, TEXAS
BILL ARCHER, TEXAS
PHILIP M. CRANE, ILLINOIS

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

JOHN L. BUCKLEY
CHIEF OF STAFF

MARY M. SCHMITT
DEPUTY CHIEF OF STAFF
(LAW)

BERNARD A. SCHMITT
DEPUTY CHIEF OF STAFF
(REVENUE ANALYSIS)

OCT 28 1994

Honorable Sam M. Gibbons
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Gibbons:

This letter is in response to your request of April 6, 1994, for a revenue estimate of a modification to Internal Revenue Code (Code) section 514(c)(9). This proposal adds certain private foundations to the list of qualified organizations eligible for the real property exception from the debt-financed property rules.

Under present law, an organization that is otherwise exempt from Federal income tax is taxed on the income derived from debt-financed property in proportion to the amount of debt financing. An exception to this rule exists for qualified organizations, including pension trusts, educational institutions, and certain title-holding companies, if the conditions specified in Code section 514(c)(9)(B) are satisfied.

This proposal would add certain private foundations to the list of qualified organizations that are exempt from the debt-financed property rule. A private foundation would be treated as a qualified organization if (1) at any time, more than half of the foundation's total assets acquired by gift or devise consisted of real property; (2) real estate acquired by gift or devise exceeded ten percent of the value of all assets held by the foundation at the time the debt was incurred; and (3) no member of the organization's governing body was a disqualified person (as defined in Code sec. 4946) other than by virtue of being a "foundation manager" for the period that the debt was outstanding.

We have assumed for purposes of estimation that this proposal would be effective for taxable years beginning after December 31, 1994. The effect on Federal fiscal year budget receipts is shown below.

Fiscal Years [Millions of Dollars]					
1995	1996	1997	1998	1999	1995-99
*	-1	-3	-7	-12	-23

NOTE: Details do not add to total due to rounding.
* Loss of less than $500,000.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

/S

John L. Buckley

"EXHIBIT 8"

JOHN D. and CATHERINE T. MacARTHUR FOUNDATION

Board of Directors

"EXHIBIT 9"

**STATEMENT FOR THE PRINTED RECORD OF RUTH M. ONO, PH.D.
WITH RESPECT TO THE HEARINGS ON MISCELLANEOUS TAX MEASURES
HELD ON JULY 11 - 13, 1995
THE HOUSE COMMITTEE ON WAYS AND MEANS**

JULY 26, 1995

The Queen Emma Foundation of Honolulu, Hawaii (the "Foundation") commends the Committee for considering a proposal to treat private foundations like educational organizations and pension funds for purposes of the unrelated business income rules governing debt-financed property. We ask that the Committee also consider extending this treatment to organizations like The Queen Emma Foundation.

BACKGROUND

The Queen Emma Foundation is a nonprofit, tax-exempt, public charity. Its purpose is to support and improve health care services in Hawaii by committing funds generated by Foundation-owned properties to The Queen's Medical Center (the "Medical Center").

The Queen's Medical Center

The Queen's Medical Center began operations in 1860 as a two-story, 124-bed hospital located in Honolulu. The Medical Center has grown to become a 536-bed accredited teaching hospital, accommodating nearly 19,000 inpatient admissions and 172,000 outpatient visits per year. The Medical Center maintains an open emergency room, and admits Medicare and Medicaid patients. It has more than 1,200 physicians on staff, and over 2,800 full-time employees.

The Queen's Health Systems, through The Medical Center, The Foundation, and its other members, provides health care services that benefit residents of all of the Hawaiian Islands. For example, The Queen's operates Molokai General Hospital, a small community hospital on the remote island of Molokai. The Queen's also operates clinics on various islands, provides home health care services, supports nursing programs at Hawaiian colleges and universities, operates a medical library, and holds health fairs and other educational events for the benefit of the community.

The Queen Emma Foundation

The Foundation's assets consist largely of land bequeathed in 1885 by Queen Emma Kaleleonalani, wife of King Kamehameha IV. Most of The Foundation's land is encumbered by long-term, fixed-rent commercial and industrial ground leases. The return produced by these leases is extremely low, as The Foundation is unable, under these leases, to increase rents to keep pace with the rapid appreciation in land values in Hawaii. This severely limits The Foundation's ability to provide funding to The Medical Center.

The Foundation could increase the funds available to support The Medical Center's health care endeavors by buying out the leases of current lessees, and leasing the land, together with any buildings on the land, at current market rates. The Foundation also could upgrade the improvements on its land to further enhance its revenue-generating potential. However, doing this on a scale that would appreciably increase the funds available to support the Medical Center would require more cash than the Foundation has available or could prudently generate by selling assets.

The best solution to this problem would be for the Foundation to borrow the necessary funds. Were the Foundation to do this, however, the debt-financed property rules under the unrelated business income tax would subject the income earned by the Foundation to income tax, greatly reducing the funds ultimately available to meet its charitable mission.

OVERVIEW OF THE DEBT-FINANCED INCOME RULES

Unrelated Business Income Tax

The unrelated business income tax ("UBIT") applies, under sections 511 through 514 of the Internal Revenue Code[1], to certain otherwise tax-exempt organizations. The UBIT generally imposes a tax on the net income earned by a tax-exempt organization from trade or business activities that are "regularly carried on" and that are not "substantially related" to the organization's exempt purpose.

In enacting the UBIT, Congress specifically excluded from tax certain types of investment income. Congress did this because, in its view, such income is "passive in character", "not likely to result in serious competition for taxable businesses", and has "long been recognized as a proper source of revenue for educational and charitable organizations and trusts."[2]

One of the categories of passive investment income normally not subject to UBIT is rents from real property. Gains from the disposition of property is another category of income normally not subject to UBIT. The exclusion for gains from the disposition of property does not apply if the property is inventory or held primarily for sale to customers in the ordinary course of the trade or business.

Debt-Financed Income

Congress was concerned, when it enacted the UBIT, with sale-leaseback transactions involving tax-exempt organizations. Congress was particularly concerned with transactions where tax-exempt organizations purchased properties for little or no money down and leased them back to the sellers. Under this scenario, the tax-exempt organization could "trade" on its tax exemption by paying an inflated price for the asset or charging a below-market rent. The tax-exempt organization could do this, while still meeting its installment obligations, because it did not have to pay taxes.

To counter this perceived abuse, the 1950 UBIT contained special rules which subjected to tax certain otherwise excludible passive income derived from debt-financed property. These rules were modified in 1969 in response to what Congress saw as continued problems in the area, particularly with so-called "Clay Brown" or "bootstrap" transactions. In this variation on a sale-leaseback transaction, the tax-exempt organization would pay the purchase price as a percentage of the rental income it earned from leasing the property back to the seller.

The rules enacted in 1969 are codified in section 514. Under section 514, for most types of tax-exempt organizations, the rules exempting from UBIT rents and gains from sale do not apply to the extent such rents and gains are derived from debt-financed property.

Qualified Organizations

Congress amended the debt-financed income rules in 1980 by enacting section 514(c)(9). Section 514(c)(9), as originally enacted, provided an exception to the debt-financed income rules for certain real estate investments of qualified pension trusts, subject to various restrictions intended to prevent abuses.

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[1]All section references hereafter are to the Internal Revenue Code of 1986.

[2]Senate Report No. 2375, 1950-2 C.B. 483.

In enacting this provision, the Senate Finance Committee stated that it felt that it was "inappropriate to continue the present law restrictions on debt-financed income to the extent that they discourage prudent debt-financed real estate investments", noting that "debt-financing is common in real estate investments", and that "specifically drawn prohibitions of debt-financed acquisitions with certain characteristics can eliminate the most egregious abuses addressed by the 1969 legislation . . ."[3]

In 1984, section 514(c)(9) was extended to cover educational institutions, such as colleges and universities, and their supporting organizations. Additional requirements were also added to prevent the abuses that existed prior to 1969. In so doing, the Senate Finance Committee stated that:

> The committee believes that it is appropriate to extend the special exception for debt-financed property held by a qualified trust to similar property held by an educational organization . . . However, the committee feels that this exemption should be extended only if certain of the present law requirements are expanded.[4]

PROPOSAL

The Foundation proposes that the exception to the debt-financed property rules that currently applies to educational organizations and pension funds be expanded to cover organizations like The Queen Emma Foundation that (1) are supporting organizations to hospitals, (2) hold significant assets in the form of bequeathed real property, and (3) are governed by boards of directors that are broadly representative of the public.

In particular, the Foundation proposes that section 514(c)(9) be amended by adding a new class of "qualified hospital support organizations" eligible for the section 514(c)(9) exception to the debt-financed property rules. A qualified hospital support organization would be defined as an organization recognized as tax-exempt under section 501(c)(3) and as a supporting organization (under section 509(a)(3)) to a hospital (as defined in section 170(b)(1)(A)(iii)).

A qualified hospital support organization would also need to meet the following requirements to qualify for the exception under section 514(c)(9):

1. at any time, since it was organized, more than half of the assets, determined by fair market value, held by the organization and acquired, directly or indirectly, by gift or devise, consisted of real property,

2. at the time the debt was originally incurred, real property, acquired, directly or indirectly, by gift or devise, including improvements, exceeded 10 percent of the fair market value of all investment assets held by the organizations, and

3. no member of the organization's governing body was a disqualified person (as defined in section 4946) at any time during the taxable year in which the debt was originally incurred, other than by virtue of being a "foundation manager".

Special-rules would apply to refinancings of debt.

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[3]Senate Report 96-1036, 1980-2 C.B. 723.

[4]Committee on Finance, United States Senate, Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984 (S. Prt. 98-169, Vol. I, April 2, 1984).

CONCLUSION

This proposal, if enacted, would enable the Foundation to generate more funds to support the Medical Center in pursuit of its charitable mission, and provide better health care to the people of Hawaii.

I urge the Committee to consider our proposal and the positive effect it would have on the health and well-being of the people of Hawaii.

HARSCH
INVESTMENT CORP.

STATEMENT FOR THE RECORD BY
HARSCH INVESTMENT CORP. AND
HAROLD AND ARLENE SCHNITZER

Before the House Ways and Means Committee Hearings on Miscellaneous Revenue Issues
July 11-13, 1995

Changes to Encourage Donations of Closely-Held Stock to Charity

Introduction

Mr. Chairman and members of the Committee, we appreciate this opportunity to testify in support of the proposed changes to permit tax-free liquidations of closely-held corporations in certain limited situations when a tax exempt 501(c)(3) organization is the beneficiary. We believe these changes are important. The proposals reflect Congress' objective of encouraging private support, as all levels of government refocus, restructure, and reduce their financial support of society's social and charitable needs, and return responsibility for such to the private sector.

Harold and Arlene Schnitzer have a long history of direct support for public charities. In addition, the Harold and Arlene Schnitzer Family Foundation was endowed in 1991 by the Schnitzers to support public charities. The Foundation's distributions are made for religious, educational, social services and medical purposes, and for the arts. The Schnitzers also endowed an operating foundation in 1994 to provide direct services and support to disadvantaged youth and elderly.

Background - Need for Proposed Changes

Fiscal constraints have limited federal funds for many programs aimed at social, educational, nutritional, medical, and other necessary programs. The fiscal restrictions are likely to grow in the years ahead. At the same time, a broad spectrum of our country's citizens recognizes that federal delivery of many necessary programs has not been effective. Despite spending hundreds of billions of dollars over the last few decades, social needs have grown.

The federal government should encourage the use of private resources for local providers and institutions to initiate or expand coverage for those programs important to those communities.

We believe local organizations have been very effective in the delivery of services to their communities. This is in part due to the fact that the visions for these programs have often been deeply held by the individual providers ("social entrepreneurs" if you will). These organizations are often strongly supported by

volunteers within the community. Transferring increased responsibilities to the local providers will require increased private financial support. The federal government must lead the way by encouraging individual contributions directly to these organizations and to those groups which support them. Changes in the federal tax code can stimulate individuals to willingly bear the financial responsibility.

A contribution of closely-held stock is not an effective method for transferring resources to a charitable organization. The absence of a market for such stock and the typical pattern of small sporadic dividends paid by closely-held companies make it difficult for the charity to benefit from the gift. Alternatively, if the charity has a controlling interest in the company, it may choose to liquidate the corporation so as to get direct access to the assets for use in its activities. Under current law, a tax is imposed on the corporation upon liquidation. This tax, at 34 percent of the gain, reduces the funds otherwise available to the charity.

The tax cost of contributing closely-held stock to charity discourages many families who would otherwise consider charitable contribution of these companies they had built up over the years. Such a tax cost would not be imposed if the business owner held the assets directly and contributed these assets to charity. Because many closely-held companies were built from scratch over many years, the tax basis can be quite low, subjecting much of the total value of the company to tax; thus the tax cost of the transaction can be very high. This cost is imposed as a result of the tax law changes in 1986 that repealed the so-called General Utilities doctrine and as a result imposed a corporate tax upon every liquidation, even if a charitable organization is the beneficiary. Present law directly reduces the funds, and donor motivation to make, available for distribution by the charities.

We believe that the tax laws should be revised to encourage owners of closely-held businesses to donate such businesses to charity and to insure that the benefits of such gifts are fully realized by the charity. These contributions should not be penalized by payment of a tax which may substantially reduce the amount left for the tax exempt organization.

Legislative Proposal for Change

Under current law, federal income tax is imposed on a corporation liquidation which reduces the funds that the charity receives by 34% of the gain. Such reduction can be significant. The proposal would eliminate the corporate level tax upon liquidation of closely-held corporations if 80 percent or more of the stock is contributed by gift or devise to a Section 501(c)(3) tax exempt organization and certain other conditions are met. Conforming changes are also required under the unrelated business income tax ("UBIT") rules of Section 514(c)(2)(B) to assure the exempt organization a reasonable period to dispose of property received in a liquidation prior to imposition of a tax. These UBIT

changes are harmonious with current statute and policy concerning direct gifts and bequests of encumbered property.

A number of limitations have been placed on this proposal for policy and revenue reasons. The restrictions are primarily designed to discourage abuse or limit its application to situations that are consistent with sound tax policy. Election of this provision would also prohibit the donor from taking a charitable deduction. This election clearly limits the tax benefits solely to the exempt organization.

> **Illustration:** To illustrate the effect of these proposals relating to liquidation and debt-financed rules, consider an individual who bequests 100 percent of the stock of a closely-held corporation to a charitable private foundation. There is little or no market to sell the stock; but there is a market for the corporation's real estate investments. To realize the value inherent in the corporation, the foundation may consider its liquidation. The charity could hold the investments directly and receive the rental income, or sell the property.
>
> Under current law, if the corporation is liquidated, there will generally be a tax at the corporate level on all the appreciation of the corporate assets. Additionally, if the charity sells debt-financed property, the charity will recognize gain in proportion to the debt on the property and will be taxed on a portion of the rental income as debt-financed income. Consequently, the charity will receive less than 100 percent of the value of the stock - perhaps only 70-75 percent of its full value.
>
> Under the proposal, there would be no taxable gain to the corporation upon liquidation and no taxable gain if the charity sells the property within ten years. Hence, the charity will retain 100 percent of the value of the stock donated to it.

Conclusion

These proposals would help modernize the tax laws and stimulate additional contributions of closely-held businesses to charitable organizations. The activities of public charities and private foundations should be encouraged and expanded. Private foundations and other tax exempt charities effectively deliver funds to a very diverse, wide ranging group of social support organizations at the community level on a timely basis.

The tax laws should be revised to encourage owners of closely-held businesses to donate their assets for charitable purposes and to insure that the benefits of such gifts are fully realized by the charity. These changes would put such owners in the same position that they would be in if they held the assets directly and donated the assets to charity. Individuals who are willing to make significant contributions of their business assets should not be penalized by payment of a corporate level tax upon liquidation, thus reducing the amount left for the tax exempt entity.

We believe that it is essential for private interests to bear more of the burden in providing charitable and social services. These efforts may be done either directly, as a provider, or indirectly, through support of charities which provide the services. The proposals have two important underpinnings. First, they provide a visible leadership role by Congress which balances program reductions with encouragement for private funding for programs at the local level. Secondly, we believe that these provisions reflect a very important ideal - one of selflessness and humanitarian efforts which truly underlies all support for charities. Under these proposals, the donor must forego any tax benefit, including a charitable deduction. The charity is the sole recipient of any tax benefit.

Elimination of these tax penalties would encourage additional, and much needed, transfers of closely-held businesses to charities. These charities can, and do, act as incubators for new and developing charitable programs delivered locally to serve community needs. Such variety permits diversity of views, processes, and charters that encourages continued innovation in the delivery and effective use of resources in the charitable sector.

Mr. Chairman and members of the Committee, we appreciate the opportunity to present our views and support of these proposals. If there are any questions or if you need any additional information, please feel free to contact Harold J. Schnitzer (503-242-2900) or Theodore P. Malaska (503-242-2900) in Portland, Oregon.

Statement Of

LAWRENCE W. O'TOOLE

President and CEO

THE NEW ENGLAND EDUCATION LOAN MARKETING CORPORATION ("NELLIE MAE")

On Behalf Of

NELLIE MAE

AND

THE STUDENT LOAN FUNDING CORPORATION

Submitted To

THE COMMITTEE ON WAYS AND MEANS
United States House of Representatives

For the Record of the Hearings on
Miscellaneous Tax Reforms
Held July 11 and 12, 1995

I.

Introduction and Overview

My name is Lawrence W. O'Toole. I am President and Chief Executive Officer of The New England Education Loan Marketing Corporation, also known as "Nellie Mae," which is located in Braintree, Massachusetts. I appreciate this opportunity to submit this statement on behalf of Nellie Mae and The Student Loan Funding Corporation, which is headquartered in Cincinnati, Ohio. Nellie Mae and The Student Loan Funding Corporation are nonprofit organizations exempt from federal income tax under Internal Revenue Code section 501(c)(3). We principally serve as secondary markets for student loans originated by private lenders under federal student loan programs. We also are members of the Education Finance Council, Inc., whose membership includes 20 such organizations from across the country, which previously has endorsed the proposal discussed in this statement.

Almost two years ago, as Congressional debate regarding federal policy toward education loan programs was beginning, I testified before the Subcommittee on Select Revenue Measures on behalf of Nellie Mae and the Education Finance Council in support of a proposal that we believe would allow us to improve our service to America's college and university students.

At that time, we predicted an increasing need for the type of financial and administrative services provided by the 23 nonprofit scholarship funding corporations across the country in meeting the education loan financing needs of students and families.

This need has in fact developed as millions of college students have had to rely increasingly on federally sponsored loan programs to meet escalating college costs. The introduction in 1994 of the Federal Direct Student Loan Program (FDSLP) and concurrent cuts in the Federal Family Education Loan Program (FFELP) have caused many banks and thrifts across the country to terminate their participation in FFELP, relying increasingly on nonprofit lenders to meet greater student needs.

To secure increased levels of funding required to meet student borrowing needs and to be able to take advantage of the most technologically effective delivery processes, the nonprofit corporations have developed the proposed amendments to the Internal Revenue Code to permit a

one-time transition election to essentially convert their activities to a taxable business corporation.

This conversion will have at least three significant consequences. First, it will allow the taxable successor companies to access the equity capital markets for investment that can be leveraged into greater levels of borrowing to meet student loan borrowing needs. Currently, the inability to increase equity capital quickly serves to limit the amount that can be borrowed to fund student loans.

Second, the taxable companies will be able to diversify their activities (not now permitted by Code section 150(d)) to both better meet student needs and better secure their long-term viability. As taxable companies, they will be better able to enter into partnerships with banks, computer service providers and others for the effective delivery of services without the complexities that such partnerships between taxable and tax-exempt entities create and without UBIT issues, because all net income will be fully taxable.

Third, the proposal has been structured as a one-time, transition rule to accommodate the change in direction of federal education policy. Significantly, the Joint Committee on Taxation has estimated that this proposal **increases federal revenues by $30 million** over a five-year period. This reflects the transfer of revenue now realized in the nonprofit sector to the taxable sector. We believe this to be a conservative estimate of likely federal revenues.

We urge the Committee to support tax amendments that would permit scholarship funding corporations to evolve, as the federal student loan programs have evolved. Our proposal, to permit scholarship funding corporations to convert to taxable business corporations, represents a practical and efficient means of assuring the formation of new capital for student loan financing and fosters competition for other educational services. Many of the same reasons underlying the proposed privatization of Sallie Mae, as well as current federal educational finance policies, support affording nonprofit scholarship funding corporations a similar opportunity to transition to the private sector to enable us to diversify our activities. This free enterprise solution will result in the most efficient provision of education financing and services to our nation's students, at a meaningful increase in federal revenues.

II.

The Role of Secondary Markets for Student Loans

A. Secondary Markets within the Framework of the Privately Funded Student Loan Programs.

Since the enactment of the Higher Education Act of 1965, Congress has championed affordable financing for college education. Until 1993, the hallmark of our nation's higher education policy was to stimulate the marketplace to provide affordable student loans under the federal guaranteed student loan programs. These programs rely on the voluntary participation of private sector organizations to supply capital to make student loans, to provide secondary markets offering liquidity to lenders, and to service student loans.

To encourage greater liquidity of student loan capital, in 1976 Congress enacted a special provision in the Internal Revenue Code (now codified at section 150(d)) permitting private, nonprofit corporations formed under state law, whose income is devoted to the single purpose of acquiring student loans, to issue tax-exempt bonds to finance the purchase of student loans. Since then, nonprofit scholarship funding corporations have played an important function in the student loan financing process by assuring originating lenders of a reliable source of replacement capital. The importance of our role is underscored by the fact that nonprofit and state secondary markets hold 20-25 percent of all outstanding loans.

Our expertise in providing a secondary market for originating lenders in fact allows us to provide a broad array of services to the participants in the federal student loan programs. Our services include making student loans, consulting with and advising lenders and loan guarantors regarding underwriting, servicing and default controls, assisting and counseling borrowers with

repayment and other matters. We also have devised sophisticated financial systems which account for and monitor outstanding loans. Our workforce is experienced, well-trained and efficient.

In sum, scholarship funding corporations have brought much innovation and efficiency to the federal student loan programs. This has reduced the burdens of students, lenders, guarantors and the federal government, while facilitating the delivery of $20 billion in new loans to almost four million students annually. Our local and regional activities often place us closest to the student borrower and make us better able to secure repayment of troubled loans, which reduces federal costs. As a consequence of our local nature and our systems and procedures, we are able to minimize the default rate on the student loans we hold.

B. Satisfying the Demands of the New Student Loan Marketplace.

The Student Loan Reform Act of 1993, adopted as part of the Omnibus Budget Reconciliation Act of 1993, represented a dramatic shift in federal policy by creating a new Federal Direct Student Loan Program, with a concomitant bureaucracy, to compete with the existing federal student loan programs. Regardless of the future of the Federal Direct Student Loan Program, the advent of this program has fundamentally and permanently changed the education financing marketplace. As we predicted in our 1993 testimony, the introduction of the Direct Loan Program, coupled with the substantial reduction in financial incentives and increase in financial risks of the current programs, have caused a number of lending institutions to terminate their participation in the federal programs.[1]

The potential significant loss of private capital to sustain student loans financed by the private sector, as well as the pending privatization or perhaps liquidation of Sallie Mae, has created a substantial need to assure student loan capital from other sources. This need can be met effectively by scholarship funding corporations, but only if aided by the conversion proposal. Furthermore, as tuition and related costs continue to skyrocket, students and schools need more financing options available to them, from assistance in originating and/or servicing loans, or simply additional sources of loan capital, among other needs.

Under current tax law, we cannot satisfy the diverse financial needs of students and schools. For example, nonprofit scholarship funding corporations face both legal and practical constraints affecting our ability to raise additional capital. As organizations described in section 501(c)(3) of the Internal Revenue Code, we are unable to raise equity capital from private investors. All of our equity capital must be internally generated through retained earnings, which builds slowly. Further, the tax-exempt debt issued by scholarship funding corporations is subject to the tax-exempt "private activity" volume cap. In addition, the default risk-sharing and reduction in loan yield provisions of the 1993 Budget Reconciliation Act have made debt financing even more difficult without added cushions of equity protection for bond and note holders. Potential investors look at our single purpose restriction and our inability to raise investor capital as unnecessary risks and impediments.

Allowing scholarship funding corporations to elect to convert to taxable corporations will give us access to investor capital that can be leveraged for the benefit of student loan programs. Just as important, our proposal provides scholarship funding corporations the opportunity to remain "going concerns" with the flexibility to effectively preserve and utilize our expertise and operational capabilities to provide other services to students and schools. It is extremely unlikely that start-up corporations could either raise sufficient private sector capital or use such capital efficiently over the short run; the investment in systems and personnel is simply too great. Our solution to the capital vacuum addresses the dual needs of avoiding operational redundancies and preserving operational efficiencies.

In short, enactment of the proposed amendments will allow scholarship funding corporations to do their jobs better, meeting the needs of students, schools and lenders, whatever the ultimate outcome of the Direct Loan Program.

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[1] Moreover, Sallie Mae, which holds $50 billion in assets devoted to student loan financing, is currently the subject of both privatization and liquidation discussions.

III.

The Efficient Solution of the Conversion Proposal

Our conversion proposal offers a simple yet efficient blueprint for strengthening the ability of the private sector to provide new sources of capital and services to student loan programs, at the same time contributing to an increase in federal tax revenues. Since 1993, we have worked closely with the staff of the Joint Committee on Taxation to refine our proposal to meet both tax policy and prudent business objectives.

In brief, the conversion proposal contains two key features. The first feature permits scholarship funding corporations to elect to convert to a taxable corporation on a "going concern" basis. This is accomplished by the voluntary transfer of the scholarship funding corporation's assets and liabilities (including both taxable and tax-exempt debt) to a successor taxable corporation in exchange for a fair market value investment in the "senior stock" of the successor. The successor thus would be able to seek investor capital. This solution would help solidify the secondary market for student loan notes, provide additional capital for loan origination and preserve expertise that can effectively aid the federal student loan programs. Most significantly, as the transition is of a "going concern," these goals will be accomplished as efficiently as possible, without the inevitably wasted lag time or market dislocation that would occur if scholarship funding corporations were forced to wind down or new organizations were formed to step in to fill the market needs.

As a result of the conversion, the successor would be permitted to engage in all types of business activities, and not be limited to solely the secondary market activities required by Code section 150(d). In addition, the nonprofit parent would be permitted to engage in all activities generally permitted Internal Revenue Code section 501(c)(3) organizations (i.e. charitable, educational or other exempt activities). The economic return received by the nonprofit from its investment in the successor would be a primary funding source for the nonprofit's exempt activities. Finally, the interest paid on the tax-exempt debt transferred to the successor would remain excluded from the gross income of the holders of such debt, but neither the successor nor the nonprofit would be permitted to issue additional tax-exempt debt.

The second feature protects the nonprofit's economic investment in the successor corporation. The required terms of the senior stock would allow the nonprofit to participate in the successor's economic prosperity but protect it against downside risk. In addition to having voting rights, the senior stock would carry a redemption right which would allow the nonprofit to cash out its investment within 10 years of the conversion. Moreover, upon either liquidation or redemption, the nonprofit would be guaranteed to receive the greater of the fair market value of the senior stock as of the redemption or liquidation date, or the value of the net assets originally transferred by the nonprofit in exchange for the stock. The successor corporation also would be prohibited from issuing any other equity interest that would have greater liquidation, redemption or dividend rights than the senior stock.

The proposal has been structured as a true transition rule. Neither the nonprofit nor the successor would be able to issue additional tax-exempt debt after the conversion, and outstanding tax-exempt debt would remain dedicated to funding student loans. Also, solely as a result of the transfer of assets and liabilities to the for-profit corporation in exchange for the senior stock, the nonprofit most likely would become a private foundation subject to the excise taxes imposed on section 501(c)(3) organizations classified as such. Our proposal provides limited relief from the imposition of the excise taxes under Internal Revenue Code sections 4942 and 4943, but all other private foundation excise taxes would be applicable. These excise taxes would not apply because the successor for-profit would be deemed "functionally related" to the existing nonprofit, so as long as more than 50 percent of the gross income of the successor corporation is derived from, or more than 50 percent of the value of the assets of the successor corporation consists of, student loan notes. Because this relief is only for transitional purposes, the "safe harbor" terminates after 10 years.

IV.

Conclusion

We urge the Committee to support the conversion option for scholarship funding corporations. This proposal offers a cost-effective means of bolstering the capital base of the student loan secondary market and of assuring that the expertise and workforce of the scholarship funding corporations are maintained to provide services in furtherance of federal student loan programs. In short, the proposal would permit scholarship funding corporations to evolve with the federal student loan policy, serve the recognized needs for capital and services provided by the private sector and, in this connection, compete with other participants to the benefit of the federal government and our nation's students.

The adoption of this amendment also will have the positive effect of increasing federal tax revenues by transferring this student loan funding activity from the nonprofit to the taxable sector.

TESTIMONY OF JAMES L. SCOTT
AMERICAN HEALTHCARE SYSTEMS

The AmHS Institute appreciates this opportunity to submit testimony in favor of a technical statutory change that will facilitate the development of more efficient and effective health care delivery organizations.

The AmHS Institute is the public policy center for American Healthcare Systems, a national alliance of not-for-profit multi-hospital systems, integrated delivery organizations, and health plans. The 40 AmHS shareholders own, lease, or manage 397 hospitals in 46 states. They are collectively, and individually dedicated to ensuring the availability of high quality health care services to their patients at a reasonable and affordable cost.

Beginning in the mid-1980s, many tax-exempt hospitals undertook corporate reorganizations with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. Typically, these reorganizations involved the creation of a health care system composed of a number of corporate entities, including a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other health care system members. Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of section 509(a)(3),[1] of the hospital member of the system to avoid characterization as a private foundation. Because the supporting organization relationships set forth in section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, reorganized health care systems find themselves with an inverted organizational structure. Specifically, the parent corporation, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation, usually a first-tier subsidiary within the organizational structure, to avoid being characterized as a private foundation.

Recognizing the structural difficulties inherent in this inverted relationship, legislation, supported by both the Treasury Department and the tax-exempt hospital community, was introduced last session that would have enacted a new category of public charity in section 509(a). A copy of the specific legislative language is attached.

The new category, set forth in proposed section 509(a)(4), would have included parent corporations of reorganized health care systems. This provision, which recognized the close working relationship between the parent corporation and the hospital corporation in a reorganized health care system would have alleviated the need for a parent corporation to be functionally subordinate to its related hospital corporation.[2] Importantly, enactment of proposed section 509(a)(4) involves no revenue consequences.

Although proposed section 509(a)(4) was not enacted during the last legislative session, support for the provision still exists in the tax-exempt hospital community and it would prove to be extremely useful inasmuch as it would alleviate the organizational constraints inherent in the supporting organization relationships, relationships that produce inverted organizational structures in the context of reorganized health care systems.

The AmHS Institute strongly recommends the new section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

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[1]All section references are to the Internal Revenue Code of 1986, as amended.

[2]One result of enactment of section 509(a)(4) would have been that the parent corporation board of trustees could have been structured as the broad, community based board of trustees required under Rev. Rul. 69-545, 1969-2 C.B 117.

ATTACHMENT

509(a) LEGISLATIVE LANGUAGE

(c) Treatment of Parent Organizations of Health Care Providers.-Section 509(a) (defining private foundation) is amended by striking "and" at the end of paragraph (3), by redesignating paragraph (4) as paragraph (5), and by inserting after paragraph (3) the following new paragraph:

> "(4) an organization which is organized and operated for the benefit of, and which directly or indirectly controls, an organization described in section 170(b)(1)(A)(iii), and".

TESTIMONY OF RICHARD W. BROWN
HEALTH MIDWEST

Health Midwest appreciates this opportunity to submit testimony in favor of a technical statutory change that will facilitate the development of more efficient and effective health care delivery organizations.

Health Midwest is a private Missouri not-for-profit corporation which serves as the parent organization for an integrated system of health care providers, including 12 hospitals, physician clinics employing over 90 doctors, home health services, hospice care, long term care services, mental health services, occupational health services, rehabilitation services, professional and diagnostic outreach programs, and residency training programs in family medicine. Health Midwest organizations are collectively and individually dedicated to ensuring the availability of high quality health care services to their patients at a reasonable and affordable cost.

The development of the Health Midwest System parallels those of many not-for-profit health care systems in the country. In 1980, Research Medical Center, a tax-exempt hospital, undertook a corporate reorganization with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. Our reorganization involved the creation of a health care system composed of a number of corporate entities, including Research Health Services, a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other health care system members.

During the 1980s, other tax exempt, not-for-profit hospitals in the Kansas City area became sister hospitals to Research Medical Center by appointing Research Health Services as their parent organization. In 1991, Research Health Services and the parent organization of another not-for-profit health system, Baptist Health Systems, combined to create Health Midwest. In the 1990s, other hospitals and health care organizations have joined the growing Health Midwest System of health care providers.

Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of Section 509(a)(3)[1], of the hospital member of the system to avoid characterization as a private foundation. Health Midwest is typical in this regard. Because the supporting organization relationships set forth in Section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, we find ourselves with an inverted organizational structure. Specifically, Health Midwest, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation first-

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[1]All section references are to the Internal Revenue Code of 1986, as amended.

tier subsidiaries within its organization structure, to avoid being characterized as a private foundation.

Recognizing the structural difficulties inherent in this inverted relationship, legislation, supported by both the Treasury Department and the tax-exempt hospital community, was introduced last session that would have enacted a new category of public charity in Section 509(l). A copy of the specific legislative language is attached.

The new category, set forth in proposed Section 509(a)(4), would have included parent corporations of reorganized health care systems like Health Midwest in a separate category of not-for-profit organizations entitled to public charity status. This provision, which recognized the close working relationship between the parent corporation and the hospital corporations in a reorganized health care system would have alleviated the need for a parent corporation like Health Midwest to be functionally subordinate to its related hospital corporations[2]. Importantly, enactment of proposed Section 509(a)(4) involves no revenue consequences.

Although proposed Section 509(a)(4) was not enacted during the last legislative session, Health Midwest and the tax-exempt hospital community generally continue to support the provision. It would prove to be extremely useful to Health Midwest and other not-for-profit tax-exempt health care systems because it would alleviate the organizational constraints inherent in the supporting organization relationships, relationships that produce inverted organizational structures in the context of reorganized health care systems.

Health Midwest strongly recommends that new Section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

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[2] One result of enactment of Section 509(a)(4) would have been that the Health Midwest board of directors could have been structured as the broad, community based board of trustees required under Rev. Rul. 69-545, 1969-2 C.B 117, rather than a board largely determined by its related hospital corporations.

Attachment

509(a) LEGISLATIVE LANGUAGE

(c) Treatment of Parent Organizations of Health Care Providers - Section 509(a) (defining private foundation) is amended by striking "and" at the end of paragraph (3), by redesignating paragraph (4) as paragraph (5), and by inserting after paragraph (3) the following new paragraph:

"(4) an organization which is organized and operated for the benefit of, and which directly or indirectly controls, an organization described in section 170(b)(1)(A)(iii), and."

Thomas F. McNulty
Senior Vice President
Chief Financial Officer and
Treasurer

Executive Offices
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Detroit, Michigan 48202-3450
Office [illegible]
Fax [illegible]

Cottage Hospital
Diversified Services Group
Health Alliance Plan
Henry Ford Continuing Care
Henry Ford Health Sciences Center
Henry Ford Hospital
Henry Ford Medical Group
Kingswood Hospital
Maplegrove Centers
Medical Value Plan
Metro Medical Group
Onika Insurance Company Limited
The Fund for Henry Ford Hospital
Wyandotte Hospital & Medical Center

July 25, 1995

The Honorable Bill Archer
Chairman, House Ways & Means Committee
1102 Longworth House Office Building
Washington, DC 20515-4307

RE: Proposed Internal Revenue Code Section 509(a)(4)

Dear Congressman Archer:

I am writing to support adding Section 509(a)(4) to the Internal Revenue Code in order to establish a new category of public charity that would facilitate reorganization of health care systems. Under current law, health systems that want to retain their not-for-profit status face certain barriers with regard to their legal structure.

The Henry Ford Health System (HFHS) has undergone several reorganizations designed to streamline management and provide a stronger and more cost-effective continuum of health care services since 1988. Although current law is not an issue for HFHS in our present configuration, it used to be a problem prior to the recent consolidation of a number of our business units into a single corporate entity, which we call the Henry Ford Health System.

We support the proposed change as beneficial to the cost and quality of health care, as more and more providers seek to collaborate and find ways of organizing themselves that are more efficient and cost-effective. This change provides important flexibility that is a building block to the reformed delivery system Congress looks to for future savings in Medicare, Medicaid and the private sector.

Enclosed please find an overview of the Henry Ford Health System which reflects the evolution of many disparate business elements over a relatively short period of time. Our experience illustrates solid benefits to patients and the community through the kind of structural consolidation that the proposed amendment would help. Enactment of proposed section 509(a)(4) involves no revenue consequences. We respectfully ask your favorable consideration of this proposal.

Sincerely,

Tom McNulty

Henry Ford Health System

Corporate Government Affairs

DESCRIPTION OF AN INTEGRATED DELIVERY SYSTEM

The Henry Ford Health System (HFHS) is organized under one corporate board as a non-profit organization that includes virtually the entire continuum of health care services. Annual revenues are approximately $1.5 billion.

Patients receive care from both the Henry Ford Medical Group, comprised of about 1,000 salaried physicians, as well as 1,200 private practice physicians connected to HFHS through network arrangements with our wholly-owned HMO, Health Alliance Plan of Michigan with 450,000 enrolled members. HFHS serves enrolled and fee-for-service Medicaid and Medicare patients, and owns and operates 35 ambulatory centers throughout Southeast Michigan, as well as a 900-bed inner-city tertiary hospital, with research and teaching as key missions.

The System has approximately 800 physicians-in-training in the System at any given time. This past year HFHS launched a major primary care medical education initiative with Case Western University and the Robert Wood Johnson Foundation. HFHS hospitals include three wholly-owned community hospitals, plus five under joint-venture and HMO network arrangements that connect them to HFHS. In addition, HFHS manages and shares in the losses of one inner-city community hospital in a multi-faceted contract that covers profits and losses with another health system. Approximately 40% of physician and hospital income is capitation, with the remainder a combination of negotiated and fee-for-service revenue.

We have major clinical programs, such as Children's Services, that we share with other systems through contracts that divide up inpatient and ambulatory care responsibilities for enrolled populations, including Medicaid patients, to avoid duplication of costs and enhance core clinical strengths. HFHS owns and operates two nursing homes and sponsors a demonstration that combines Medicare, Medicaid and private financing under a strategy to keep frail seniors independent and in their own homes, rather than in nursing homes.

HFHS managed care is aimed at providing better quality and higher patient satisfaction. Our experience has been that higher quality strategies simultaneously produce reduced cost. Managed care has meant charting all of the things that happen to a patient during an episode of care and finding ways to coordinate health services across outpatient and hospital settings, as well as across a variety of caregivers.

60 percent of the Henry Ford Health System's revenue comes from non-HMO members, yet we provide managed care medicine to all our patients, regardless of the type of insurance coverage they have. Our design for managed care produces "best practices" and clinical guidelines for the 1,000 salaried physicians who make up the Henry Ford Medical Group, as well as the approximately 1,200 private work physicians who practice in our hospitals and clinics and share responsibility for our approximately 450,000 HMO patients. Henry Ford Hospital is currently charting the top 20 DRGs to get similar results. Examples of programs we have launched as part of our quality-based managed care include: 1) error-free cervical cancer screening; 2) short-stay hip and knee joint replacement; 3) hospital Patient Focused Care Unit. Savings and patient satisfaction are welcome results of these and other quality improvement initiatives.

Darlene Burgess, Vice President

JUNE, 1995

TESTIMONY OF CHARLES J. MARR, FACHE
IMMANUEL HEALTHCARE SYSTEMS

Immanuel Healthcare Systems appreciates this opportunity to submit written testimony in support of a technical statutory change that will facilitate the formation of more efficient and effective healthcare delivery organizations.

Immanuel Healthcare Systems of Omaha, Nebraska is a not-for-profit integrated network of health services. The network provides primary care, pediatrics, maternity, inpatient and outpatient surgery, cardiology, oncology, orthopedics, home healthcare, physical rehabilitation, behavioral health and other healthcare services at more than 75 sites in Omaha, eastern Nebraska and western Iowa. Our network goes beyond caring for episodic illness to focusing on the total well-being of an individual through prevention, wellness and education.

Beginning in the mid-1980's, many not-for-profit hospitals completed corporate reorganizations with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. These reorganizations involved the creation of a healthcare system composed of a number of corporate entities, including a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other healthcare system members. Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of section 509(a)(3)[1], of the hospital member of the system to avoid characterization as a private foundation.

Because the supporting organization relationships set forth in section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, reorganized healthcare systems find themselves with an inverted organizational structure. Specifically, the parent corporation, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation, usually a first-tier subsidiary within the organizational structure, to avoid being characterized as a private foundation.

Recognizing the structural difficulties inherent in this inverted relationship, legislation, supported by both the Treasury Department and the not-for-profit hospital community, was introduced last session that would have enacted a new category of public charity in section 509(a). The specific legislative language is shown below:

509(a) Legislative Language

> (c) Treatment of Parent Organizations of Health Care Providers, Section 509(a) (defining private foundation) is amended by striking "and" at the end of paragraph (3), by redesignating paragraph (4) as paragraph (5), and by inserting after paragraph (3) the following new paragraph:
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[1]All section references are to the Internal Revenue Code of 1986, as amended.

The new category, set forth in proposed section 509(a)(4), would have included parent corporations of reorganized healthcare systems. This provision, which recognized the close working relationship between the parent corporation and the hospital corporation in a reorganized healthcare system would have alleviated the need for the parent corporation to be functionally subordinate to its related hospital corporation.[2] Importantly, enactment of proposed section 509(a)(4) involves no revenue consequences.

Although proposed section 509(a)(4) was not enacted during the last legislative session, support for the provision still exists in the not-for-profit hospital community and it would prove to be extremely useful as it alleviates the organizational constraints inherent in the supporting organization relationships - relationships that produce inverted organizational structures in the context of reorganized healthcare systems.

Immanuel Healthcare Systems strongly recommends that the new section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

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[2]One result of enactment of section 509(a)(4) would have been that the parent corporation board of trustees could have been structured as the broad, community based board of trustees required under Rev. Rul. 69-545, 1969-2 C.B. 117.

TESTIMONY OF MAURICE W. ELLIOTT
METHODIST HEALTH SYSTEMS

The Methodist Health Systems appreciates this opportunity to submit written testimony in favor of a technical statutory change that will facilitate the development of more efficient and effective health care delivery organizations.

The Memphis-based Methodist is a not-for-profit health care system consisting of twelve hospitals in three states and a home health care and hospice agency. The System's flagship institution, Methodist Hospital Central, located in the Memphis Medical Center has one of the country's most active heart programs. Methodist Hospitals of Memphis contains four centers of excellence, the Mid-South Heart Institute, the Methodist Hospital Cancer Care Center, Women's Health Resources, and Memphis Neurosciences Center. The System's twelve hospitals represent 2,587 licensed beds.

Beginning in the mid-1980's, many tax-exempt hospitals undertook corporate reorganizations with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. Typically, these reorganizations involved the creation of a health care system composed of a number of corporate entities, including a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other health care system members. Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of section 509(a)(3)[1], of the hospital member of the system to avoid characterization as a private foundation. Because the supporting organization relationships set forth in section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, reorganized health care systems find themselves with an inverted organizational structure. Specifically, the parent corporation, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation, usually a first-tier subsidiary within the organizational structure, to avoid being characterized as a private foundation.

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The Methodist Health Systems recommends the new section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

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TESTIMONY OF LARRY L. MATHIS
METHODIST HOSPITAL SYSTEM

The Methodist Hospital System appreciates this opportunity to submit written testimony in favor of a technical statutory change that will facilitate the development of more efficient and effective health care delivery organizations.

The Houston-based Methodist is a not-for-profit health care system consisting of three hospitals and a home health care and hospice agency. The three hospitals are The Methodist Hospital, the System's flagship institution, located in the world renowned Texas Medical Center, that serves as the primary adult teaching hospital for Baylor College of Medicine, Diagnostic Center Hospital of the Texas Medical Center, and San Jacinto Methodist Hospital of Baytown. These hospitals represent 1,935 licensed beds.

Beginning in the mid-1980's, many tax-exempt hospitals undertook corporate reorganizations with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. Typically, these reorganizations involved the creation of a health care system composed of a number of corporate entities, including a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other health care system members. Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of section 509(a)(3)[1], of the hospital member of the system to avoid characterization as a private foundation. Because the supporting organization relationships set forth in section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, reorganized health care systems find themselves with an inverted organizational structure. Specifically, the parent corporation, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation, usually a first-tier subsidiary within the organizational structure, to avoid being characterized as a private foundation.

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The Methodist Hospital System strongly recommends the new section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

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Presbyterian Healthcare System

8220 Walnut Hill Lane
Suite 700
Dallas, Texas 75231
(214) 345-8501

Douglas D. Hawthorne, FACHE
President
Chief Executive Officer

July 17, 1995

Members of the Ways and Means Committee
c/o Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Honorable Members of the Committee:

Presbyterian Healthcare System appreciates this opportunity to submit written testimony in favor of a technical statutory change that will facilitate the development of more efficient and effective health care delivery organizations.

The Dallas-based Presbyterian Healthcare System is a not-for-profit, multiunit system consisting of four hospitals, three affiliated hospitals, a retirement community, and senior primary care centers serving North and East Texas. In addition, an allied company operates nine urgent care centers. The four hospitals are the flagship institution, Presbyterian Hospital of Dallas, plus Presbyterian Hospital of Kaufman, Presbyterian Hospital of Plano, and Presbyterian Hospital of Winnsboro. These hospitals represent more than 1,100 licensed beds.

Beginning in the mid-1980s, many tax-exempt hospitals undertook corporate reorganizations with the objective of creating management efficiencies by segregating discrete functions into separate corporate entities. Typically, these reorganizations involved the creation of a health care system composed of a number of corporate entities, including a parent corporation charged with providing overall strategic planning, financial coordination and guidance to the other health care system members. Typically, parent corporations of reorganized health care systems have few tangible assets and, as such, must frequently, if not always, be structured as a "supporting organization," within the meaning of section 509(a)(3),[1] of the hospital member of the system to avoid characterization as a private foundation. Because the supporting organization relationships set forth in section 509(a)(3) contemplate that the supporting organization will be subordinate to the supported organization, reorganized health care systems find themselves with an inverted organizational structure.

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Specifically, the parent corporation, viewed as the source of overall system direction, management and guidance, must be subordinate to the hospital corporation, usually a first-tier subsidiary within the organizational structure, to avoid being characterized as a private foundation.

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Although proposed section 509(a)(4) was not enacted during the last legislative session, support for the provision still exists in the tax-exempt hospital community and it would prove to be extremely useful inasmuch as it would alleviate the organizational constraints inherent in the supporting organization relationships, relationship that produce inverted organizational structures in the context of reorganized health care systems.

The AmHS institute strongly recommends the new section 509(a)(4) be included in the Committee's miscellaneous tax reform measure.

Sincerely,

Douglas D. Hawthorne, FACHE
President and CEO

DDH:jt

Attachment

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ATTACHMENT

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STATEMENT SUBMITTED FOR HEARING RECORD

ON BEHALF OF

PULTE HOME CORPORATION

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

HEARINGS ON MISCELLANEOUS TAX REFORMS

JULY 11 AND 12, 1995

Pulte Home Corporation ("Pulte") strongly supports Financial Institutions Proposal #1, which would repeal the provisions in the Omnibus Budget Reconciliation Act of 1993 that retroactively denied tax deductions for so-called "covered asset" losses reimbursed by FSLIC assistance for failed thrifts. The 1993 legislation should be repealed because it constitutes a breach of contract as well as a breach of faith with taxpayers, such as Pulte, who acted in reliance on the availability of these losses in purchasing failed thrift institutions in 1988. The facts as described below are complicated, but the bottom line principle is very simple. This 1993 legislation unfairly and unilaterally reneged on contracts that Pulte and others entered into with the U.S. government. The legislation should never have been enacted, and repealing it will save the government the time and expense associated with defending against breach of contract suits by Pulte and the other similarly situated taxpayers. Moreover, because we have every expectation that those claims will therefore be decided in our favor -- and that the revenue expected to be saved under the 1993 provision will be returned to the taxpayers in judgments for breach of contract -- we believe that the repeal of the provision should be viewed as essentially cost-free.

The Facts Regarding Pulte

Pulte is one of the largest home builders in the U.S., with extensive operations in Virginia, Maryland, Florida, North Carolina, Georgia, Texas, Arizona, Michigan, Illinois, Minnesota, Colorado, Ohio and California. As a natural and complementary extension of its business of building homes for, and providing mortgage financing to, its customers, Pulte investigated the strategic acquisition of a thrift from February 1986 through early 1987.

In June 1987, at FSLIC's invitation, Pulte submitted a proposal to acquire Heights Savings Association of Houston, Texas. FSLIC indicated that it was seeking Pulte's professional management, financial expertise (particularly with respect to home mortgage financing) and fresh capital. Pulte sought to use its expertise and capital in order to realize the upside potential from rehabilitating Heights -- a very troubled but promising institution -- and to benefit from the synergistic opportunities that Heights would bring to its home building and mortgage finance businesses.

In September 1987, Pulte won the FSLIC competition to be the sole company negotiating for Heights. During the balance of 1987 and early 1988, Pulte formally revised its proposal on four separate occasions in order to accommodate changes in FSLIC internal priorities. Throughout this period, FSLIC repeatedly indicated its readiness to close.

In early 1988, FSLIC's internal policies and practices changed with respect to the disposition of troubled thrifts. In March 1988, FSLIC suddenly advised Pulte that Heights would be placed into the so-called "Southwest Plan" and would only be sold pursuant to new negotiations with Pulte as part of a package with four other thrifts. Pulte was given

no opportunity to perform due diligence (i.e., to examine books and records) with respect to these thrifts. As time has revealed, the four thrifts were totally bankrupt and had material covered asset losses. They also lacked Heights's "consumer franchise" value. That is, they (unlike Heights) had no significant base of stable low interest cost consumer deposits. Most of their funds were obtained by volatile high cost "brokered" deposits (obtained through investment bankers) and loans from the Federal Home Loan Bank of Dallas.

At this point, FSLIC indicated that the tax benefits attributable to the thrifts would be an important economic element taken into account in the negotiations. Pulte indicated that it was willing to cede very substantial tax savings (including covered asset losses) to FSLIC if FSLIC would provide Pulte with nontax economic terms that FSLIC similarly provided to the acquirers of other thrifts before September 1988. FSLIC rejected Pulte's proposal. FSLIC preferred to give lower yield maintenance and lower gain sharing (sharing in the increase in value of the covered assets over the value of such assets at the time of their acquisition) and to provide higher tax benefits in order to induce Pulte to buy the Southwest Plan package of thrifts.

After extended negotiations, Pulte was successful in acquiring the five thrifts in September 1988. The acquisition was closed in two stages, the last of which occurred on September 23, 1988. The second stage was required to accommodate the late substitution of Champion Savings Association of Houston. Champion was the largest thrift in Pulte's package of thrifts. Champion had very substantial covered asset losses, which appeared to be significantly greater than the covered asset losses of the thrift for which it was substituted. Also, Champion had little consumer franchise value. The competitive bidding process and Pulte's acquisition are described in the RTC Report -- Case Study No. 6, which was designated as the OWL Transaction (the "OWL Report").

Pulte ultimately agreed to accept substantial tax benefits, including those attributable to covered asset losses, in lieu of the higher gain sharing and yield maintenance that it previously sought. Pulte also accepted thrifts with a lower consumer franchise value. The thrifts that Pulte ultimately purchased, particularly Champion, had a higher percentage of high-cost brokered deposits. In general, Pulte received 75% of the tax benefits, and FSLIC retained 25%.

The 75% share of the tax benefits allocable to Pulte was an important economic element in the negotiations. It affected the level of yield maintenance assistance that FSLIC would provide, the administrative obligations that Pulte undertook, the amount of capital that Pulte would be required to invest in the troubled thrifts (eventually $52.5 million), and other commitments by FSLIC and Pulte. The contracts specifically required Pulte to "maximize" tax benefits by, for example, filing consolidated returns with the thrifts so that losses that were incurred could offset profits of Pulte from its home building businesses. In addition, as stated in the OWL Report, FSLIC concluded that --

> if one considers the FSLIC's portion of the tax benefits that Pulte predicts it will receive, then Pulte's proposal appears to be the least costly solution to the FSLIC.

This conclusion was reached pursuant to statutory policies that, at that time, called upon FSLIC to evaluate every proposed acquisition to determine whether it would be less

expensive for FSLIC to liquidate the institution or to accept the more favorable terms offered by any bidder.

Incidentally, FSLIC was not "out-negotiated." It was represented by analysts and a very large and sophisticated law firm with substantial experience in negotiating, structuring and executing FSLIC-assisted transactions and all associated tax consequences.

Deductibility of Covered Asset Losses

FSLIC provided written materials to parties engaged in negotiations pursuant to the Southwest Plan, including Pulte, that, among other things, provided representations and assurances as to the tax consequences, including specific representations and assurances that covered asset losses were deductible. (A copy of the relevant portion of these materials is attached to this statement as Exhibit 1.) IRS personnel participated in FSLIC-sponsored seminars and provided the same assurances as to the tax consequences. It was a standard element of every acquisition that FSLIC provided assistance payments equal to the excess of the book value (generally tax basis) of the covered assets over the sales price so that the acquirer received cash from FSLIC equal to the amount of the loss realized on the sale of the covered assets. Inasmuch as Code § 597 provided at that time both that FSLIC assistance payments to a thrift were tax exempt for federal tax purposes and that the payments did not reduce the basis in the thrift's assets, the FSLIC/IRS assurances appeared sound and were taken by bidders at face value. Pulte nonetheless requested a private letter ruling on November 29, 1988, as to the acquisition, which Pulte eventually received on July 27, 1989.

The IRS ruling letter, among other matters, specifically described the covered asset loss payments to be made by FSLIC. The ruling stated, among some thirty-two separate ruling paragraphs, that (i) Code § 382(a) would not limit "the carryover and deductibility of the net operating and [covered asset] losses" of those thrifts acquired by Pulte as to which other requirements of Code § 382 were satisfied; (ii) pursuant to Code § 597(a), the FSLIC assistance payments would not be included in gross income; (iii) the FSLIC assistance payments would generate earnings and profits; and (iv) pursuant to § 904(c)(2)(B) of the Tax Reform Act of 1986, Code § 265 would not deny any deduction by reason of such deduction being allocable to amounts excluded from gross income under Code § 597. The ruling followed the same pattern as several other rulings on such acquisitions issued by the IRS in the latter part of 1988 and in 1989.

Pulte read the private letter ruling as being comprehensive as to the tax consequences and as providing assurance, among other things, that the covered asset losses were deductible. The earnings and profits ruling, for example, necessarily assumed that the losses were deductible. There could logically be an increase in earnings and profits on account of FSLIC covered asset loss assistance payments only if there were a corresponding decrease by reason of a covered asset loss deduction. Similarly, the paragraphs as to the carryover and deductibility of covered asset losses, and the non-application of Code § 265, were largely meaningful only if the losses were deductible.

At the time that Pulte sought its ruling in the fall of 1988, no question existed as to the deduction of the losses under Code § 165. The provisions of the Code stating specifically that the FSLIC payments were not income and did not reduce basis would have been disingenuous if the payments nonetheless reduced a loss deduction otherwise allowable. The substantive effect of treating a payment as compensation for a loss is the same as including it in gross income, or applying

it to reduce the basis of the asset. The Internal Revenue Code is not normally read to contain manifest inconsistencies such as explicitly excluding an amount from income and from basis reduction but nonetheless then applying the amount to reduce a deduction otherwise clearly available. The IRS had already recognized that no such inconsistency could exist in the Code because it had issued a Technical Advice Memorandum in 1986 that a thrift's loss was allowable for tax purposes even though by reason of FSLIC assistance there was no economic loss. PLR 8637005.

The analysis of the tax treatment of troubled thrifts by the Joint Committee on Taxation dated February 16, 1989 (JCS-3-89) stated that if a thrift sold a covered asset with a tax basis and book value of $100 for $60, and received a covered loss assistance payment from FSLIC of $40, it had a loss of $40 for tax purposes which it could use "to offset future taxable income." The testimony of Dana L. Trier, Acting Tax Legislative Counsel, U.S. Treasury Department, before the Subcommittee on Taxation and Debt Management, Senate Committee on Finance, on March 28, 1988, clearly assumed that such losses were deductible.

The Treasury Department's official position on this issue is now to the contrary, and the Department supported the 1993 provision as a legislative "clarification" of that position. Yet tax lawyers both within and without the government advised bidders for the thrifts in 1988 that these deductions were allowable, notwithstanding the fact that FSLIC reimbursement of these losses would be received. Although the representations from the IRS and Treasury officials were verbal, the written Technical Advice Memorandum just referred to clearly stated that these losses were deductible. Subsequently, in December of 1988, the IRS also entered into a written closing agreement with another taxpayer that stated that the deductions were allowable. If this was not the position of the IRS and Treasury at the time of these transactions, why did they issue written and verbal assurances that these deductions were allowable? Officials at the Treasury Department and the IRS were clearly aware of what taxpayers and the FSLIC were doing. If they did not believe the deductions were allowable, the Treasury should have made an official statement to that effect and not waited until March 1991, over two years later, when it first voiced its objections.

This was not a case of companies designing a scheme to take tax deductions based upon some far-out theory dreamed up by their tax lawyers. Officials at both the FSLIC and the IRS reassured Pulte at that time that these deductions were allowable, and they encouraged Pulte to put money into these institutions based upon that assumption.

Retroactivity and Unfairness of 1993 Legislation

As can be seen from the above analysis of the facts involving Pulte, the deduction of covered asset losses as a tax benefit was frequently a major inducement to those who acquired troubled thrifts in 1988. The benefit, like the other tax benefits involved at the time, was offered to acquirers in lieu of cash, which was in short supply at the FSLIC at the time. Both the Treasury Department and the FSLIC affirmatively advertised the benefit and consistently assured acquirers, orally and in writing, that both an exclusion of FSLIC assistance from income and a deduction for covered asset losses would be allowed under the Tax Code.

Congress itself was also well aware of the benefit. In the tax bill enacted in November of 1988, Congress decided to keep the benefit intact for the balance of that year before phasing it out in 1989. The FSLIC advocated retention of the benefit because of its value in promoting troubled thrift

acquisitions that could help the FSLIC fund. In short, the government collectively decided that the tax benefit would be used to induce potential acquirers to take ailing thrift institutions off the hands of the government in the latter part of 1988.

The 1993 revocation of these tax benefits was retroactive and unfair. Even though it was not enacted until 1993, the repeal was effective for FSLIC assistance credited on or after March 4, 1991, and it had a specific cutback in the deduction of losses incurred prior to the effective date for those companies that had net operating loss carryovers to taxable years ending after that date. This means that taxpayers who had losses in the years prior to March 4, 1991, but could not use them because they did not have adequate income -- such as those in the home building business -- are prevented from ever using them. Companies that were lucky enough to have had the income to offset their losses prior to March 4, 1991, are unaffected.

The effective date operates especially harshly upon Pulte because it is also based upon when taxpayers' FSLIC assistance is credited, rather than simply upon when the losses were incurred. Had Pulte received the FSLIC assistance when it wrote off the losses in years prior to 1991, Pulte would not be subject to the cutback of net operating loss carryovers. In Pulte's case, however, FSLIC was restricted under the assistance agreement from directing writedowns, requiring sales and/or purchasing assets that aggregated more than 10% of the beginning amount of covered assets in any one year. Thus, by virtue of the contract with FSLIC, Pulte could not have been paid or credited with assistance in an amount greater than that 10% amount.

Furthermore, it was the policy of the RTC (FSLIC's successor) to try to pay off the covered assets as quickly as possible in the "worst deals" from the government's point of view. The effective date, in a sense, rewards those who received the FSLIC assistance first and punishes those who received the assistance later.

Conclusion

The tax benefits at issue were clearly an important element in the negotiations that led to Pulte's thrift purchase and the purchases of many other acquirers. Pulte reasonably believed at the time that it would be entitled to the covered asset loss deductions that motivated its purchase because the relevant government agencies consistently advised the company that it would receive those deductions. It is clear that without those tax benefits as consideration, Pulte and many of the other acquirers would never have considered purchasing the thrifts they ultimately acquired. It was accordingly a gross breach of faith for Congress to retroactively deny those benefits in 1993. The 1993 legislation should therefore be repealed.

EXHIBIT 1

Federal Home Loan Bank Board
Federal Savings and Loan Insurance Corporation
Washington, D.C.

INFORMATION AND INSTRUCTIONS FOR THE PREPARATION AND SUBMISSION OF PROPOSALS

For the Acquisition of:
One or more Savings Institutions
in the Southwest

THIS MATTER IS SENSITIVE AND CONFIDENTIAL.
THIS AND ALL OTHER DOCUMENTS AND ALL INFORMATION CONTAINED THEREIN OR OTHERWISE MADE AVAILABLE TO PROSPECTIVE OFFERORS ARE NOT INTENDED FOR PUBLIC DISSEMINATION AND SHOULD NOT BE DISCLOSED BY ANY RECIPIENT TO ANY OTHER ENTITY OR PERSON EXCEPT AS PROVIDED IN THE CONFIDENTIALITY AGREEMENT EXECUTED BY THE RECIPIENT

b. an evaluation of other contingent or potential costs and risks to the FSLIC of each acquisition proposal;

c. an analysis of the projected financial viability of the resulting institution after the acquisition contemplated by the proposal;

d. an assessment of the financial and managerial resources of the prospective acquiror;

e. an assessment of the acquiror's plan for managing problem assets;

f. an assessment of the acquiror's business plan for reducing operating expenses and cost of funds;

g. an analysis of pertinent anti-competitive and anti-trust considerations;

h. an overall determination of the proposal which is most advantageous to the depositors and other creditors of the acquired institution and to the FSLIC; and

i. a consideration of applicable standards and priorities imposed by statute or regulation.

TAX BENEFITS

10. In general, the Internal Revenue Code of 1986 presently contains three provisions that provide favorable Federal income tax consequences to a taxpayer that acquires a savings and loan institution in an FSLIC-assisted transaction. First, most FSLIC-assisted acquisitions will qualify as a tax-free reorganization under section 368(a)(1)(G) of the Code. Because of this the tax basis of the assets of the acquired institution will carry over to the acquiror and permit the acquiror to recognize a tax loss upon the disposition of an acquired asset which has a tax basis greater than its fair market value. Second section 382 of the Code generally will permit any net operating loss carryover of the acquired institution to be utilized by the acquiring institution to offset post-acquisition taxable income. Third, section 597 of the Code provides that FSLIC assistance payments received by a savings and loan institution are not includible in income and do not require a reduction in the basis of other assets. These consequences often occur under state income tax laws as well.

11. These provisions have the effect of permitting an acquiring institution to realize tax benefits attributable to a particular item even though FSLIC assistance is received with respect to such item. For example, if the acquiror receives coverage for capital losses incurred on the disposition of identified assets of the acquired institution, the acquiror is entitled to deduct such loss for federal income tax purposes, notwithstanding that it is reimbursed for the loss by the FSLIC, and that the FSLIC payment is tax free. Similarly, if payments are made by the FSLIC to an acquiror pursuant to a yield guarantee, such assistance need not be reported as taxable income by the acquiror.

12. These provisions were intended to aid the FSLIC by reducing the amount of FSLIC assistance that should be required by an acquiring institution for a particular cost, expense or loss by the amount of the tax benefit obtained by the acquiring institution with respect to such cost, expense or loss. This reduction in required assistance can be realized by the FSLIC in one of two ways: (1) Assistance amounts to be paid by FSLIC to the acquiring institution can be reduced by the amount of the tax benefit available to the acquiring institution with respect to the item for which assistance is being paid. For example, if capital loss or undisclosed liability coverage is requested, and the combined marginal federal and state income tax rate is 40%, FSLIC can pay 60% of any loss or liability incurred and the acquiring institution can recover the remaining 40% of the loss or liability through a deduction of the loss or liability on its tax returns. (2) Assistance amounts can be paid in full by FSLIC to the acquiring institution and the acquiring institution can return to FSLIC the allocable tax benefit when it is realized by the filing of income tax returns. Thus, under this method in the above example, FSLIC will pay 100% of the loss or liability and the acquiring institution will pay the tax benefit to FSLIC when the tax returns recognizing such benefit are filed. In taking account of tax benefits, FSLIC prefers to use method (1) but will consider method (2).

13. Since most assisted acquisitions will quality as a tax-free reorganization under section 368(a)(1)(G) of the Internal Revenue Code, the net operating loss carryover of the acquired institution may be usable by the acquiring institution. FSLIC would expect the acquiring institution to agree to share any benefit received from the utilization of such loss carryover as it is realized. This is especially true in case where assistance in the form of a contribution for negative net worth is requested.

14. Proposals should state (a) the combined federal and state income tax rates which are applicable: (b) whether FSLIC assistance payments may be reduced by available tax benefits when paid by FSLIC (method (1) above), or whether FSLIC will be required to pay 100% of the assisted item and receive the tax savings when realized (method (2) above), and (c) the percentage of net operating loss carryover which will be returned to FSLIC when realized.

ACCOUNTING ISSUES

15. At the FSLIC's option, an audit and inventory of the assets and liabilities of the acquired institution as of the date of acquisition will be performed by a public accounting firm selected by the FSLIC. The scope of any audit or inventory will be determined, and its expense borne by, the FSLIC. Any audit will be conducted in accordance with specifications and for purposes prescribed by the FSLIC and not necessarily in accordance with generally accepted auditing standards.

16. For purposes of financial reporting to the public, proposals should refer to Accounting Principles Board Opinion No. 15 and the Financial Accounting Standards Board's "Statement of Financial Accounting Standards No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions."

TSCBA

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July 27, 1995

The Honorable Bill Archer
Chairman
Committee on Ways & Means
U.S. House of Representatives
Washington, DC 20515

re: 1993 Retroactive Denial of Losses Reimbursed by FSLIC Assistance for Failed Thrifts

Dear Mr. Chairman:

This statement is submitted on behalf of the members of the Texas Savings & Community Bankers Association which acquired failed thrifts in supervisory acquisitions that qualified as tax-free reorganizations. More specifically, these members acquired such institutions pursuant to assistance agreements entered into with the Federal Savings and Loan Insurance Corporation (FSLIC) providing for the certain well-established tax benefits. For the reasons stated herein, we support the proposal to repeal that provision of the Economic Recovery and Deficit Reduction Act of 1993 which **retroactively denied these contractual benefits** by prohibiting the FSLIC from reimbursing the acquirors for losses incurred upon the sale of the acquired thrifts' so-called covered assets.

The legislative history of Section 597 of the Internal Revenue Code, including its enactment in 1981 and each amendment including its repeal in 1989, makes it clear that Congress intended that the exclusion of FSLIC assistance from income would entitle the recipient to deduct losses that were fully compensated by the receipt of such assistance. Congress was fully aware that the effect of Section 597 was to create a tax subsidy for troubled financial institutions. Moreover, this tax subsidy was scheduled to expire at the end of 1988 and Congress, understanding the effect of this subsidy, elected to extend it in the 1988 Act, albeit at a reduced level. The 1988 Act reduced this subsidy by adding Section 597(c) (the "attributable cutback rule"), which required the institution receiving FSLIC assistance to reduce one or more of three tax attributes (its net operating loss carryovers, interest expense, or recognized built-in portfolio losses) by 50 percent of the FSLIC assistance received.

As legislative history shows, Congress intended that the exclusion of FSLIC assistance from income would entitle the recipient to deduct losses that were fully compensated by the receipt of that assistance. Congress understood and intended that the exclusion of FSLIC assistance from gross income by reason of Section 597 (a) would give rise to deductions for federal income tax purposes as a result of a high carryover tax basis in the assets acquired from a failed thrift. This was the very reason why Code Section 368 (a)(3)(D) permitted the failed thrift's high tax basis in its assets to be preserved in a supervisory acquisition and why Section 382(l)(5)(F) excepted many of these supervisory acquisitions from the Section 382 limitations on the use of net operating loss carryovers and built-in losses.

When the FSLIC arranged a qualifying supervisory acquisition of a troubled thrift institution by a healthy institution, the tax attributes of the acquired institution (including net operating loss carryovers and built-in losses reflected in the basis of acquired assets) were carried over to the surviving entity. Assuming that the 20% continuity of interest test of Section 382 of the Internal Revenue Code (as applicable to supervisory mergers) was also met, the net operating loss carryforwards and built-in losses were available for use by the surviving institutions without limitation. Additionally, Section 597 of the Code had the effect of ensuring that payments of FSLIC financial assistance in connection with the transaction were not included in the income of the surviving institution, either immediately or on a deferred basis through an adjustment to the basis of that institution's assets.

The fact that the transferor's basis carried over to the surviving institution allowed that institution to recognize a tax loss if an asset was sold or satisfied at less than its basis. This, coupled with the tax-free treatment of FSLIC assistance payments, enabled the FSLIC to reimburse losses on covered assets at a lower overall cost. Similarly, the yield maintenance and interest on FSLIC notes were paid at a lower "after-tax" rate, thereby reducing the overall cost of assistance.

During hearings before the Senate Finance Committee in 1988, then Chairman of the Federal Home Loan Bank Board, M. Danny Wall, testified:

> Code Section 597 provides that assistance paid by the FSLIC in connection with an assisted acquisition will not be considered taxable income. <u>This tax benefit does not inure to the troubled institution or the acquiror, but helps the FSLIC by reducing the amount of assistance otherwise needed</u>. For example, if under current law the FSLIC must pay an acquiror $100 as an inducement to acquire a troubled thrift, the FSLIC may need to pay potential acquirors $150 if that assistance payment is to be subject to tax.

According to <u>The Washington Post</u>, **"tax benefits are the glue that holds most of these deals together and enhance the value of federal assistance by millions of dollars...."** (11/2/88).

It remains clear that Sections 597(a) and (b) were enacted to enable <u>all</u> FSLIC assistance to be received without giving rise to any income and without application of the basis reduction rule of Section 362 (c):

> The Act excludes from income of a thrift all money or property contributed to the thrift by the FSLIC under its financial assistance program without reduction in basis of property... No inference is intended as to the proper treatment of FSLIC assistance payments under prior law with respect to whether such payments are excluded from income or require a basis reduction. *H. Rep. No. 215, 97th Cong., 1st Sess., p.284 (1981).*

Congress also understood when it first enacted Section 597(c) that, in the case of a thrift with a low tax basis in its assets by reason of having acquired them in a taxable asset acquisition, each dollar of FSLIC assistance would not give rise to a federal tax benefit. That is precisely why Section 597(c)(5)(C) explicitly relaxed the operation of the attribute cutback rule for FSLIC assistance received by thrifts which had not acquired their assets in a tax-free supervisory acquisition. Congress did not, however, relax the operation of the attribute cutback rule in the case of thrifts which had a high carryover tax basis in their assets by reason of Section 368(a)(3)(D) because Congress was aware that each dollar of FSLIC assistance to those thrifts generated a tax benefit.

On February 16, 1989, the Joint Committee on Taxation prepared an analysis of the federal income tax treatment of financially troubled thrifts. Among other things, the analysis addressed the federal income tax treatment of FSLIC assistance in the form of a $40 capital loss payment to a thrift which sold, for $60, a covered asset it had acquired in a December 1988 tax-free supervisory acquisition and in which it had a carryover $100 tax basis. The Joint Committee explained that the disposition resulted in a $40 loss and a $40 decrease in earnings and profits. Furthermore, the receipt of the $40 of FSLIC assistance, which was not taken into account in determining the loss on the sale of the covered asset, increased earnings and profits by $40. The example by the Joint Committee illustrated why the $40 loss, because its use was not limited by Section 382, would be available to "offset future taxable income of the reorganized thrift institution." *Joint Committee on Taxation, Current Tax Rules Relating to Financially Troubled Savings and Loan Associations (JCS-3-89).*

Importantly, the Internal Revenue Service ("IRS") also issued numerous private letter rulings in which it had generally held that all FSLIC assistance payments are items of income that (i) are excluded from gross income by reason of Old Section 597(a) and (ii) generate earnings and profits. [PLR 8850051 (September 21, 1988) (Ruling 10), as supplemented by PLR 8924087 (March 23, 1989) (ruling 13); PLR 8912043 (December 27, 1988) (Rulings 12 and 18); PLR 8915011 (December 29, 1988 (Ruling 10); PLR 8925065 (March 28, 1989) (Rulings 9 and 14); PLR 8938033 (June 27, 1989) (Rulings 13 and 20); PLR 8943033 (July 28, 1989) (Rulings 20 and 22); PLR 8944037 (August 8, 1989) (Ruling 7); PLR 9010077 (December 14, 1989) (Rulings 8 and 18); and PLR 9037015 (June 14, 1990) (Rulings 13 and 14)].

It is on this uncontested interpretation of the law that FSLIC solicited bidders and negotiated and consummated the supervisory acquisitions, namely that all FSLIC assistance, including capital loss payments, generated federal income tax benefits:

> The provisions have the effect of permitting an acquiring institution to realize tax benefits attributable to a particular item even though FSLIC assistance is received with respect to such item. For example, if the Acquiror receives coverage for capital losses incurred on the disposition of identified assets of the acquired institution, the Acquiror is entitled to deduct such loss for federal income tax purposes, notwithstanding that it is reimbursed for loss incurred and that the FSLIC payment is tax-free. *Information and Instructions for the Preparation and Submission of Proposals for the Acquisition of One or More Savings Institutions in the Southwest, p. 6 (prepared by FSLIC and the Federal Home Loan Bank Board.)*

For the reasons described above, it is clear that Congress intended that the exclusion of FSLIC assistance from income would entitle the recipient to deduct losses that were fully compensated by the receipt of such assistance. Congress understood that the effect of Section 597 was to create a tax subsidy for troubled financial institutions. To be sure, in the vast majority of cases, the most efficient, effective, and least cost means of dealing with a financially troubled institution was not to liquidate the institution and pay off the insured depositors, but instead to arrange for the troubled institution's acquisition by a healthier institution. Since the troubled institution typically had a negative net worth, the FSLIC usually needed to provide various forms of financial assistance to induce the acquirer to take over the sick institution's liabilities and problem assets. In addition to the reduced cost of assisted acquisitions and long-term cost savings to the Treasury, there were important intangible benefits -- in terms of the general level of confidence in the nation's financial system -- from being able to avoid the failure and liquidation of a depository institution.

Against this background, the provision of the 1993 Act repealing these tax benefits was a blatant breach of the letter and the intent of the statutory law and the regulatory interpretations thereof, made all the worse by the fact that this usurpation of the acquirors' rights was legislated retroactively to March 4, 1991. Repeal of this provision inflicted upon private parties whose only "offense" was to come to the aid of the federal government at a time when the direct public resources available to resolve the thrift crisis were woefully inadequate is overdue. Moreover, in the long run, repeal of this provision will save the federal government money since this gross injustice is certain to be challenged in court and, in the view of many tax practitioners, eventually resolved in favor of the acquirors.

We greatly appreciate the opportunity to submit these views.

Respectfully,

Eric T. Sandberg

"USING THE TAX CODE TO DISCOURAGE AMERICANS FROM LIVING AND WORKING ABROAD HAS CREATED THE WORLD'S LARGEST AND MOST CHRONIC TRADE DEFICIT. THIS IS NOT A SENSIBLE TRADE POLICY."

Written Statement of
Andrew P. Sundberg
Director of ACA

Mr. Chairman, Members of the Committee, it is a great pleasure for me, on behalf on my organization, to have the opportunity to submit this written statement in support of HR 57.

ACA is a non-profit, non-partisan association of U.S. citizens living outside of the United States with members in more than ninety countries. Everyone working in our organization is a volunteer, and our sole goal is to make the United States a stronger and more prosperous country. We believe that greater strength and prosperity will ensue when overseas Americans have a fair chance to compete on a level playing field. ACA's challenge is to try to persuade America's political leaders that policies that harm the interests of Americans overseas harm the interests of all Americans, at home and abroad. These harmful policies need to be changed. But first, they need to be identified, the harm clearly explained, and the most appropriate means of redress elaborated. Our mission is to ensure that any changes that are made will increase the benefits, and reduce the lingering harm, to and for all Americans, at home and abroad.

First, Mr. Chairman, let me thank you personally for your initiative to ease some of the double-tax burden on the two million U.S. citizens living abroad in the private sector. This intervention on our behalf is welcome and will provide a modicum of relief to a certain number in our ranks.

Let me make an impassioned plea, however, for much greater boldness on the part of your Committee and the Congress. Please broaden the scope of HR 57 to finally and fully reverse **the longest running failed economic experiment** that has ever been tried in the **employment field** anywhere in the world. Yes, I mention employment, because a close reading of the origins of the 1962 law, which began the notorious practice of taxing the overseas income of U.S. citizens who were bona fide residents of a foreign country, makes clear that this tax was to be used not only to raise revenue, but principally **to serve as a disincentive for individuals to live, work and invest abroad**.

The theoretical argument that was used by the Kennedy Administration, with strong support from American labor unions, was that Americans living abroad would invest abroad, and this would create jobs abroad that would otherwise have been created at home. Therefore, to protect jobs at home, we should discourage Americans from living and working abroad, and we should use the tax code for this purpose.

This was and still is diametrically opposed to the philosophy of all of the other major trading nations of the world who believe, as we should but do not, that their greatest assets

on the trade battlefields of the world markets are their own citizens. They, therefore, have designed their policies toward their overseas citizens from the perspective of making them "most favored competitors". Our government alone guarantees to our citizens that no matter where they might be abroad, they will always be "least favored competitors". We remain, and will continue to be, even after enactment of HR 57, the only country in modern times that imposes an "export tax" on our own labor.

Mr. Chairman, for the last thirty-three years we have been operating under these rules. We need to ask ourselves once again, why does the United States encourage American companies not to hire Americans to work abroad? When Americans are offered the chance to work abroad they expect to receive the same take-home pay they would have received in the United States, and the same take-home pay that their foreign colleagues earn abroad in a comparable job at a comparable gross salary. Since the U.S. tax practice makes it likely that the take home pay of the American working abroad will be less than formerly earned at home (foreign taxes, higher living costs, etc) some adjustment has to be made to the base salary formerly earned in the United States. Then comes the imposition of U.S. taxes on top of the foreign taxes. Either the individual American suffers a loss, or the company picks up the difference. When the company picks up the difference, it immediately becomes clear that having an American on the staff abroad is much more expensive than having a foreigner, even for the same job at the same gross salary. This is the punitive use of the American tax code to discourage hiring Americans abroad by making it cheaper to hire anyone with a non-American passport. It is very hard to understand why we want to continue this practice and what positive good it brings about.

The United Nations, already short of cash, wastes millions of dollars every year operating a Potemkin Village tax to please the United States by pretending that American employees of the UN are paying U.S. taxes, and then reimbursing these Americans for the taxes that they have paid to the U.S. Government. This farce is carried out with a straight face and yet is transparently absurd.

Small wonder that a story in the International Herald Tribune on July 19th announced that May 1995 set another record monthly trade deficit. The United States is chronically running annual trade deficits of over $ 100 billion, and, if the May figure were to be extrapolated for a year, we would be heading for a $ 137 billion addition to the accumulated deficit of more than a trillion dollars in the following twelve months.

In fairness, the Congress, already in 1962 did add a provision to the tax law giving a modest amount of foreign earned income exclusion from the double tax disincentive. This, unfortunately, has been as much a small relief from double taxation as a sore point for many Americans living at home. It would be a rather easy argument to justify doing away with taxing Americans abroad on the basis of this being standard practice of all of the trading nations of the world. Once we start using these dollar amounts for the earned income exclusion, they come across as just another loophole for the rich, and are easily exploited by those with motives other than a sensible trade policy and international tax neutrality.

Mr. Chairman, the situation that you and your Committee are confronting in your deliberations on HR 57 is one with a double dimension. First, you must be implicitly or explicitly deciding whether it is still appropriate American policy to punish Americans for

living overseas and to use the tax code for this purpose. If your conclusion is that such punishment must continue, then the argument switches to how great this punishment should contnue to be. Unfortunately, implicit in the language of HR 57 is the assumption that such punishment still is merited, as it was when the original legislation imposing this tax was first instituted by Congress in 1962. HR 57 says, in effect, yes, we must continue punishing Americans, but perhaps we should make this punishment a little less than before.

If, however, you conclude, as ACA hopes you will conclude, that discouraging Americans from living abroad is inappropriate, and using the tax code to inflict this disincentive is also wrong, then the only equitable conclusion must be that we should get rid of this nefarious tax once and for all. This new position (which was our old position prior to 1962) would also have a strong theoretical justification because it would restore true international tax neutrality to the tax code. All individuals, of whatever nationality, working in the same place, under the same circumstances, would be taxed in the same way. Individuals of a single nationality would no longer be singled out for harsher tax treatment than everyone else

It is ironic, and unfortunate, that the taxation of overseas Americans has long been considered a "miscellaneous" tax matter, and not a prime component in U.S. trade policy. Since it is a miscellaneous item, it rarely if ever comes onto the table when major revisions of trade policy are being considered. As proof of this contention let me cite the many letters that our organization has written to Secretaries of Commerce and senior trade officials of both Republican and Democratic administrations since 1962. For example, within the last two years I have corresponded with the Secretary of Commerce and his associates and asked them to indicate whether full competitive equality for individual Americans in foreign markets is important or not. They evade an answer and refer any questions concerning taxation of Americans abroad to the Treasury Department. Treasury has not wanted to take the initiative to look at the trade implications of this tax and, therefore, we are caught in a jurisdictional impasse, just as we have been for the last thirty-three years.

It strikes American citizens abroad as passing strange that the United States expends such vigorous efforts to make sure that U.S. products and services have a fair and equal chance to compete in foreign markets, and at the same time we expend such extraordinary efforts to make sure that U.S. citizens cannot enjoy competitive employment opportunities or competitive entrepreneurial opportunities abroad. The strength of the U.S. effort to deny competitive equality to Americans overseas has resulted in a massive depletion of the ranks of U.S. citizens in jobs overseas, an impoverishment of overseas market experience among our executive corps in major corporations, the loss of collateral trade benefits from Americans in a decision-making position specifying American raw materials and components for American companies abroad, and the growing need to hire foreigners to fill top world marketing jobs even in the United States. The ultimate irony of the use of the tax code to keep Americans out of jobs abroad, to protect jobs at home, is that not only are we losing jobs we could be generating from a better trade performance, but we are now recruiting foreigners for jobs in the United States because we do not have enough experienced Americans for these same positions.

Mr. Chairman, the incremental change that HR 57 is proposing, albeit welcome by some of us, is not going to make very much difference. The reason is that Americans who are

already living abroad will remain abroad. The change will not bring about much increase in the desire of U.S. or foreign companies to add additional American staff to their overseas operations because the basic policy is so flawed that this small incremental change will be of little impact. Yes, there will be some marginal positive decisions to keep a few extra Americans employed abroad who would have been sent home because they were becoming too expensive, but there will be no great incentive to bring more Americans overseas again.

And, the changes you propose will have almost no impact on alleviating the ridiculous burden now imposed on American entrepreneurs who set up small businesses abroad. The burdens of keeping two sets of books (one according to local accounting standards and one to U.S. tax practices), the costs of translating information from the local language into English to satisfy the voracious appetite of the IRS for information on all foreign businesses in which Americans have a significant equity position, etc, can easily represent the difference between a profit and a loss for such small businesses. Small wonder again that many entrepreneurs consider this burden so unfair that they ignore all of this reporting, especially when no taxes need to be paid anyway. For most overseas American entrepreneurs, the present law is simply very onerous and expensive harassment that leads to no apparent gain for anyone.

The only really effective change that would have a major dramatic impact on increasing the ranks of Americans abroad, and a monumental impact on improving U.S. trade performance, would be for the Congress to show the courage to finally admit that the taxation of Americans abroad was a mistake from the very beginning, and has been the cause of massive harm to the United States. This policy, single handedly, has caused greater weakness to our economy than any action by any foreign government. The U. S. Government is the principal architect of our enormous failure, because the U.S. Government has adopted laws and regulations that are so harmful to American interests abroad Therefore, the U.S. Government can also redress this problem. Fortunately the redress needed is very simple. Eliminate the misguided tax approach of 1962, and give back to overseas Americans the competitive equality they formerly enjoyed. It is, surprisingly, just that simple. Yes, the Japanese are tough competitors, but they come a far distant second to the competitive obstacles we as a country put in our own path.

Your colleague, Congressman Ben Gilman, offered the legislative language that would truly solve this problem when he introduced HR 4562, the "Overseas American Economic Competition Enhancement Act of 1992". This would give overseas Americans full competitive equality everywhere in the world. This is the bold solution that all Americans need to be offered.

Having tried a trade policy driven by a tax code that penalizes Americans who fight on the front lines of our trade wars, why not try a more sensible trade policy that builds on the entrepreneurial talents and skills of Americans at home who should be encouraged to defend our interests abroad? Rather than punishing Americans who are fighting these trade wars, we could at least leave them alone. That is all the HR 4562 proposed to do. HR 57 is fine, and I hope that it is quickly enacted, but it does not solve our problem, it only lessens the punishment for a crime no one has ever committed.

Mr. Chairman, how extraordinary is the gap between the way the U.S. Government treats its overseas citizens and the way overseas citizens are treated by the other major trading powers of the world! Try to imagine any other country deliberately setting up policies to harm the competitive interests of their citizens abroad. Try to imagine how you could encourage another country to copy U.S. practice of making it more expensive to hire an American abroad than it is to hire a citizen of any other country because the U.S. Government wants a part of the salary of the overseas American employee, but will not get any part of the salary of a foreign employee working for the same American company abroad. Try, for example, suggesting to the Japanese that they should tax the income of Japanese citizens living and working in the United States to protect jobs in Japan and they would laugh in your face. The Japanese do everything they can to make overseas Japanese more competitive, not hobble them with heavier economic burdens than those against whom they are competing.

Mr. Chairman, the time for boldness has come. HR 57 is welcome, of course, but only a pale substitute for the action that this Committee could and should take to end the farce of America being its own worst enemy in world markets. Let us get our own house fully in order, and let us end the adversarial relationship between the U.S. Government and our overseas citizens. If only we could once again become members of the same team, all working together rather than at cross purposes, we could quickly regain the position of number one trading nation in the world. We will never regain world trade leadership while we are a house divided against itself. The U.S. Government has to end its trade war with itself and bring about an equitable settlement with its own citizens abroad.

We look to you, Mr. Chairman, and to the members of this committee and this Congress to show such bold leadership that our country so sorely needs. The time for half measures is over. The time for clear thinking, courage, and the wisdom to admit that the experiment of the Kennedy years needs to be recognized as the failure that it always was.

Full competitive equality for overseas Americans should be the starting point for the deliberations of this and every other Committee of Congress. Finally, ACa believes that the insignificant loss in revenue by abolishing this tax will be more than compensated by the surge in exports, growth in jobs, and increase in the general prosperity and new tax revenues at home.

Thank you, Mr. Chairman, for your initiative in getting started in the right direction. We give you and your colleagues our strongest possible encouragement to now "go all the way".

As additional supporting materials for our position on this issue, I have appended the ACA position paper on the Taxation of Overseas Americans, and an abbreviated chronology of some of the major tax events affecting overseas Americans.

Thank you, Mr. Chairman.

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Enclosed: (1) The ACA Position Paper on the Taxation of Overseas Americans
(2) A Chronological list of Major Overseas Tax Events.

Enclosure One

THE ACA POSITION ON THE TAXATION OF U.S. CITIZENS RESIDING OUTSIDE THE UNITED STATES

"ACA believes that the U.S. Government should not tax the foreign source income of U.S. citizens who are bona fide residents of a foreign country, or who have met an appropriate test of physical presence outside the United States during a taxable year. U.S. citizens who qualify under the bona fide residence rules, or under the physical presence rules, should be treated for tax filing purposes in the same way that non-resident aliens are now treated. They should be required to file a U.S. Federal income tax declaration only if they derive taxable income from a U.S. source."

The ACA position is essentially the one that was the official policy of the United States Government from 1926 to 1962. This policy was changed in 1962 when the U.S. Congress, under pressure from labor unions, decided that the Tax Code should be used to discourage U.S. citizens, and especially entrepreneurs, from living, working, and investing abroad. Living and working abroad was equated to investing abroad, and this was deemed to be equivalent to the exporting of jobs. The Tax Code was the chosen weapon to fight against this perceived threat. It was a costly experiment that has had catastrophic results on our trade balance.

The world has changed greatly since 1962. The international economic system is much more cost conscious today, and much more knowledgeable. The distortion in factor pricing this policy has introduced in the cost of hiring a U.S. citizen to work abroad has become more and more important in the analysis a potential employer carries out as to whether it is worth the extra cost to hire a U.S. citizen to work abroad. Many U.S. corporations have sent almost all of their U.S. employees back home. This is a rational response on their part to U.S. tax policy.

It is cheaper to hire a foreigner even at the same base pay, because no other government has placed an export tax on its expatriate workforce. Since corporations usually agree to pick up this additional tax burden because they don't want their U.S. employees to have a smaller take home pay than their employees of other nationalities with the same base pay, they have to pay a very expensive premium to the U.S. Government for the luxury of each additional U.S. citizen on their payroll. Since the U.S. Government not only wants taxes to be paid on their overseas base income, but also on all of the allowances for schooling, cost of living, home leave, etc., the extra burden to have a U.S. employee cascades. Many corporate tax equalization packages protect U.S. employees abroad from double taxation. These usually involve the corporation picking up the foreign tax burden, with the employee only having to pay from his own pocket the amount of tax due on the base salary that would have been earned in the United States. Under such a practice, the extra corporate cost burden usually grows larger every year. Since the corporation reimburses the individual for foreign tax and excess U.S. tax, this reimbursed tax amount has to be added to the base taxable income the following year, and the total grows and grows.

Does it really matter that the United States treats its overseas citizens differently than governments of all of our trading competitors? ACA believes it does. First, it has resulted

in an impoverished resource base of U.S. citizens with knowledge and experience of overseas markets. This feeds back into products and services that are not optimally designed to meet the needs of foreign markets. It has also had the paradoxical result of some U.S. employers in the United States having to hire foreign citizens with such knowledge to work in the United States on international management, technical or marketing assignments because there were no qualified U.S. candidates.

Second, when foreigners replace U.S. citizens in marketing and procurement jobs abroad, U.S. products and services are not given the "chauvinistic push" that citizens of all nationalities tend to give to their home countries' exports. There are many documented cases of U.S. citizens being replaced in jobs abroad by foreigners simply because the American has become too expensive (due solely to the difference caused by U.S. taxation). When this happens, one of the principal collateral benefits of having an American overseas disappears. Foreigners who replace Americans are more likely to procure products and services from their home countries, than from the United States. Many cases also can document this phenomenon.

Third, the impact of taxation and controlled-foreign corporation rules that apply to U.S. owners of a business abroad, especially small businesses, have led to a severe diminution in the number and the activities of U.S. entrepreneurs abroad, especially in developing countries where American business practices could be the most efficient method of promoting more rapid economic development.

The strangest thing about this unique approach to taxation is the fact that its greatest impact is on people who will never pay this tax, the Americans who do not live abroad, and who, because of the disincentive of this tax, never will. It would be too expensive to hire them to work abroad and they are not attracted to the prospect of competing in foreign markets on their own with the U.S. Government as a harasser rather than a helper. The difference between being an attractive employee and one that is too expensive is the extra amount that the U.S. Government wants from their pay check, or from their employer's profits.

The OECD has developed a model tax treaty that is based on the concept of residence-basis taxation. All OECD members use this model for their bilateral tax treaties. The U.S. Government does too, but then adds an additional and unilateral exclusion to the protection of citizens of both countries from double taxation so that U.S. citizens abroad will have extra burdens not imposed on the citizens of treaty partners who live and work in the United States.

ACA asks for the United States to go back to this standard too. This would not only level the playing field for U.S. employees abroad, it would also level the playing field for companies that employ them. Finally, it would unleash the explosive entrepreneurial talent potential of U.S. citizens that is being effectively crippled today.

The ACA position is supported by the American Chambers of Commerce in Europe, the Middle East, Asia and Latin America. It is also supported by AARO. It is based on the recommendation of the President's Export Council in 1979 which reported that our policy of citizenship based taxation of overseas citizens was causing great harm to the United States.

We ask the Congress to give us back what we once had: the right to be fully competitive in our search for employment abroad, and in the setting up and operation of new entrepreneurial businesses all over the world.

Enclosure Two
LEGISLATIVE HISTORY OF THE TAXATION OF AMERICANS ABROAD

1861 Congress enacts the Revenue Act of 1861 to pay for what is anticipated to be a short civil war. For the first time an income tax is levied at the Federal level in the United States. The rate of imposition is 3% on all incomes higher than $ 800 per year. (Revenue Act of 1861)).

1862 Congress enacts a new revenue act introducing for the first time a progressive tax feature. Personal income tax is 3% for income between $ 800 and $ 10,000 while higher incomes are to be taxed at a rate of 5%. A standard deduction of $ 600 is introduced, along with other deductions. Income tax is to be withheld at source by the employer. (Revenue Act of 1862).

1872 The income tax is abolished. (Revenue Act of 1872).

1894 The income tax is reintroduced. (Revenue Act of 1894)

1895 Supreme Court holds the income tax is unconstitutional since it is not apportioned according to the population in each state.

1913 The 36th State ratifies the Sixteenth Amendment to the Constitution thus rendering constitutional the establishment of an income tax. In October, 1913, the first income tax law is enacted requiring taxes to be paid on all "lawful" income. Less than 1% of the population is required to pay income taxes. (Revenue Act of 1913).

1914 First income tax returns filed on Form 1040. There are 357,515 taxpayers paying a total tax of $ 28 million. Tax per capita of all U.S. inhabitants is twenty-eight cents.

1916 Congress amends the law to remove the ambiguous question of what taxing "lawful" income means, and substitutes instead "from whatever source derived". In the new law, all income is taxable even if it is earned by illegal means. This new language also becomes the basis on which the taxation of overseas source income is included. (Revenue Act of 1916).

1917 Because of the expense of World War I, the Federal Budget is almost equal to the total U.S. budget for all the years between 1791 and 1916. The Congress enacts new tax provisions to lower exemptions and increase taxes. Amount of tax to be collected increases fourfold from $ 809 million in 1917 to $ 3.6 billion in 1918. (War Revenue Act of 1917).

1918 Efforts are made to exempt foreign source income from the U.S. taxation because of alleged competitive disadvantages suffered by American corporations operating branches abroad. (Hearings Before the House Committee on Ways and Means on the Revenue Act of 1918, 65th Congress, 2nd Session 648(1918)).

A new revenue act is passed increasing taxes on incomes in excess of $ 1 million per year to a rate of 77%. The new act also introduces estate taxes and excess profits taxes. Still only 5% of the population has to pay income taxes. Americans working abroad are allowed to reduce their federal income tax liability with a tax credit equal to the amount of any foreign income taxes paid. Until 1918, all foreign taxes were treated as deductible expenses in the same manner as state and local taxes. (Revenue Act of 1918).

1921 Congress enacts a new tax law which is held to also apply to overseas Americans. Treasury Regulation No. 62 is issued applying the tax to overseas Americans under Article 3 of the Act, codified in Treasury Regulations, Section 1.1-1(b), T.D. 7332, 1975-1 C.B. 205,207. (Revenue Act of 1921).

A determined effort is made to exempt foreign income from U.S. tax in the case of U.S. Corporations that derive 80% of their income from foreign sources. The Treasury, Commerce and State Departments favor the exemption, but it runs into determined opposition in the Congress. The provision finally passes in the House, but is defeated in the Senate. (61 Congressional Record 7023, 7026 (1921)).

The legislation is amended providing for an exemption for corporate income earned in a U.S. possession but not remitted to the United States. (Revenue Act of 1921, Chapter 262, 42 Stat. 271 (1921)).

1924 In Cook v Tait, the Supreme Court upholds the Constitutionality of the taxation of Americans on their foreign earned income. The Court states:

"The principle was declared that the government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete. Or to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, if being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal - the government having power to impose the tax." (Cook v. Tait, 265 U.S. 47(1924)).

1926 After expressions of great concern in the Congress about the competitive handicap caused to U.S. citizens and U.S. corporations abroad, legislation is enacted giving full exclusion of overseas income from U.S. taxation if an American citizen is absent from the United States more than six months in any calendar year. (Revenue Act of 1926, Chapter 27, Section 213(b)(14), 44 Stat. 9 (1926).

1932 Taxes were cut five times in the 1920's. The onset of the depression creates a need for new revenues. In 1932, only $ 1.5 billion is collected compared to $ 5.5 billion in 1920. A new tax law is enacted raising tax rates and lowering exemption levels.

The foreign earned income exclusion is taken away from the gross income definition section and becomes codified in I.R.C. Section 116, Exclusion from Gross Income. The law expands the applicability of the foreign earned income exclusion by permitting profit derived from a trade or business into which both personal services and capital have been injected to be considered 20% income and eligible for exclusion. (The Revenue Act of 1932, Chapter 209, Section 116(a), 47 Stat. 169, 204-05).

<u>1933</u> Internal revenue collections amount to $ 1.6 billion.

<u>1934</u> Congress narrows the applicability of the foreign earned income exclusion by denying use of the exclusion for income paid by the United States or any federal agency. State Department employees overseas and other Federal employees on assignment abroad lose their tax exemptions. (The Revenue Act of 1934, Chapter 277, Section 116(a), 48 Stat. 680, 712). (See also Senate Rep. No. 665, 72nd Congress, 1st Sess. 31 (1932)).

<u>1936</u> Congress enacts a new tax law but retains the codified language of the 1934 Act. (Revenue Act of 1934, Ch. 277, Section 116(a), 49 Stat. 1648, 1689 (1936)).

<u>1938</u> Congress enacts another new tax law but retains the codified language of the 1934 act. (Revenue Act of 1938, Chapter 289, Section 116(a), 52 Stat 447, 498 (1938)).

<u>1939</u> Total number of U.S. taxpayers is around 4 million.

<u>1941</u> The 1941 Revenue Act lowers exemptions and increases taxes on excess profits being made on the war effort. Internal revenue collection increases to $ 7.4 billion. (The Revenue Act of 1941).

<u>1942</u> The eligibility for exclusion of overseas income is tightened from the 6 months away from home rule to a "bona fide" residence rule for an entire tax year. (Revenue Act of 1942, Chapter 619, Section 148, 56 Stat. 798, 841-2 (1942)).

<u>1945</u> Internal revenue collects $ 45 billion from 43 million taxpayers.

<u>1951</u> A new tax law is written and Congress reintroduces a "physical presence" rule on the basis of absence from the United States for 17 out of 18 months, and maintains the "bona fide" foreign residence alternative. (Senate Report No. 781, 82nd Congress, 1st Session 52-53 (1951).) (Revenue Act of 1951, chapter 521, Section 321, 65 Stat 452, 498 (1951)).

<u>1953</u> Congress attempts to do away with the "physical presence" exclusion again, but settles for a $ 20,000 exclusion for 17 out of 18 month "physical presence" overseas Americans. Total exclusion for the bona fide foreign resident is unchanged. (Technical Changes Act of 1953, PL 83-287, Chapter 204, 67 Stat. 615(1953)).

<u>1954</u> The Congress revises and organizes all tax laws into a single new Internal Revenue Code. Tax laws enacted in the future will be amendments to the code. (Tax Act of 1954).

<u>1962</u> Congress eliminates of the total exclusion for a "bona fide" foreign resident. A $ 20,000 per year overseas earned income exclusion is established, rising to $ 35,000 after three years abroad. Tax credit is given for taxes paid abroad on excluded income. The Act also introduces separate rules for "unearned income" abroad, and Subpart F rules for controlled foreign corporations. (Revenue Act of 1962, PL 87-834, Chapter 11, 76 Stat. 960(1962)). (See Conference Report No. 2508 of 1 October, 1962).

<u>1964</u> A new revenue law reduces the exclusion for physical presence and bona fide residents to $ 20,000, rising to $ 25,000 after three years abroad.

<u>1969</u> Congress enacts a new tax law lowering income tax rates for both individuals and private foundations. (Tax Reform Act of 1969).

<u>1974</u> The House Ways and Means Committee tries to abolish the foreign earned income exclusion. (H.R. 17488, 93rd Congress, 2nd Session, Section 311(1974)).

<u>1975</u> The House continues consideration of abolishing the foreign earned income exclusion. (H.R. 10612, 94th Congress, 1st Session, Section 1011(1975)).

<u>1976</u> The Senate resists the abolition of the foreign earned income exclusion, but accepts that the exclusion should be modified to "prevent abuse". (Senate Report No. 938, 94th Congress, 2nd Session 210 (1976)).

The Treasury Department makes a study of tax returns of 1968 and estimates that the revenue gain from enactment of total elimination of the foreign earned income exclusion would be $ 60 million. Enactment of the proposed 1976 Tax Reform Act is estimated to yield a gain of only about $ 40 million.

The Conference Committee Report on the Tax Reform Act of 1976 indicates an anticipated revenue gain of $ 44 million in 1977 and $ 38 million annually thereafter as a result of the amendments of section 911. When spread over an estimated 102,000 tax returns from abroad, the projected additional tax burden would amount to less than $ 500 per return. (H.R. Rep. No. 1515, 94th Congress, 2nd Session. 632 (1976)).

Congress decides to amend the tax law so that the overseas earned income exclusion will be reduced to $ 15,000 (off the bottom). No tax credit will be given for taxes paid abroad on excluded income, and there will be no exclusion for income received outside of the foreign country in which earned if one of the purposes is to avoid local income tax abroad. (Tax Reform Act of 1976, Publ L. No. 94-455, 90 Stat. 1520 (1976)).

<u>1976</u> The Tax Court holds in McDonald v. Commissioner that the market value of a Japanese apartment provided by an employer to a taxpayer was not excludable from the employee's income by reason of section 119 of the Tax Code. The court determined that the leasehold arrangement was primarily for the convenience of the employee, that occasional business use of the apartment did not make the lodging eligible as a "business premises of the employer", and that acceptance of the lodging was not a "condition of employment" because it was not integrally related to the various facets of the employee's position. In addition, the court ruled that the value of the

accommodations to the employee was the rental value (i.e. the local market value in Japan) of the apartment as negotiated by the employer and the Japanese landlord, rather than the price the employee would expect to pay for a similar apartment in the United States. (66 T.C. 223 (1976)).

Tax Court rules in a second Japanese housing case, Stephens v. Commissioner, that the housing supplied by an employer to an employee was includable in the employee's gross income at its full local value, despite a specific finding that "quarters reasonably equivalent to (the taxpayer's) style of living were not available at American prices". (66 T.C. 226, (1976)).

<u>1977</u> Following voluminous complaints from overseas Americans and their employers about the impact of the 1976 Tax Reform Act, Congress postpones the effective date from 1 January, 1976 to 1 January, 1977. (Tax Reduction and Simplification Act of 1977, PL 95-30, Section 302, 91 Stat. 126 (1977)).

Treasury Secretary William Simon calls for consideration of using the residence principle for taxing international flows of income. ("Blueprint for Basic Tax Reform", Department of the Treasury, Washington, D.C., January 17, 1977, Chapter on International Considerations).

The Treasury Department carries out a comprehensive study of the 1975 tax returns filed by overseas Americans and finds that the tax impact of the Tax Reform Act changes were far greater than the Treasury or the Members of Congress had anticipated. Based on the study of the 1975 data, the Treasury determines that the revenue gain from the Tax Reform Act amendments amounted to $ 381 million in 1977, rather than the $ 44 million that Treasury had estimated based upon its previous study in 1976 using 1968 tax return data. Further, the 1976 Tax Court decisions increased the burden on overseas taxpayers by an additional $ 65 million in 1976, yielding a total increase of $ 383 million over 1975 reporting practice, or an average $ 2,700 per return. (U.S. Department of the Treasury, Taxation of Americans Working Overseas 8 (1978)).

<u>1978</u> The General Accounting Office completes a two-part study of the impact of the Tax Reform Act changes. The first part is a non-scientific sampling of 367 firms employing Americans abroad. Eighty-five percent of the company officials surveyed believed that United States exports would decline by more than five percent as a result of the 1976 tax law and Tax Court decisions The companies most severely affected were those operating in countries where living costs were high or where minimal taxes were imposed on foreigners. In the Middle East and Africa, Japan and Latin America tax increases were on average $ 4,700 per return.

The second part of the GAO study consisted of an econometric projection of the macroeconomic effects of the Tax Reform Act changes and the 1976 Tax Court rulings. The GAO model assumed that there was a high inelasticity of foreign demand for United States exports, and therefore the net effect of the 1976 changes would actually be an improvement in the U.S. balance of payments.

<u>1978</u> Because of the critical assumption of inelasticity of demand for U.S. products, the GAO chooses not to base its recommendations on its own model and rather recommends to the Congress: "Because of the seriousness of the deteriorating United States international economic position, the relatively few policy instruments available for promoting United States exports and commercial competitiveness abroad, and uncertainties about the effectiveness of these, serious consideration should be given to continuing section 911-type incentives of the Internal Revenue Code, at least until more effective policy instruments are identified and implemented." (U.S. General Accounting Office, Doc. No. 78-13, Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas (1978)).

The House of Representatives proposes to repeal the 1976 changes in section 911 and reinstate computation of the earned income exclusion under the method in effect prior to the Tax Reform Act of 1976, but would limit the exclusion to persons who lived in countries other than Canada or Western Europe. (H.R. 13488, 95th Congress, 2nd Session (1978)).

The Senate approves a proposal, sponsored by Senator Abraham Ribicoff, which replaces the foreign earned income exclusion with specific deductions for certain excess foreign living costs, including excess foreign housing costs, educational costs, and cost of living. (S. 2115, 95th Congress, 2nd Session (1978)).

The Carter Administration introduces a proposal similar to the Senate bill, including deductions for excess foreign housing and education costs, and for the travel costs of one trip to the United States every other year, but not including a cost of living deduction. The Administration also proposes special rules for foreign moving expenses and for deferral while abroad of tax on the gain from selling a home. (BNA, Daily Tax Report, Nov. 8, 1977, at G-6)).

<u>1978</u> Congress votes for a total elimination of overseas earned income exclusion to be replaced by the specific deductions along the lines of the Ribicoff proposal modified by the addition of several of the features of the Carter Administration's proposal including the deduction for one round trip voyage for a family to the United States (at the lowest cost economy fare) per year. (Foreign Earned Income Act of 1978, PL 95-615, Sections 201-210; 92 Stat. 3097 (1978)).

The Joint Tax Committee Staff estimates that the 1978 revenue cost of the Foreign Earned Income Act will be $ 412 million, compared with $ 194 million had the 1976 Act provisions applied that year, and $ 538 million had the law which had been in effect prior to the 1976 Act applied. For the overseas American taxpayer, the 1976 Tax Reform Act had added $ 344 million to taxes in 1978, and the 1978 Tax Act eliminated $ 116 million. If the pre-1976 Tax Laws would have still been in effect, and had the 1976 Tax Court rulings not been made, overseas Americans would have paid $ 228 million less than foreseen by the 1978 Tax Law changes (Staff of Joint Committee on Taxation, 95th Congress, lst Session, General Explanation of the Foreign Earned Income Act of 1978 (Comm. Print 1979)).

The Court of Claims holds in Adams v. United States that the luxurious residence provided to the president of a Japanese subsidiary of an American oil company was

excludable under section 119 of the Tax Code. The court stressed that for over 10 years the taxpayer had been required to live there as a condition of his employment and that certain rooms had been designed in whole or in part for business activities. The court also emphasizes that in Japan business success depends greatly on maintaining high social standing. (585 F. 2nd 1060 (Ct.Cl. 1978), 77-2 USTC Section 9609, 40 AFTR 2nd 5607 (J.Rep.,Ct.Cl 1977)).

The Tax Court reaffirms the McDonald decision in Bornstein v. Commissioner, another Japanese housing case. The Tax Court denies the exclusion of housing allowances and easily distinguishes this decision from Adams on its facts. (37 TCM 1186, P-H T.C. Memo 78,278 (1978)).

1981 Congress reintroduces a $ 75,000 foreign earned income exclusion for "physical presence" and "bona fide" residents abroad (rising by $ 5,000 per year until $ 95,000 in 1986). There are additional deductions or exclusions for excess cost of foreign housing. No tax credit is given for taxes paid abroad on excluded income. There is no change in the full taxation of "unearned" income including retirement pensions earned abroad. (Economic Recovery Tax Act of 1981, PL 97-34, 95 Stat. 172 (1981)).

1982 The Treasury Department tells the Congress that it needs more enforcement power overseas to stop the drug trade. Congress enacts legislation which defines all overseas Americans as resident in the District of Columbia for certain legal purposes, including requests for information and the serving of summons. Overseas Americans are also to be subjected to a new form of request for the provision of documents pertaining to their work abroad. Failure to provide such documents, even in the case where providing them is against the law of the country of foreign residence, will subject the overseas American to civil and eventually criminal penalties in the United States. (Tax Act of 1982 Sections 336,337 and 342 of the Act and sec. 7701 and new section 982 of the Code). (For legislative background see H.R. 4961 as reported by the Senate Finance Committee, sec. 372, 373 and 374; S. Rep. No. 97-494 (Vol. 1) July 12, 1982, p. 298+; and H. Rep. No. 97-760 (August 17, 1982), pages 590+).

1983 In Rowe v. Internal Revenue Service a taxpayer suit to have the Foreign Earned Income Act of 1978 declared unconstitutional is dismissed with prejudice on the basis of res judicata. The suit repeated claims of the taxpayer which previously had been litigated and dismissed on the merits by the Court of Claims. The taxpayer had failed in two earlier attempts (summarized at 4 U.S.E.T. 6, 105-106 and 125) to have the 1978 Act declared unconstitutional because it gives foreign citizens a competitive advantage over U.S. citizens in working abroad. in this present case, the Court noted that, while it had jurisdiction over a tax refund suit under Section 1346(a)(1), venue is improper. Venue for a refund action is restricted by Section 1402(a)(1) to the federal district court where the plaintiff resides whereas the plaintiff in this case resides in Honduras. However, in an evident desire to compel the plaintiff to desist from further litigation, the court went beyond the venue determination to dismiss the action with prejudice on the basis of res judicata. The general rule of res judicata is that parties to a suit and those in privity with them are bound not only as to every matter which was offered and received to sustain or defeat the claim or demand in a prior action but as to any other admissible matter which might have been offered for that purpose. (Rowe v. Internal Revenue Service, 83-1 U.S.T.C. 9238 (D.D.C. 1983))

The Internal Revenue Service, in conducting audits overseas, attempts to make the definition of a "bona fide" resident contingent on the overseas taxpayer actually paying an income tax to the foreign country of "bona fide" residence. This practice, if sustained, will place taxpayers in countries where there is no local income tax in a worse tax position than they have ever been in before.

1983 New IRS rules for taxation of Social Security Retirement benefits indicate that there will be a zero level of base income above which Social Security Benefits will be taxed (50% of the benefit will be taxable) for those who file as married filing separately. There is a dollar earnings base of about $ 20,000 for those filing a single return, and double this amount for married filing a joint return. This ruling will be especially harsh for overseas taxpayers married to aliens who have to file as married filing separately to exclude the non-resident alien spouse's income from taxation by the USA.

1992 Congressmen Bill Alexander (D-Ark) and Ben Gilman (R-NY) co-sponsor HR 4562 on 25 March 1992 during the Second Session of the 102nd Congress. Entitled the "Overseas American Economic Competition Enhancement Act of 1992", this proposal would bring the U.S. tax practice for overseas citizens into conformity with every other major country of the world by putting taxation on a residency basis rather than a citizenship basis. U.S. citizens would no longer pay U.S. income tax on foreign source income if the U.S. citizen was a bona fide resident of a foreign country, or lived outside the United States for more than 183 days per year. This was the tax practice of the United States prior to 1962. Such a change would have given overseas Americans full competitive equality in world markets for the first time in thirty years.

1995 ***WE HOPE:* Congress finally realizes the mistake of making overseas American uncompetitive in world markets, repeals the punitive tax legislation of 1962, and gives overseas Americans full international competitive equality with individuals of all of the other trading nations of the world. By looking to what made our country so prosperous in the past, Congress reaffirms the wisdom of being fair to all of our own citizens. ACA's hope should be the hope of all clear thinking Americans, at home and abroad. For, as ACA believes, where there is hope, there is always hope.**

* * * * *

July 17, 1995

Mr. Philip D. Moseley, Chief of Staff, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Building
Washington, D.C. 20515

Subject: HR 57, Hearings held 11-13 July 1995

Dear Sir,

I am one of the few who are dramatically affected by HR57, and perhaps my case is different enough that you should hear of it. I am currently residing in Brussels, working for a US Corporation (the MITRE Corporation, a Federally Funded Research and Development Corporation), on a NATO job. I am a senior Systems Engineer, and from what I have seen of the multi-national environment that I work in, my skills, developed through 30 years of working with the US Military Intelligence community, building automated intelligence systems, is sorely needed here.

Having been posted in Europe in the early eighties, when the dollar was strong, I enjoyed then what Europe had to offer. There were two reasons for returning last year, and neither was to see the sights again. They were (1) to cap off my career with a job where I could easily make a positive difference for good, and (2) to make and save as much money as possible to facilitate a slightly earlier than usual voluntary retirement. The first objective is being realized, and I expect that in 12-15 more months, my main contributions will have been made, and the first objective will be history. It might take longer to realize the second one.

The second objective is what you should hear about. This tax law change will affect me to the tune of an additional $10-15K in my pocket until the time when I return to the States. What good does that do? As I said, I came here partly to round up my retirement savings. That $15K does not get spent in Europe or on luxuries; it gets saved to help get me started into retirement sooner. I think that is important enough to underline: it will not get spent on European goods. It gets put aside to help pay for the new Dodge pickup truck I have already ordered for Stateside delivery next year. It helps pay for the retirement homesite in North Carolina that I have just purchased. It will trigger starting my $100-150K house, with Anderson windows, Weyerhaeuser lumber, Carrier heating and A/C, and everything else American, much sooner. In other words, it gets my retirement savings flowing into the US economy much sooner than would happen otherwise.

Equally important, it puts me into voluntary early retirement giving my company, and consequently the US Government, a financial break. Since I'll be going out early and voluntarily, there will be no separation compensation, no insurance coverage, no expense at all to the Corporation, and that will result in net savings to the government that could easily mean ten times less outlay than the $15K I will receive. Also, when I roll out, it will create a billet vacancy. That new job will be filled by a younger person and their costs to the Government will be lower simply because they would not have built up the salary level that I have. My experience will be missed, but technology is moving so fast that what I now master can be available in limited shots of consulting at a fraction of what it costs to keep me permanently on the payroll.

The bottom line is that this infusion of money to me accelerates my "contribution" to the US economy, my participation in "job flow" to younger and lower paid individuals, and will result in net saving to the government. I think it makes a lot of sense to support HR57.

Sincerely,

Thomas C. Hilinski

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Daniel E. Jones
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24 July 1995

Mr. Philip D. Mosely,
Chief of Staff, Committee on Ways and Means
U.S. House of Representative
1102 Longworth House Building
Washington, DC 20515

Subject: Support for HR 57

I am a legal resident of Texas, currently working in Taegu, Korea. I would like to express my support for HR 57, which was introduced by Rep. Archer. This bill would increase the foreign earned income exclusion from $70,000 to $100,000 and index it for inflation. I understand that your committee recently held hearings on Miscellaneous Tax Reforms which considered this bill. (11-13 July)

Like most overseas workers, I receive adjustments to my basic salary. These adjustments include an allowance for housing (Korea is almost as expensive as Japan), cost of living (ditto), schooling for my daughter, and a semi-annual home leave. These adjustments are intended to maintain a parity in living standards with comparable personnel in the U.S.

I am a member of the technical staff for an American systems engineering firm, not a manager or executive. Nonetheless, the adjustments that I currently receive for working in Korea exceed the current $70,000 exclusion. Consequently, my taxable income will actually be higher than it would be had I simply remained in the U.S. This is a disincentive to remain working here, and in my opinion is not entirely fair. I assume that for a higher paid executive the disincentive is even greater. This likely must be offset by corresponding increases in other compensation, increasing the contract costs.

I think the proposed increase in the exclusion is a good idea in that it will (1) provide for fairer tax treatment of Americans working overseas, and (2) will improve the competitive position of U.S. companies and workers.

If you need further information, I can be contacted at the address above, or electronically as follows:

Home phone: +82-53-625-2712
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Fax: +82-53-470-7640
Electronic mail: djones@mitre.org

(Note that the '82' is the country code for Korea, '53' the city code for Taegu.) (The DSN "area code" for Korea is 315)

Sincerely,

Daniel E. Jones

Daniel E. Jones

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

PRESENTED TO THE HOUSE WAYS AND MEANS COMMITTEE ON MISCELLANEOUS TAX REFORMS

Mr. Chairman and Members of the Committee:

The National Foreign Trade Council, Inc. (NFTC) is pleased to present its views regarding certain revenue proposals on which hearings were held by the Ways and Means Committee on July 11-12, 1995.

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The primary focus of the NFTC is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. For that reason, our testimony and written statement will concentrate on certain proposals described in the press release issued by the Committee dated, June 30, 1995, affecting the taxation of international transactions.

In particular, the NFTC wishes to commend Representatives Amo Houghton (R-NY) and Sander Levin (D-MI) for recently introducing legislation (H.R. 1690), "The International Tax Simplification and Reform Act," that would make a number of needed reforms to the U.S. international tax regime. As prominent members of the Tax-Writing House Ways and Means Committee, Representatives Houghton and Levin are to be saluted for showing extraordinary bipartisan leadership in tackling one of the most difficult and complex areas of the U.S. federal income system, namely, the rules for taxing international transactions.

It is a widely accepted fact that the international tax rules in the U.S. have become increasingly complex, administratively burdensome, and have made it difficult for U.S. companies to compete abroad. The current U.S. international tax rules were developed in a much different era when U.S. companies were dominant, and competition from foreign companies was virtually nonexistent. The focus of all business activity at that time was to improve a company's market share in the U.S. The global economy of the contemporary era demands that the U.S. rules be modernized to reflect current competitive realities, in which U.S. multinational companies are aggressively competing against their foreign counterparts in the growth markets of the world, including China, Indonesia, and portions of Southeast Asia.

The proposals contained in the Houghton/Levin legislation reflect an attempt by the authors to achieve certain objectives for the U.S. business community operating abroad without completely overhauling the U.S. international tax regime. The NFTC strongly supports pursuit of these objectives, which include:

- Allowing U.S. companies to compete on a more equal footing for market share against their foreign counterparts;
- Reducing the incidence of double taxation on U.S. companies operating abroad;
- Mitigating the inordinate compliance costs to U.S. companies operating in foreign jurisdictions without causing a serious revenue drain to the Treasury;
- Supporting proposals that are generic in nature and apply to a broad spectrum of U.s. industry conducting business abroad; and

Encouraging manufacturing and the performance in the U.S. of research and development, which will lead to the licensing and sale of U.S. products in foreign markets.

Although the primary focus of our written statement will be to concentrate on provisions in H.R. 1690, the Houghton/Levin legislation, the NFTC will also briefly comment on other provisions in the foreign area that would affect the tax treatment of international transactions. However, we will confine our remarks to those proposals described in the Committee's press release of June 30, 1995 on pages 5-6 under the sub-heading "Foreign."

1. Increase in Section 911 Exclusion. The NFTC supports the proposal to increase the exclusion provided under Section 911 of the Code from the current amount of $70,000 to the higher figure of $100,000, including indexation of that figure to reflect the impact of inflation. We commend Chairman Archer for his leadership on this issue in introducing legislation to raise the current exclusion level under Section 911. Chairman Archer's proposal reflects his appreciation of the competitive disadvantages under which U.S. companies operate in competing against foreign multinational companies whose employees quite often are not taxed by their home countries. The U.S. tax rules dramatically increase the costs for U.S. companies operating in high cost, high tax jurisdictions and quite often lead to the hiring of foreign employees simply to reduce the overall overhead of the business operations.

2. Repeal of Limitation on Foreign Sales Corporation Exemption for Military Property. The NFTC supports the proposal to repeal the limitation on the exemption for the sale of military property under the foreign sales corporation (FSC) provisions that are found in Section 923(a)(5). Under this provision, the export of military property through an FSC is accorded one-half the tax benefit that is provided to exports of non-military property.

In light of the demise of the former Soviet Union and its satellite countries, the NFTC believes that the present limitation on the full benefits for export sales of military property are no longer valid. In order to facilitate the continued viability of the U.S. defense community following the end of the cold war, the NFTC would urge repeal of the present limitation on extending the full tax benefits to the export sales of military property under the FSC provisions.

3. Inclusion of Computer Software as Foreign Sales Corporation Export Property. The NFTC supports the proposal to include computer software as eligible export property under the FSC provisions. Under Treasury regulation Section 1.927(a)-1T(f)(3), copyrights on computer software do not constitute export property eligible for the exemption provided under the FSC provisions.

The proposal to permit computer software, whether or not patented, to qualify as export property under the FSC provisions would place computer software property on an equal footing with other eligible property. It would also encourage the export of property, namely, computer software, that constitutes one of the principal growth products in the global economy.

4. Recharacterization of Overall Domestic Loss for Foreign Tax Credit Limitation Purposes The NFTC supports the proposal contained in H.R. 1690 that would apply a resourcing rule to U.S. income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a previously incurred domestic loss.

Legislation enacted in 1976 causes a portion of foreign source taxable income to be recharacterized as U.S. source taxable income after an overall foreign loss has occurred. However, the recapture rule adopted in 1976 does not address the reverse situation, in

which a taxpayer has suffered a domestic loss. In that event, the domestic loss reduces the taxpayer's worldwide taxable income, thereby reducing the amount of the taxpayer's foreign tax credit.

The proposal in H.R. 1690 would achieve a certain symmetry between the treatment of foreign and domestic losses under the sourcing rules. Under the proposal, if a taxpayer has incurred an overall domestic loss, the portion of the taxpayer's U.S. source taxable income for each succeeding taxable year which is equal to the lesser of (1) the amount of the recharacterized overall loss, or (2) 50 percent of the taxpayer's U.S. source taxable income for the succeeding taxable year, would be recharacterized as foreign source taxable income. We would also note that this proposal is identical to a provision contained in H.R. 5270, the Rostenkowski/Gradison bill that was introduced in 1992.

5. Election to Use Earnings and Profits Basis for Allocation of Interest Expense. The NFTC supports the proposal contained in H.R. 1690 to permit use of the basis of assets for earnings and profits purposes in allocating interest expense between domestic and foreign source. This calculation is important in determining the amount of a taxpayer's foreign tax credit.

Under present law, interest expense is allocated between domestic and foreign source based on an asset test, which is determined by using either the tax book value or fair market value. For practical purposes, tax book value is the equivalent of the basis for tax purposes. The effect of these rules is to create a higher basis under domestic law, due to accelerated depreciation, than is the case for foreign assets. Consequently, interest expense is allocated under the asset test disproportionately to U.S. source as opposed to foreign source, and, consequently, a taxpayer's foreign tax credit is reduced.

The proposal in H.R. 1690 would equate the basis of assets that are domestically or foreign held and thereby increase a taxpayer's foreign tax credit. The proposal would help reduce the incidence of double taxation, caused by a taxpayers inability to obtain a deduction in the foreign country for interest expense allocable to foreign sources.

6. Extension and Modification of Special Allocation of Research and Experimental Expenses to U.S. Source Income for Foreign Tax Credit Purposes. The NFTC supports the proposal in H.R. 1690 to fix the percentage of the taxpayer's research and experimental expenses conducted in the United States that may be allocated to U.S. source income at 64 percent. H.R. 1690 would make the 64 percent allocation permanent.

The history of the rules surrounding allocation of research and development expenses between domestic and foreign source has been inconsistent, uncertain, and unpredictable. Since 1977 when the Treasury first proposed regulations, the percentage allocable to domestic source has varied between 30 percent and 100 percent. Most recently, the percentage was fixed by an administrative fiat at 50 percent. However, the Treasury Department recently issued proposed regulations that make a number of changes to the allocation rules, but generally establish the allocation at 50 percent allocable to domestic source.

The provision in H.R. 1690 has a number of positive aspects for U.S. business operating abroad. First, it establishes by statute a permanent rule that allocates 64 percent of the R&D expenses to U.S. source. Second, by establishing the allocable percentage by statute, the proposal precludes the Treasury Department from altering this percentage by regulation if it elects to revise or withdraw the recently proposed regulations. And finally, the higher percentage (64 percent to 50 percent) would eliminate or at least reduce the incidence of double taxation attributable to disallowance of a deduction for a portion of the

expense allocable to foreign countries. Most foreign countries will not permit a deduction under their own tax system for research and development conducted outside of their country.

7. Repeal Foreign Tax Credit Basket for "10/50" Non-Controlled Corporations. The NFTC supports the proposal in H.R. 1690 that would repeal the separate foreign tax credit limitation baskets for noncontrolled foreign corporations in determining the foreign tax credit basket in which dividends and related foreign taxes from distributing corporations should be categorized if appropriate information is available. If the information is unavailable, then the proposal in H.R. 1690 would assign the dividend and the associated foreign taxes with respect to a noncontrolled corporation in a basket for dividends from all noncontrolled corporations. In general, the proposal extends the look-through rule to dividends from noncontrolled foreign corporations.

The 1986 Tax Reform Act included a positive provision for U.S. multinational companies which involves the adoption of a so-called look-through rule. Under this rule, income is assigned the same character in the hands of a U.S. shareholder as the income from which it was paid as a CFC. The look-through rule applies to interest, rents, royalties, and dividends. Most U.S. companies seek to have their income assigned to the overall foreign tax credit limitation basket, which is the principal basket into which active business profits are assigned. The look-through rule is unavailable for a noncontrolled corporation/i.e./companies which have a minimum of a 10 percent ownership interest but not more than a 50 percent voting interest in the corporation.

The punitive rules under present law that create a separate foreign tax credit basket for each 10/50 corporation are a major impediment for U.S. companies doing business abroad. Many U.S. companies create joint ventures with local concerns in order to do business in a region or a local market. The separate limitation basket for each 10/50 company exposes U.S. companies to double taxation, due to the inability to cross-credit the income and taxes paid with other activities of the parent company and its CFCs.

The proposal in H.R. 1690 would permit U.S. companies the flexibility that is necessary to structure joint venture arrangements in foreign countries or in regions of the world.

8. Extension of Period to Which Excess Foreign Tax Credits May Be Carried. The NFTC supports the proposal in H.R. 1690 that would extend the current foreign tax credit carryback and carryover rules. Under the proposal, the foreign tax credit carryback period would be extended from two to three years, and the carryforward period would be extended from five to 15 years. Excess credits would be utilized in the earliest years to which they could be carried.

Enactment of the Tax Reform Act of 1986, caused the number of companies with excess foreign tax credits to proliferate. This increase in the number of companies with excess foreign tax credits was caused by a myriad of different factors: reduction in the corporate tax rate from 46 to 34 percent; restrictive interest allocation rules; separate foreign tax credit limitation baskets; and other factors. Moreover, the rules for net operating loss carrybacks and carryforwards are substantially more generous/ e.g./net operating losses may be carryback for five years and carryforward for 15 years. Many companies have experienced a loss of excess foreign tax credits due to the relatively short carryback and carryforward rules of present law.

It is also important to note that this proposal was included in the recent bipartisan effort sponsored by Congressman Rostenkowski and Gradison in H.R. 5270 that was introduced in 1992.

9. Expansion of DeMinimis Exception to Subpart F Income Treatment. The NFTC supports the proposal to expand the deminimis exception from Subpart F income to 10 percent of gross income. The exemption from Subpart F treatment under present law is limited to the lesser of five percent of the CFC's gross income or $1 million.

Increasing the amount of the exemption from Subpart F treatment would reduce the administrative complexities of complying with the intricacies of Subpart F for many small business companies, which are seeking to expand their export operations. Due to the complexity of the international provisions in general and the Subpart F rules in particular, many small business operations seeking to penetrate foreign markets are faced with administrative recordkeeping requirements that cost more than the revenue produced by the provisions.

Expansion of the Subpart F exemption rule would simplify tax compliance for many small, export oriented U.S. business concerns.

10. Treatment of Foreign Base Company Sales and Services Income of Controlled Foreign Corporations in the European Union. The NFTC supports the proposal to treat the countries in the European Union (EU) as a single country for purposes of applying the Subpart F rules regarding foreign base company sales and foreign base company services to a CFC that was created or organized in an EU country.

In general, a U.S. corporation is not taxed on the earnings of its foreign subsidiaries until those earnings are repatriated to the U.S. parent, principally in the form of a dividend. One of the exceptions to the general rule of deferral arises under Subpart F of the Code. Under Subpart F, a U.S. company must pay tax on the current income of CFCs to the extent the income is produced and consumed outside the CFC's country of incorporation.

Subpart F rules under Section 954 concerning foreign base company income were enacted in 1962 to deter the formation by U.S. companies of business operations in tax haven jurisdictions. However, the rules of Section 954 place U.S. companies at a distinct disadvantage in highly competitive regional trading blocs, such as the EU. The current rules force U.S. companies to choose between current taxation on the earnings of a foreign subsidiary doing business in a number of jurisdictions or incorporating in every country in a regional trading bloc in which conducts business. To illustrate, it makes no sense to require a U.S. company that does business in Germany through a CFC in Denmark to incorporate in Germany to avoid the immediate taxation imposed under Subpart F.

Moreover, the EU countries are jurisdictions which possess tax and wage rates comparable to the U.S. Consequently, U.S. companies do not choose to conduct business in the EU to avoid taxation. The proposal in H.R. 1690 would afford U.S. companies the flexibility to decide upon the appropriate business structure for their operations in the EU irrespective of U.S. tax considerations.

One proposed modification that we would suggest to this provision in H.R. 1690 would be to expand the categories of income eligible for the "same country" exception for EU countries to include foreign personal holding company income and foreign base company oil-related income. The current provision applies only to foreign base company sales and services income.

11. Exempt Controlled Foreign Corporations from Uniform Capitalization Rules. The NFTC supports the proposal in H.R. 1690 that would exempt CFCs from the uniform capitalization rules provided in Section 263A.

Section 263A provides a set of rules that determine which expenses can be deducted currently and which costs are to be capitalized and included in inventory. The uniform capitalization

rules apply generally to property produced by a taxpayer or acquired by a taxpayer for resale. The current rules apply to foreign persons whether or not engaged in business in the United States. The rules are inordinately complex, especially as applied to CFCs of U.S. parent companies. Creating an exemption from the uniform capitalization rules would obviate burdensome administrative problems for U.S. controlled entities without entailing a revenue loss to the Treasury. This proposal was contained in H.R. 5270 introduced by Congressmen Rostenkowski and Gradison several years ago.

One slight modification that the NFTC would suggest is to exempt from the uniform capitalization rules foreign companies not doing business in the U.S. for purposes of calculating both actual dividends and Subpart F constructive dividends. Since many CFCs may possess at least minimal Subpart F income, it is necessary to exempt foreign corporations not doing business in the U.S. from Section 263A if maximum administrative savings are to be achieved.

12. Reporting of Foreign Corporations Earnings and Profits on a U.S. GAAP Basis. The NFTC supports the proposal in H.R. 1690 that would require CFCs to compute their earnings and profits using U.S. generally accepted accounting principles ("GAAP") for purposes of computing their Subpart F income.

Numerous differences arise under present law between the tax accounting treatment of various tax items under U.S. tax accounting rules and U.S. GAAP reporting principles. To illustrate, depreciation and the economic performance test are treated differently between U.S. tax accounting and U.S. GAAP reporting.

The proposal would simplify recordkeeping and tax compliance for many taxpayers, especially with respect to the treatment of important tax preference items.

13 Increase in Reporting Threshold for Stock Ownership of a Foreign Corporation. The NFTC supports the proposal in H.R. 1690 to increase the reporting threshold under Section 6046 from the current 5 percent stock ownership requirement to 10 percent. The proposal would conform the reporting requirements under Section 6046 to the 10 percent stock ownership requirement for claiming the indirect deemed paid foreign tax credit under Section 902.

The increase in the number of foreign subsidiaries in joint ventures involving minority U.S. investments has compounded the compliance and administrative problems for U.S. companies in monitoring transactions subject to reporting under Section 6046. Increasing the ownership requirements for reporting under Section 6046 would greatly simplify the administrative burdens for U.S. multinational companies without any revenue costs to the Treasury. The NFTC strongly supports the proposal in H.R. 1690 to increase the ownership requirement under Section 6046 from the current 5 percent level to a 10 percent ownership requirement.

14. Exception from Foreign Personal Holding Company Income and Foreign Base Company Services Income for Active Financing Income. The NFTC is particularly supportive of the concept provided in H.R. 1690 to restore an exemption from Subpart F inclusion for income derived in the active conduct of a banking, financing or similar business. Repeal of the exemption for active financing income contained in the 1986 Tax Reform Act has placed U.S. financial service companies at a serious disadvantage in competing against their foreign counterparts, which are not burdened with similar restrictions in their own countries.

The NFTC and its Task Force on Financial Services are studying the "same country" requirement in H.R. 1690 that restricts the restoration of deferral for active financing income to income derived from sources within the country in which the controlled foreign corporation is formed. We understand the concerns of the

Houghton and Levin offices in imposing the "same country" requirement, which is intended to assure that deferral is restored only for income derived from the active conduct of a financial service business. We have some concern that the "same country" requirement may exclude certain income that clearly constitutes "active financing income." In this regard, the NFTC may propose that the "same country" approach be modified to reflect certain modern banking practices. Alternatively, the NFTC may suggest a different approach to protect against tax avoidance while restoring the exemption for active financing income.

The NFTC will share its views on this issue with the Houghton and Levin offices at the appropriate time

15. Exemption of United States Shareholders of Controlled Foreign Corporations from Passive Foreign Investment Company Provisions. The NFTC supports the proposal in H.R. 1690 to exempt CFCs from the passive foreign investment company (PFIC provisions). The PFIC rules were primarily intended to eliminate certain abuses relating to the taxation of U.S. investors in foreign mutual funds. Unfortunately, the legislation was drafted in a manner that subjects CFCs to the PFIC rules as well. The application of the PFIC rules to CFCs can have unintended results and imposes enormous administrative burdens. The NFTC supports an exemption from the PFIC rules for CFCs.

16. Translation of Foreign Taxes into U.S. Dollar Amounts Using Average Exchange Rate. The NFTC supports the proposal in H.R. 1690 to permit taxpayers using the accrual method of accounting to utilize the average exchange rate for the taxable year to which the taxes relate. The average exchange rate would be applied in determining the amount of foreign taxes paid for purposes of calculating the foreign tax credit. This proposal is similar to Section 421 of H.R. 3419 as approved by the House of Representatives last year.

The NFTC strongly supports this provision as a means of simplifying the foreign tax credit calculations for U.S. taxpayers doing business abroad. The ability to use the average exchange rate avoids the requirement under present law of ascertaining the exchange rate on the date of payment.

The NFTC supports one proposed modification to this provision that has been discussed with the Treasury Office of International Tax Counsel. Section 421 of H.R. 3419 and the provision in H.R. 1690 would require taxpayers to claim foreign tax credits in the year of payment instead of the year of accrual when foreign taxes are paid more than two years after the end of the taxable year to which the taxes relate. In order to avoid double taxation caused by the potential mismatch of foreign source income and foreign tax credits in different taxable years, the NFTC would propose that a taxpayer use the currency rate on the date of payment as the appropriate rate for calculating foreign tax credits if an amended return is filed more than two years after the end of the accrual year. However, the proposed modification would permit accrual method taxpayers to treat the taxes as paid for the year to which the taxes relate for purposes of calculating the foreign tax credit.

17. Extend Deemed Paid Foreign Tax Credit to Dividends from, or Subpart F Income of, CFCs Below Third Tier. The NFTC supports the proposal in H.R. 1690 to extend the indirect foreign tax credit under Section 902 to the sixth tier subsidiary. The three requirements that must be satisfied for a taxpayer to extend the indirect credit to the sixth tier include: the foreign company must be a controlled foreign corporation; the domestic corporation must be a U.S. shareholder with respect to the CFCs; and the product of the percentage ownership of voting stock at each level

from the U.S. corporation down must be at least 5 percent. This provision was also included in H.R. 3419 approved by the House of Representatives last year.

The present limitation restricting availability of the deemed paid credit under Section 902 to taxes paid from the third tier subsidiary prevent many U.S. corporations operating under a layered corporate structure from claiming foreign tax credits for all of the income taxes paid through the chain of corporate ownership. The result is to cause double taxation for U.S. companies and a competitive disadvantage relative to their foreign concerns.

The NFTC supports the provision in H.R. 1690 to extend the indirect credit through the sixth tier of corporate ownership.

18. Repeal Portfolio Interest Exemption. The NFTC strongly opposes the proposal to remove the present law exemption found in Sections 871(h) and 881(c) for portfolio interest received by foreign investors from U.S. sources.

Repeal of the exemption would discourage the flow into this country of foreign capital on which the U.S. economy so heavily depends. It is a widely accepted fact among economists that the influx of foreign capital and the purchase by foreign investors of U.S. debt has had the salutary effect of restraining interest rates even though the federal deficit has soared.

Second, repeal of the exemption would cause U.S. interest rates to rise. Since the exemption for portfolio interest received by foreign taxpayers has contributed to the influx of foreign capital, repeal of the exemption conversely would cause a massive exodus of foreign ownership of U.S. debt instruments. The inevitable consequence of this scenario would be to raise interest rates for both governmental and private purposes in the U.S.

Third, repeal of the exemption for portfolio interest would constitute a material breach of current U.S. treaty obligations. Passage of the legislation to repeal the exemption for portfolio interest paid to foreign investors would materially violate the terms of numerous treaties that the U.S. has with its allies, unless such legislation expressly provided that repeal of the exemption did not interfere with existing U.S. treaty obligations. Otherwise, repeal of the exemption would cause the general withholding rate of 30 percent of gross income to apply to interest paid to foreign taxpayers.

And finally, repeal of the exemption would invite a return to treaty-shopping. One of the primary reasons for passage of the exemption for portfolio interest was the acknowledgement by both the U.S. Treasury and the Congress that imposition of high withholding rates on interest only caused foreign taxpayers to borrow through tax haven countries, which had tax treaties that provided for little or no tax on interest paid from the U.S.

For the foregoing reasons, the NFTC strongly opposes the proposal to repeal the exemption for portfolio interest received by foreign investors from U.S. sources under Sections 871(h) and 881(c).

The NFTC appreciates the opportunity to comment on the various provisions of interest affecting the tax treatment of international transactions. We commend the Chairman and the Committee for holding hearings on these important issues. We would be delighted to answer any questions that the Committee or the staff may have.

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Mr. Philip Moseley
House of Representatives
1102 Longworth House Building
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July 17 1995 House Resolution 57 Hearings Held 11-13 July 1995□□

Sir:

I am writing to register my approval for the raise of limits in Foreign Earned Income exclusion from $70K to $100K proposed by Representative Archer. To be candid my support is quite selfish since I would benefit from the change. There are also benefits to the United States that would ensue. Let me give you a few words on that.

I am a degreed professional, an Electrical Engineer, who accepted a foreign posting from my US employer, the MITRE Corp. I have lived outside the US previously so moving to a foreign country was not a totally new experience. I was somewhat reluctant to leave my well established lifestyle and exchange that for one which would require extensive adjustment. The monetary gain involved was the factor which led me to accept the assignment.

What do I do with the monetary gain you may ask? Most of it goes into savings and mutual funds, all in the US. The news reports we see here on CNN and in Stars and Stripes says that US Citizens are among the least disciplined "savers" among the developed world, I must be one of the very few who believes in delayed gratification. I work long hours in my job here in Brussels (typically 60+ hours per week) and do not jet-set around europe spending my "ill gotten" gains. I am approaching retirement and am saving to ensure a comfortable retirement. I have one grandchild and have established an education fund for him to which I add regularly. I expect more grandchildren and will do the same for each one borne. I want to see that each of my grandchildren has the opportunity to attend the college of his/her choice. I have an aged motherwho is retired living on Social Security; occasionally she will accept a small check from me (she is a very independent lady and I learned many of my monetary values from her).

I fly US Flag carriers when I return to the US as I did recently to attend my daughter's University graduation (she got a Masters Degree; that is also where some of my tax-exempt money went) and the goods and services that I purchase are from US companies if at all possible. I have retained my residence in the US and am paying off the mortgage at an accelerated rate.

An increase in the level of the exemption will permit me to accelerate my retirement by one year and will free up a well-paying job for one more US individual. When that occurs the money that I draw from my 403B is taxable. Both of these create tax events favorable to the US.

I think that I am quite representative of the community which will benefit if the HR 57 levels are raised. Hard working middle class Americans who will use the financial gain in a manner that will benefit the economy as a whole.

I believe that the change merits implementation.

Sincerely

T. Pender

THE SECTION 911 EXCLUSION:
LEVELING THE INTERNATIONAL PLAYING FIELD FOR AMERICAN WORKERS & U.S. COMPANIES

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EXECUTIVE SUMMARY

U.S. exports have increasingly become the driving force behind growth in America's economy. U.S. companies, large and small, are looking for new markets overseas for their goods and services. American business leaders know first-hand that in this highly competitive environment, U.S. citizens abroad play a critical role because they ***buy*** American, ***sell*** American, ***specify*** American, ***hire*** American, and ***create opportunities*** for the United States in foreign markets.

Despite the importance of Americans overseas, U.S. tax policy puts American workers abroad and their employers at a significant competitive disadvantage. The United States is the only major industrial country in the world that taxes on the basis of citizenship rather than residence. This means that the United States, unlike any of its major trade competitors, taxes its citizens on the income that they earn while working overseas.

Because this U.S. tax policy is out of step with the rest of the world, American workers are significantly more expensive to hire than comparably qualified foreign nationals. The $70,000 Section 911 foreign earned income exclusion helps to offset some of the imbalance created by this policy, but U.S. companies and Americans abroad remain vulnerable. U.S. citizens overseas must include as taxable "income" many non-salary, quality-of-life items for which their employers provide reimbursement: schooling for children, cost-of-living allowances, home leave, emergency travel, and other necessary and often expensive aspects of living overseas. Such taxable reimbursement often doubles an overseas American's taxable income. He or she therefore has a much higher tax liability than does a worker with the same salary employed in the United States. If his or her employer agrees to offset these increased taxes, the cost to the company of hiring this American worker goes still higher. As a result, the trend worldwide -- among U.S. companies and foreign companies alike -- is to replace American workers with less expensive (inclusive of taxes) third country nationals, especially Europeans.

Current U.S. tax policy makes it very difficult for U.S. companies to bid competitively on international contracts if they plan to utilize American employees to staff overseas projects. The Section 911 exclusion offers an important step toward placing U.S. companies on a level playing field with non-U.S. companies competing for these global contracts. In the continuing battle for international market share, Section 911 has proved to be one of the most important weapons in America's trade arsenal because this exclusion:

- Makes U.S. citizens working overseas more competitive with foreign nationals who pay no tax on their overseas earned income;
- Makes American companies more competitive in their bids on overseas projects;
- Helps to put Americans "into the field" overseas, where they promote U.S. goods and services, repatriate much of their earnings to the USA, pave the way for future growth of U.S. export opportunities, and create hundreds of thousands of jobs in the United States.

Preliminary results from two studies in progress -- conducted by Price Waterhouse and Professors Charles Pearson and James Riedel at the Johns Hopkins University -- have reinforced the long-held view that Section 911 is especially important to the "little guy" trying to do business or provide educational services overseas. The results of a recent international survey commissioned by the Section 911 Coalition suggest that the overseas American workforce of small and medium-sized companies is some ten times more dependent on Section 911 than that of large companies surveyed. Small and medium-sized companies said that altering Section 911 upward or downward would have the following impact: ▪ Nearly two-thirds said elimination of Section 911 would result in a moderate or major negative change in their ability to retain U.S. employees overseas; ▪ 85% said elimination of Section 911 would result in a moderate or major negative change in their future hiring practices of Americans overseas; ▪ 82% said the loss of this exclusion would result in a moderate or major negative change in their ability to secure projects or compete abroad; ▪ 89% said their American expatriate employees preferentially source American products and services, with 76% stating that this is a "large tendency." ▪ Nearly two-thirds of both small and large companies said their competitive advantage would improve if the exclusion were increased from $70,000 to $100,000.

In addition, preliminary Price Waterhouse results indicate that the benefits of Section 911 are more important for lower-paid Americans abroad than for those who receive higher pay. This finding reinforces a 1993 U.S. Treasury Department study which noted that Section 911 is an important mechanism for mitigating the tax liability of lower income taxpayers working abroad.

Even with the support of Section 911, however, U.S. companies and Americans abroad are not on a level "business playing field" with America's trade competitors. **According to the Price Waterhouse study, the benefit of the current exclusion has dropped by 43 percent in little more than a decade, and this trend is expected to continue.**

To turn this situation around, the Section 911 Coalition supports an unlimited foreign earned income exclusion -- a position that is consistent with earlier recommendations provided by the General Accounting Office and Chase Econometrics. An unlimited exclusion, Price Waterhouse notes, would be "consistent with the international tax policy standards of competitiveness, preservation of the U.S. tax base, and harmonization." These preliminary results also suggest that the traditional standards for evaluating income tax provisions -- fairness and economic efficiency -- justify exclusion of that portion of foreign earned income attributable to the additional costs of living abroad.

The Section 911 Coalition believes that having Americans overseas is not just helpful, it is ***essential***. In effect, taxation of foreign earned income amounts to a shortsighted, indirect ***tax on U.S. exports and American culture***. This is a debilitating and entirely self-inflicted wound -- a policy which discriminates against America's companies, U.S. workers, and American educational institutions abroad.

Even though its real value is continually being eroded by inflation, the current $70,000 exclusion has made a substantial difference, to be sure. Now, however, **is the time for Congress to take a decisive step forward to position the United States for trade competition in the twenty-first century.** None of America's competitors tax foreign earned income, and the U.S. should adopt the same policy if the United States intends to take on its international competitors on equal terms.

With current budgetary constraints in mind, Mr. Chairman, our Coalition endorses an *interim* step as spelled out in your bill, H.R. 57. This bill accomplishes two things. First, H.R. 57 increases the exclusion from $70,000 to $100,000, thereby restoring the value of the exclusion that has been eroded away by inflation over the years. Second, H.R. 57 indexes the exclusion to prevent inflationary erosion in the future -- the same sort of erosion that has effectively reduced the real value of the Section 911 exclusion since 1987. Such indexation would also be consistent with the inflation adjustments made in many other dollar amounts in the individual income tax system -- the standards deduction, personal exemption, tax bracket amounts, earned income credit, phase-out of itemized deductions and personal exemptions, and so on.

American jobs are on the line, especially for small and medium-sized businesses, and we ask that the Ways and Means Committee take steps this year that are long overdue. Increasing the Section 911 exclusion by $30,000 and indexing it against inflationary effects would be a small investment that promises to yield billions of dollars in dividends to the American economy and U.S. citizens in the years ahead.

# # #

Thank you, Mr. Chairman, for the opportunity to testify today. The Section 911 Coalition is a group of like-minded companies, business organizations, non-profit associations, and individuals that has come together in the past year to call attention to the importance of the Section 911 foreign earned income exclusion. The Coalition currently has some 70 members, including representatives of more than 70 American chambers of commerce overseas and over 500 American and international schools abroad.

In recent years, exports have been the most impressive engine of growth for America's economy. Between 1986 and 1993, according to the U.S. Department of Commerce, nearly 40 percent of the growth of America's Gross Domestic Product resulted from U.S. exports of goods and services.[1] Commerce Department statistics also indicate that every $1 billion in U.S. exports creates or sustains 17,000 man-years of direct domestic employment.[2] America exported $701.2 billion worth of goods and services in 1994, which translates into nearly 12 million American jobs.[3]

Exports don't just happen by themselves. Independent studies and raw statistical data show a direct correlation between the number of Americans working overseas and the level of U.S. exports. Any business owner will tell you that to generate business, you've got to put your sales people in the field. Experience shows that Americans abroad are the best sales people for U.S. goods and services overseas. The bottom line, Mr. Chairman, is this:

Americans Abroad = U.S. Exports = U.S. Jobs.

In the ongoing battle for international market share, the Section 911 exclusion has proved to be one of the most important weapons in America's trade arsenal. By helping to maintain U.S. citizens "in the field" around the world, where they promote America's national interests on a daily basis, Section 911 has had a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets.

The $70,000 exclusion has made a substantial difference, to be sure, but Congress should remove the limitations on this exclusion in order to give American workers a "leg up" in the global marketplace. None of America's trade competitors tax foreign earned income, and the U.S. should move to an unlimited exclusion if we truly want to level the international business playing field. Reinstating the unlimited exclusion today would be a positive, forward-looking measure and would do more to move the United States toward a foreign trade surplus and a balanced budget than would many of the painful program cuts that are currently under consideration by Congress.

We realize, however, that removing the cap on the foreign earned income exclusion may be unrealistic at a time when Congress is *reducing* the size of many programs. This is especially true because under the current revenue estimating procedure, the unlimited exclusion, in the short-term, would somewhat curtail short-term tax revenues. Our Coalition would argue, however, that anticipated revenue losses have been grossly overstated. In the medium-term, in our view, net revenue ***gains*** would be substantial and, in the longer-term, such gains would be even greater. (On the other hand, reducing or eliminating the current exclusion, as a handful of Congressmen have suggested over the years, would likely generate some short-term revenues but would virtually guarantee reduction of tax revenues in the long run -- something that all of us here today want to avoid.)

With this in mind, Mr. Chairman, the Section 911 Coalition endorses an *interim* step as spelled out in your bill, H.R. 57. This bill accomplishes two things. First, H.R. 57 would increase the exclusion from $70,000 to $100,000, thereby restoring the value of the exclusion that has been eroded away by inflation over the years. Second, H.R. 57 would index the exclusion to prevent inflationary erosion in the future -- the same sort of erosion that has effectively reduced the real value of the Section 911 exclusion since 1987. Such indexation would also be consistent with the inflation adjustments made in many other dollar amounts in the individual income tax system -- the standards deduction, personal exemption, tax bracket amounts, earned income credit, phase-out of itemized deductions and personal exemptions, and so on.

By enacting H.R. 57, Congress would be taking an important step forward to enhance U.S. competitiveness and create more American jobs. Our Coalition believes that by making American workers more affordable in the global marketplace, as H.R. 57 would, Congress would pave the way for more U.S. citizens overseas to *buy* American, *sell* American, *specify* American, *hire* American, and *create opportunities* for other Americans abroad. In short, indexing the Section 911 exclusion and increasing it by $30,000 would be a small investment that will position the United States to compete in the twenty-first century and yield billions of dollars worth of dividends to the U.S. economy in the years ahead.

America's Foreign Earned Income Exclusion: A Short History

Section 911 provides for a foreign earned income exclusion of up to $70,000 annually to Americans working overseas, thereby assisting them to compete against comparably qualified non-Americans (who pay no taxes on income earned abroad). A U.S. citizen or resident alien whose tax home is outside the United States and who is a *bona fide* resident of a foreign country or who is present in a foreign country for 11 months out of 12 (330 days in any 365 day period) may exclude from gross income up to $70,000 per year of foreign earned income, plus a housing cost amount.

Originally unlimited for *bona fide* residents of a foreign country, the foreign earned income exclusion has been part of the Internal Revenue Code since 1926. Congress enacted the exclusion nearly 70 years ago in an effort to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries."[4]

Limiting the foreign earned income exclusion is a concept that goes back to 1953, when Congress first capped the exclusion. In the immediate aftermath of World War II, there may have been a good reason for limiting the exclusion. However, times have changed dramatically since the 1950s, when the U.S. economy was a global colossus with no serious competition, and U.S. tax policy has not kept pace with the changing times. We are long overdue to bring the Section 911 tax policy into the present, Mr. Chairman, and to position it for the year 2000 and beyond.

In 1978, the Foreign Earned Income Act replaced the exclusion with a series of deductions for certain expenses associated with living abroad (former Section 913). American workers and U.S. companies in overseas markets were hit hard by the 1978 amendments and lost considerable overseas market share as a result. Recognizing this, Congress in 1981 restored the flat earned income exclusion (Section 911) at $75,000 per year for 1982 with scheduled increases to $95,000 in 1986. Noting that the rules enacted in 1978 reduced exports, Congress in 1981 "was concerned with the increasing competitive pressures that American businesses faced abroad. The Congress decided that in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive" through Section 911.[5]

The exclusion was revisited in 1984 and 1986. The Deficit Reduction Act of 1984 delayed the scheduled increases in the exclusion, freezing the benefit at $80,000 (the 1983 benefit level) through 1987. The Tax Reform Act of 1986 reduced the exclusion to $70,000, and it remains at that level today.

Needless to say, because the exclusion has not been indexed for inflation, its real value has dropped substantially. According to the accounting firm of Price Waterhouse, the benefit of the exclusion has dropped by 39 percent from its 1953 level, when it was first limited, and by 43 percent from its 1982 level, when the exclusion reached its highest relative point ($75,000) after the 1981 Act.[6] If the $70,000 exclusion had been indexed for inflation since its enactment in 1987, by these same calculations, it would be $94,000 as of 1995, rising to over $111,000 in the year 2000.

U.S. Competitiveness: Learning from Our Mistakes

In an effort to put an end once and for all to continuing budget deficits, Congress is currently examining and re-evaluating every program and all aspects of the tax code to cut unnecessary spending. Programs once viewed as sacred and untouchable are now being subjected to the budget cutting scalpel. Every expenditure must be justified, and every program must provide a return commensurate with its cost.

The Coalition recognizes that, in such an environment, the Section 911 exclusion must also be justified. Many Members of Congress serving today were not witness to the extensive Congressional debates which resulted in the enactment of the exclusion in 1981. Those of us who are familiar with the exclusion and recognize its importance have a responsibility to explain to the 104th Congress why the exclusion came about, why it provides a return to the U.S. economy that far exceeds its estimated revenue losses, and why the Section 911 exclusion has such an impact on U.S. business competitiveness overseas.

Mr. Chairman, you and the Ranking Member, Mr. Gibbons, are among the few veterans of those earlier debates who remain on Capitol Hill and follow this issue today. We are grateful to both of you for your long-standing support

for Section 911, a truly bipartisan issue that affects all U.S. companies and Americans abroad -- regardless of political affiliation.

For those Members of the Committee who may not be aware of the disastrous steps that were taken in the 1970s to move away from the existing foreign earned income exclusion, a short review may be instructive. The Tax Reform Act of 1976 generally reduced the exclusion to $15,000 per year. While this cut in the exclusion did not take effect in the end, it nevertheless had a "chilling" effect on U.S. companies' efforts to send American workers abroad. A 1978 General Accounting Office (GAO) survey of 183 U.S. companies found that more than 80 percent of these companies felt that reducing the exclusion along the lines of the 1976 Act would result in a reduction of U.S. exports by at least five percent.[7]

Two years after the 1976 Act, the situation went from bad to worse. The Foreign Earned Income Act of 1978 repealed the foreign earned income exclusion and put in its place Section 913, composed of five factors: 1) A cost-of-living deduction based on the differential between U.S. and overseas costs of living; 2) A housing deduction; 3) A deduction for schooling expenses where a U.S.-type school was not within a reasonable commuting distance; 4) A travel expense deduction for an annual round-trip visit to the United States; 5) A deduction for work in a hardship area.

The 1978 Act, compared to prior law, represented a 23 percent reduction in the tax benefit of the exclusion. To determine the impact of this reduction, the GAO conducted a survey in 1980 of 33 key firms in four industries. The GAO found that additional costs attributable to the 1978 Act was a primary reason why these firms had decreased their employment of Americans abroad. The numbers decreased absolutely from 1979 to 1980 in three of the industries and, during the period 1976 to 1980, the relative number of Americans abroad dropped compared to third country nationals.[8]

As a result of these findings, the GAO produced the following recommendation:

> "We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income."[9]

The GAO went on to say that "complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers . . . would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."[10]

Findings in a 1980 report by Chase Econometrics provided more evidence of the dangers for U.S. competitiveness of restricting the foreign earned income exclusion. As a result of the changes in 1976 and 1978, Chase noted, a significant number of Americans working overseas would be forced to return home. **Chase determined that a ten percent drop in Americans overseas would lead to a five percent drop in U.S. exports. The study went on to say that the "drop in U.S. income due to a five percent drop in real exports will raise domestic unemployment by 80,000 [persons] and reduce federal receipts on personal and corporate income taxes by more than $6 billion, many times the value of increased taxes on overseas workers."[11]**

The U.S. & Overseas Tax Fairness Committee, an *ad hoc* group established in the late 1970s to defend the foreign earned income exclusion, noted in 1980 that "of all the current U.S. disincentives that discourage trade, none is easier to eliminate than the U.S. practices of taxing foreign earned income . . . and none will produce faster or more substantial results for our balance of trade."[12] In an effort to show what damage the 1976 and 1978 Acts had done as of 1980, the Committee cited the example of the U.S. construction and engineering industry operating in the Middle East. American companies in this sector "had over ten percent of the construction volume in the Middle East four years ago and now has less than two percent -- almost entirely due to the current U.S. tax treatment of overseas Americans," the Committee noted, "and industry is finding it very difficult to recapture its former standing."[13]

The message is as clear today as it was in 1980: Changes in the foreign earned income exclusion generate a substantial and direct impact -- positive or negative -- on the ability of U.S. companies to compete in overseas markets.

Why Section 911 is Important

America's trade competitors realized long ago that encouraging their citizens to work overseas has a pronounced, salutary impact on their domestic economies. Sending their workers abroad has become an integral part of these nations' export strategies. To facilitate this "export" of their citizens (and thus the export of products and services), other governments do not tax their citizens on the money they make while working abroad. This makes these citizens extremely competitive in foreign markets.

U.S. Government tax policies, by contrast, have generally *discouraged* Americans from working abroad. Alone among the world's industrialized nations, the United States still taxes its citizens on the basis of citizenship rather than residence. Further, overseas Americans must also pay U.S. income tax on benefits, allowances, and overseas adjustments. The practical effects of this tax policy are clear: Americans overseas are at a significant competitive disadvantage and are being priced out of foreign markets because prospective employers must provide more income to compensate American workers for these additional tax burdens.

Overseas employers are faced with a choice: They must pay an American worker more than they would pay other comparably qualified nationals (so that the American may keep a comparable after-tax income) *or* they must utilize a tax equalization program to keep the employee whole for his or her additional tax burden. Both approaches involve additional costs to the employer -- a burden that many employers are unwilling to accept even if the American worker is more productive and has better professional qualifications than the competition.

For those companies that have a tax equalization program in place, where the company pays any actual taxes for its overseas employees, the Section 911 exclusion helps to mitigate the tax burden mentioned above -- thereby cutting company costs and enabling it to be more competitive abroad. For companies that do *not* utilize a tax equalization program -- and most small and medium-sized companies working overseas fall into this category -- the Section 911 exclusion is most helpful to the *employee*, who is responsible for paying his own taxes. The current exclusion helps to make a difference in both cases, but the difference may still not be substantial enough to enable an American worker overseas to defend his or her job against foreign nationals.

The cost of hiring or maintaining an American worker is inordinately high because *non-salary*, quality-of-life items must be included in the worker's taxable income, often adding as much as 50 - 100 percent of base pay. Such "income" includes reimbursement for the cost of children's schooling, cost-of-living allowances, home leave, emergency travel, and other necessary and often expensive aspects of living overseas. Because so many overseas contracts today are decided on the basis of cost, and when companies' profit margins grow tighter and tighter, many employers (including American employers) simply aren't prepared to cover the additional tax burden to "Hire American."

A Section 911 Coalition member offered this case in point:

> A large American company recently won a multi-billion dollar, multi-year overseas contract to supply telecommunications equipment and services. The U.S.-based company would prefer to have Americans heading its overseas operations but, because the U.S. tax system effectively prices Americans out of the international job market, the company tends to hire Europeans instead. The President of this company's international operations is British, and his Vice President is Dutch. Not surprisingly, the Human Resources Director, who answers to the Vice President, is also from Holland. He has hired approximately 2000 technical employees for this project, most of whom are Dutch. In addition, Volvos were purchased instead of U.S.-made vehicles because they are considered "more suitable" for the technical employees. If the U.S. tax system were more like those of America's trade competitors, who maintain an unlimited foreign earned income exclusion, most of these 2,000+ jobs would have gone to Americans rather than Europeans, and a large number of American cars would have been exported instead of Volvos.

Section 911 is important because it makes a substantial difference in our nation's efforts to compete on the international business playing field. Without this exclusion, there is good reason to believe that many thousands of Americans currently overseas would be priced out of the global marketplace. This would be a devastating blow to America's national interests because Americans abroad:

- Direct business and jobs to the United States;
- Carry America's culture and business ethic to other nations;
- Specify and purchase U.S. goods and services for overseas projects;
- Set standards and shape ideas which guide future policies in the development of infrastructures and economies overseas.

In addition, for U.S. companies to continue expanding their market share worldwide, they must think and act globally. To stay competitive internationally, American managers need the kind of "hands on" experience that can only be gained by living and working abroad. In recent years, for example, two of the Big Three automobile companies promoted their CEOs directly from European positions to corporate headquarters. This clearly demonstrates recognition by these companies of the role that international experience plays in their economic futures.

In short, Mr. Chairman, Section 911 helps to protect against replacement of Americans abroad by third country nationals who pay no taxes at all on their overseas income. Given the tens of thousands of overseas business opportunities that are of interest to U.S. companies and U.S.-based institutions each year, increasing the Section 911 exclusion stands to make a substantial difference for American influence abroad, U.S. exports, U.S. jobs, and overall American competitiveness.

Who is Affected by Section 911?

The loss of U.S. market share and the cutback in American jobs overseas represent a setback for American competitiveness. However, this tells only part of the story. The other part, of more immediate concern here at home, is the impact felt in communities all across the United States as jobs created or sustained by exports would disappear. *All* Americans abroad, whatever their background, are helping to fuel the economy in the United States. By securing employment overseas, they free up jobs for other Americans back home, thereby reducing unemployment. They also support the American economy by repatriating much of their overseas earnings back to the United States. Most important of all, perhaps, Americans working overseas serve as the front-line marketing and sales force for U.S. exports. Unless all Americans support competitiveness through exports, our nation's trade deficit will surely continue.

I noted earlier that exports are the engine of growth for the U.S. economy, and it is generally accepted that small and medium-sized companies provide the fuel for this engine. When the engine of growth is stalled out by constrictive U.S. tax laws that are no longer appropriate, Americans everywhere pay the price.

For years, supporters of Section 911 have emphasized that the exclusion is especially important to small and medium-sized companies operating in overseas markets. "Real world" experience has borne out that:

1) Small companies, when trying to gain a foothold overseas, are more likely than large companies (many with an established overseas presence already) to draw on U.S.-based personnel to penetrate foreign markets.

2) Small and medium-sized companies, because they lack the world-class name recognition that might provide them with open access to foreign customers, traditionally rely very heavily on Americans overseas to specify and purchase their products.

3) Small and medium-sized companies are, by necessity, much more sensitive to individual cost elements and the financial bottom line. Without the $70,000 Section 911 exclusion to help make overseas Americans more competitive with foreign nationals, relatively few of these small and medium-sized companies would be able to hire Americans to fill overseas slots.

Preliminary results from two studies in progress -- conducted by Price Waterhouse and Professors Charles Pearson and James Riedel at the Johns Hopkins University School of Advanced International Studies -- have reinforced the long-held view that Section 911 is especially important to the "little guy" trying to do business overseas.[14] (This also applies to American schools abroad, whose efforts to provide educational services overseas have played an instrumental role in promoting the American Way and U.S. products.) Preliminary results of these studies indicate that:

- **For small and medium-sized companies (0 - 500 employees), elimination of the Section 911 exclusion would have a significant impact on the ability of American workers abroad to keep their jobs.** In a recent survey conducted by Professors Pearson and Riedel for the Section 911 Coalition, nearly two-thirds (64 percent) of small and medium-sized respondents said elimination of Section 911 would result in a "moderate" change (6 to 25 percent) or a "major" change (above 25 percent) in their ability to retain American employees overseas. (In the same survey, 70 percent of large companies said elimination of Section 911 would result in some job loss change, and 38 percent said this change would be a moderate or major change.)

- **For small and medium-sized companies, elimination of Section 911 would have an even greater impact on *prospective* U.S. citizen hires that would be lost or substituted with foreign nationals.** Eighty-five percent of these companies said elimination of Section 911 would result in a moderate or major change in their future hiring practices. (For small and medium-sized companies responding to the survey, 32 percent of their total overseas employees are U.S. nationals.) Fifty-four percent of the large companies said elimination of Section 911 would result in a moderate or major change in their future hiring practices.

- **For small and medium-sized companies, elimination of Section 911 would have a substantial impact on these companies' abilities to secure projects or compete abroad.** Eighty-two percent of these companies said the loss of this exclusion would result in a moderate or major change in their ability to secure projects or compete abroad. (The equivalent number for large companies was 64 percent.)

- **For small and large companies alike, there was widespread agreement that increasing the current exclusion from $70,000 to $100,000 would have a substantive impact on their ability to secure projects.** Sixty five percent of respondents said their competitive advantage would improve, with 38 percent stating that the improvement would be moderate or major.

- **For small and medium-sized companies, U.S. nationals employed abroad are far more likely to source their imports of goods and services from the United States.** Eighty-nine percent of these companies said there is a tendency to source American, with 76 percent stating that this is a "large tendency." (The equivalent number for large companies was 77 percent and 46 percent, respectively. This is especially meaningful in light of the fact that U.S. multinational corporations currently account for 58 percent of U.S. exports and that almost half of that trade is between parent companies and affiliates, according to the March 1995 "Survey of Current Business.") Seventy-seven percent of all respondents (small and large) made it clear that U.S. citizens abroad "Buy American" and that more than two-thirds of these found a "large tendency" to source U.S. goods and services.

- **With regard to compensation levels, the benefits of Section 911 are more important for lower-paid Americans abroad (such as employees of small companies, educators, NGOs and non-profit organizations) than for higher-paid Americans abroad.** If Section 911 had been eliminated in 1993, employers would have needed to increase compensation by 12.7 percent to protect the after-tax income of U.S. expatriates at the lower end of the income scale (base pay of $12,720 per year). At the other end of the scale, for those with a base pay of $152,640 per year, compensation would have needed to increase by an average of only 6.8 percent.

This latter finding reinforces a 1993 U.S. Treasury Department study which noted that Section 911 is an important mechanism for mitigating the tax liability of lower income taxpayers working abroad.[15] These facts do not support the negative "spin" that some would put on the foreign earned income exclusion -- the wrongheaded suggestion that the exclusion benefits only the so-called corporate "fat cats."

It is also important to note, however, that more senior (and consequently more expensive) managers working overseas tend to be best positioned to benefit the U.S. economy most. The senior managers are more likely to influence the buying and hiring decisions of their company, and they are also more likely to assist other U.S. companies trying to do business abroad. In addition, they are the ones most apt to gain the international experience required by future senior executives for American companies looking to compete successfully in the increasingly global economy. Nevertheless, it is often very difficult to persuade key employees to adjust their career paths and family situations by leaving corporate headquarters and the United States. And from the companies' perspective, despite the many advantages of hiring American peak performers to head overseas offices, current tax policies tend to make this option prohibitively expensive.

How Section 911 Works

The cost of hiring an American varies widely around the world depending on such factors as local housing costs, local standards of living, availability of schools and recreation facilities, remoteness and hardships, and so forth. Nevertheless, it may be instructive to look at a typical example of how the foreign earned income exclusion works. The American Business Council of the Gulf Countries, an Executive Committee member of the Section 911 Coalition, provided the following example.

> The cost for a grade school student to attend the American School in Dubai is approximately $10,000 per year -- not for an exclusive private school, but for the *only* American curriculum school there. If an employer reimburses this cost for two children, the employee has an additional $20,000 of imputed taxable "income." This places an additional tax burden on the individual of up to $8,000.
>
> If the employer chooses to make the reimbursement of this schooling cost tax-neutral to the employee, the total reimbursement cost to the company could exceed $33,000 (including the compounding effect of tax reimbursements, which are also considered taxable "income" to the employee). This represents a $13,000 (65 percent) additional cost *to the company* to provide education for the American employee's children (compared to providing the same education for children of a comparable European employee) -- simply because of U.S. tax policy.
>
> If the employer provides an annual trip back to the United States for home leave for the employee and family (spouse and two children), the employee has an additional $10,000 or more of taxable "income." Emergency and sympathy travel generate taxable income; cost of living adjustments are considered taxable income; hardship allowances are taxable income; tax reimbursement is taxable income.

In other words, as this typical example shows, taxable compensation that does not represent either "perks" or disposable income to the employee typically absorbs a very large part of the current $70,000 exclusion. This is a burden borne solely by Americans, significantly hampering their ability to compete in the international arena.

The National Constructors Association, another member of the Coalition's Executive Committee, asked one of its member companies to compare the annual costs of employing an engineer with and without the benefit of Section 911. The results of this comparison are striking:[16]

	Hong Kong	United Kingdom	Saudi Arabia	Chile
Engineer's Base Pay	$112,800	$100,000	$121,824	$100,000
Tax Cost to Company with 911 Exclusion	$11,743	$34,275	$11,433	$4,843
Tax Cost to Company without 911 Exclusion	$103,513	$51,151	$66,019	$27,413
Increased Tax Cost to Company	$91,770	$16,876*	$54,586	$22,570*

* *In high tax countries, these savings may not be typical but may be realized in certain dual-contract situations. It should also be noted that the tax burden shown above includes taxes on allowances.*

While the Section 911 exclusion is particularly helpful in low-tax foreign jurisdictions like Saudi Arabia and Hong Kong, it can also make a very substantial difference in those nations with relatively high levels of individual income tax. Filings of Internal Revenue Service Form 2555 provide an adequate measure of those Americans abroad utilizing the Section 911 exclusion. According to IRS figures, nearly two-thirds (61.8 percent) of Forms 2555 filed in 1987 were submitted by Americans in just 15 nations.[17] The vast majority of these nations -- led by Germany and the United Kingdom, with Canada and Japan not far behind -- are considered relatively high-tax jurisdictions. This is consistent with Price Waterhouse's preliminary findings which note that, absent Section 911, required compensation would increase by an average of 8.6 percent in Australia, 8.0 percent in Japan, 5.4 percent in Switzerland, 4.5 percent in France, 3.3 percent in Canada, and 3.1 percent in Germany.[18] (Price Waterhouse calculated the average change in compensation required if Section 911 were repealed for *all* expatriates at *all* income levels in each of the 15 nations.)

According to Price Waterhouse, Section 911 can be beneficial in high-tax countries for a number of often overlooked reasons, including:

- Countries with very high statutory rates may have generous deductions and exclusions that result in relatively low tax liability, particularly for taxpayers at modest income levels;
- International assignments often begin or end at mid-year, resulting in little foreign income tax liability in the year of assignment and/or return;
- Unlike the foreign tax credit, Section 911 may cause U.S. source income of Americans working abroad to be taxed in lower U.S. income tax brackets.

In short, no matter where in the world U.S. companies and American citizens work, the Section 911 exclusion can make a substantial difference for U.S. competitiveness.

Voices from Abroad: Americans Speak Out on Section 911

By their very presence overseas, U.S. citizens help to promote America's national interests. This is true of all Americans abroad -- whether they are representatives of major U.S. corporations, cultural or religious institutions, service providers, educators, entrepreneurs, heads of charitable organizations, or homemakers. Americans abroad foster a positive image of the United States throughout the world while also contributing to our nation's economic and cultural well-being at home.

Nearly a quarter-million Americans abroad filed IRS Form 2555 last year to make use of the Section 911 exclusion. Based on survey feedback received by Professors Pearson and Riedel at the Johns Hopkins University, Americans who use the foreign earned income exclusion come from all walks of life and can be found in all parts of the globe. From their comments, a sampling of which are provided below, it is also clear that Section 911 makes a substantial difference in the lives of Americans abroad.

> "When I first arrived here, Americans from our firm in the U.S. totaled 90 percent of our professional staff. As time progressed, because of the high cost of the tax equalization program, we first changed to hiring local Americans [those not recruited from the United States] and some foreign nationals. Each year as the cost of Americans increased (the reduction to $70,000 exclusion really hurt) we have slowly reduced our American percentage to today's 28 percent. These professionals not only 'buy American' for our company needs, but as consultants to local businesses also recommend American products to foreign companies. Without U.S. taxes overseas, we would double the number of Americans employed."
>
> "In 1988 when I joined [Company X] our U.S. imports were 0. Since starting our major import program in 1991 we are now (1994) importing over 120 containers of U.S. product annually plus air freight delivery of U.S. produce and beef on a weekly basis."
>
> "Without the tax exclusion, we would not be able to attract U.S. citizens to work at our school and they would be replaced by locally hired Mexican nationals. U.S. textbooks and supplies would probably be discontinued and Spanish materials would be used in their place."
>
> "It becomes very obvious to me around October of each year when the physicians submit their budget requests to me how nationality affects one's thinking. The American (or American trained) physicians will request U.S. manufactured supplies, equipment and pharmaceutical items. Likewise the Germans, British and French physicians request those that they are more familiar with."
>
> "As we are strictly tuition based, an increase in personnel costs is directly reflected in the cost of tuition. In the past we have chosen to hire less expensive teachers from other countries. If we raise tuition, many companies will not send families to Korea. American businesses need a high quality school in Seoul in order to convince their best people to come. Were we to lose our Section 911 it would have a serious impact on the competitiveness of other American businesses in Korea."
>
> "If the exclusion is lost, the company will probably lose the American management it prides itself on and turn to Saudis or British nationals. If this happens, the odds of Americans ever working for this company again will be nil."
>
> "Under [President] Carter, the tax exclusion was eliminated, U.S. companies pulled out of many foreign locations (or greatly reduced their expatriate contingent) and U.S. overseas schools suffered tremendous enrollment / revenue losses. The losses were compensated by increasing host country populations in the schools, an effect which is still felt today, particularly in Latin America."
>
> "We constantly hear it clearly stated by business people here that they would not be here if they did not have access to an American educational program. During the last draw down of the exclusion in the late seventies, the availability of teachers willing to come overseas to work dropped significantly. They saw no advantage to being overseas."
>
> "Elimination of the Section 911 exclusion and even the current limitation dictates that we recruit on a cost-effective basis; i.e., lower cost nationalities due to tax advantages. This will be particularly true

for our smelter project in {country X} which requires an expatriate staff of about 185. Projections are that between 60 - 80 percent will be TCNs [third-country nationals]."

"Administering an overseas school in 1980 in Bangladesh when the foreign earned income exclusion was taken away, I observed first hand the impact on American business, especially on the construction industry. I was building a new school at the time for $4,000,000, half of which was financed by the U.S. government. There were 2 bidders: a U.S. company and a Korean company. The Americans lost the contract on price, and the difference was the tax on U.S. personnel! . . . . It was proven back then that abolishing the 911 exemption *cost* money: it didn't gain a dime. Have we learned nothing from experience?"

Having Americans overseas is not just helpful, it is *essential.* In effect, taxation of foreign earned income amounts to a shortsighted, indirect *tax on U.S. exports and American culture.* This is a debilitating and entirely self-inflicted wound -- a policy which discriminates against America's companies, U.S. workers, and American educational institutions abroad.

Tax Policy Implications of Section 911

The concept of a foreign earned income exclusion has been part of U.S. tax law for nearly 70 years. During that time, the exclusion has undergone a number of configurations. The debate over whether to increase Section 911, decrease Section 911, or maintain it at current levels centers on an evaluation of basic tax policy rationale for such an exclusion. In a study in progress for the Section 911 Coalition, Price Waterhouse is analyzing the tax policy implications of the foreign earned income exclusion. **Price Waterhouse's preliminary results suggest that the traditional standards for evaluating income tax provisions -- fairness and economic efficiency -- justify exclusion of the portion of foreign earned income attributable to the additional costs of living abroad. The Section 911 exclusion is an approximate method for meeting the equity and efficiency standards and also satisfies a third tax policy objective: simplicity.**

Fairness -- Price Waterhouse notes that the concept of "ability to pay" taxes is inherently subjective, but that it has generally been recognized that an individual's costs associated with earning income reduce the ability to pay taxes and should be deducted. By this logic, individuals on international assignment should not be taxed on that part of their compensation which reasonably reflects the added costs of working abroad (extra housing costs, the education of children, home leave, cost-of-living adjustments, etc.).

Economic Efficiency -- This standard dictates that the tax law not interfere with the efficient allocation of resources. Economic efficiency suggests that in foreign markets, American workers should be allowed to compete according to prevailing rules. Absent Section 911, Price Waterhouse suggests, the tax law would frequently discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred.

Simplicity -- By all accounts, the Section 911 exclusion simplifies deductions revolving around doing business overseas, especially when compared to the 1978 rules that the current exclusion replaced.

Three additional tax policy standards are often used to evaluate U.S. tax provisions that affect international income: competitiveness, harmonization, and protection of the U.S. tax base. Once again, Price Waterhouse has found that the Section 911 exclusion clearly meets these standards.

International competitiveness -- This standard requires that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets. Price Waterhouse notes that for Americans abroad,

"the competitiveness standard would be achieved if the United States excluded all foreign earned income without the $70,000 limitation in present law. In this way, Americans working abroad would be subject only to foreign income taxes on their foreign earned income in exactly the same manner as foreign workers are taxed."

Harmonization -- Price Waterhouse points out that Section 911 provides a "glaring example of the failure on the part of the United States to harmonize with international tax practice. As noted by the General Accounting Office, the United States is the only major industrial power that taxes its individuals on the basis of citizenship rather than residence. In today's global economy . . . the failure of the United States to harmonize the tax treatment of expatriate workers means that U.S. citizens are more expensive to employ abroad than citizens of many other industrial nations. In summary, the principle of tax harmonization strongly argues for complete exclusion of foreign earned income" as was the case in the United States during the period 1926 - 1952.

Protecting the U.S. Tax Base -- This standard is intended to prevent U.S. source income from escaping the income tax net. The Section 911 exclusion does not undermine the U.S. tax base because the exclusion has been carefully designed to prevent U.S. source income from escaping U.S. taxation.

In summary, according to Price Waterhouse, "an unlimited foreign earned income exclusion would be consistent with the international tax policy standards of competitiveness, preservation of the U.S. tax base, and harmonization. Thus it would be appropriate to lift the $70,000 cap on the foreign earned income exclusion to better achieve these tax policy objectives."[19]

<u>Conclusion: Increasing Section 911 = Increasing Business</u>

In recent months, Mr. Chairman, a handful of Congressmen have suggested eliminating the foreign earned income exclusion in an effort to curb America's budget deficit. The Section 911 Coalition certainly supports all reasoned and realistic efforts to reduce this deficit, but we submit that it would be penny-wise and pound-foolish to scale back Section 911, a key incentive that enhances U.S. business competitiveness and permits more Americans to work abroad. Even by the most conservative estimates, reducing Section 911 would jeopardize tens of thousands of American jobs, seriously weaken America's export position, and ultimately ***add*** to the nation's deficit.

As the Coalition noted at the outset of today's remarks, **Americans Abroad = U.S. Exports = U.S. Jobs.** Perhaps more than any other provision of law, Section 911 helps to put U.S. citizens "in the field" around the world where they *buy* American, *sell* American, *specify* American, *hire* American, and *create opportunities* for other Americans. As such, Section 911 has a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets -- a substantial growth area for the United States now and as we move into the twenty-first century.

To help place America on an equal footing with our trade competitors, the Section 911 Coalition supports the *interim* step that you have proposed, Mr. Chairman, in introducing H.R. 57 -- effectively restoring that portion of the exclusion that has been lost to inflation over the years and indexing against future inflationary losses. From our experience, increasing the exclusion to $100,000 will not make American workers and companies as competitive as would an *unlimited* exclusion, but it certainly is an important step in the right direction. American jobs are on the line Mr. Chairman, especially for small and medium-sized businesses, and we look forward to an opportunity to work with the Ways and Means Committee on this important piece of legislation.

# # #

Endnotes

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Aerospace Industries Association

Statement for the Record

House Ways and Means Committee

July 24, 1995

Mr. Chairman and members of the committee, thank you for providing us the opportunity to present our views on the repeal of section 923(a)(5) of the Internal Revenue Code.

The Aerospace Industries Association is the nonprofit trade association representing the nation's manufacturers of commercial, military, and business aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment.

The aerospace industry is one of the strongest exporting industries in the United States. It produced a $25 billion positive balance of trade in 1994, and is highly labor intensive and relies on highly technical manufacturing skills. For every $1 billion in aerospace sales, 18,238 direct and indirect jobs are created.

Section 923(a)(5) of the Internal Revenue Code prevents aerospace companies from competing as effectively as they could in foreign markets. That provision reduces the benefits available to companies that sell military goods abroad to 50 percent of the benefits available to other exporters. This provision is inconsistent with the purposes of encouraging economic recovery and foreign commerce and should be repealed.

<u>**History of Tax Law**</u>

Code section 923(a)(5) is part of the Foreign Sales Corporation or "FSC" provisions. To understand why Code section 923(a)(5) should be repealed, it is helpful to review briefly the historical context in which the FSC provisions were enacted. The genesis of the FSC was the Domestic International Sales Corporation or "DISC".

Congress enacted the DISC provisions in 1971 to help offset what was deemed a competitive disadvantage faced by U.S. exporters because of the differing nature of European and U.S. tax structures. By removing the bias in our tax system, we could keep our companies competitive with those in other countries and thereby reduce our balance-of-payment difficulties. Many countries gave exporters tax relief from value added and other indirect taxes. The DISC provisions were intended to stimulate exports by granting a Federal income tax deferral opportunity to United States firms engaged in exporting through domestic corporations. H.R. Report No. 533, 92nd Cong., 1st Sess. 58(1971). The advantage of exporting goods through a DISC was that a DISC was not subject to federal income tax on its earnings. Instead, the DISC's parent company was taxed each year on part of the DISC's earnings as if the parent company had received a dividend from the DISC. The DISC's remaining earnings were not taxed until actually distributed to the parent company. Until 1976, up to 50 percent of the DISC's annual export profits could be deferred in this manner, including profits from the sale of military products.

Almost since its inception, however, the DISC program was the subject of a dispute between the United States and other signatories of the General Agreement on Tariffs and Trade ("GATT"). Some countries contended that the DISC provisions essentially created an illegal export subsidy that violated the GATT.

In part as a response to these criticisms, Congress reduced DISC benefits in the Tax Reform Act of 1976. First, Congress changed the tax rules in such a way that less than 25 percent, rather than 50 percent, of a corporations earnings from exports could be deferred from U.S. taxation. Second, DISC benefits for the sale of military products were cut back. The House originally proposed to terminate all DISC benefits for military sales, except if the products were to be used solely for nonmilitary purposes. The Senate recommended that all DISC benefits be terminated for military sales unless it was determined that the property was competitive with foreign-manufactured property.

The compromise reached by the Joint Committee was that DISC benefits would be terminated for 50 percent of military sales (whether or not competitive) made after October 2, 1975. H.R. Report 1515, 94th Congress, 2d Sess. 473(1976). "Military property" for this purpose was defined very broadly to include any property listed in the munitions list published pursuant to the Military Security Act of 1954 and now contained in 22 U.S.C. §2778. Military property includes any article that is inherently military in character without regard to its intended use such as, communications satellites and their components, launch vehicles, and many aircraft and their components.

The DISC dispute remained a serious irritant in U.S. trade relations with other countries, particularly the European Economic Community. Thus, the United States informed the GATT Council in October 1982, that it would propose to Congress legislation that would address the concerns of its trading partners over the DISC program. In March 1983, the administration announced the general elements of an alternative to the DISC program. Legislation on the proposed alternative was introduced in Congress on August 4, 1983, to replace DISC's (with limited exceptions) with Foreign Sales Corporations. The FSC provisions were signed into law on July 18, 1984, as part of the Deficit Reduction Act of 1984.

The FSC provisions are similar to the DISC provisions in that they were designed to encourage exports by allowing exporters to exempt a percentage of export income from taxation. FSC benefits are provided for property manufactured or produced in the United States. The exemption on the sale of military goods, again, is half the amount otherwise allowed for other types of property. The legislative history makes it clear that this special rule for military property was simply a carryover from the DISC provisions. H. Report No. 681, 98th Cong., 2d Sess. 976 (1984).

<u>**Reasons for Change**</u>

To Summarize, this brief review of the history of Code section 923(a)(5) indicates that the only reason the provision was enacted was the premise that military products were not sold in a competitive market. While this may have been true 19 years ago when U.S. military technology was superior to that of other countries, today the international market environment has changed drastically. U.S. aerospace companies compete directly with foreign manufacturers, many of which are subsidized by their governments, or even directly with foreign governments.

For example, five companies are competing for the sale of 80 deep strike aircraft for approximately $7 billion to the United Arab Emirates; Lockheed Martin from the United States, Dassault from France, the European Community and a company from Russia. Norway is another potential venue for a US-European fighter contest. Lockheed Martin is also competing with Dassault and BAE from the UK for a sale to the UK of a replacement maritime control aircraft with a potential value of $3 billion. As cuts are made to the U.S. defense budget, it becomes increasingly important for aerospace companies to turn their attention to foreign markets in order to retain or increase employment in the U.S. and to preserve the skills and facilities necessary for a viable defense industrial base. Failure to retain this highly skilled work force would impair the industry's ability to develop the next generation of leading-edge weapon systems and could cause the U.S. to lose its technological preeminence.

The repeal of Code section 923(a)(5) would put aerospace companies in a more level playing field with other competitors, not only with respect to military products, but also with respect to commercial products. This is because companies that have developed skills and expertise by producing goods for military use are most likely to use that skill and expertise in commercial markets by developing new uses for military products or close derivatives from those products. Since the FSC provisions rely on a definition of military products that focuses upon the source of the product's development and its potential use, but not upon the actual intended use, a significant portion of all products currently produced by the aerospace industry will be subject to the 50 percent FSC limitation under current law even if these products or close derivatives are exported for strictly commercial purposes.

It should be emphasized at this point, that the repeal of section 923(a)(5) will not result in the loss of control by the U.S. Government over the export of property that has potential military application. Whether a product with potential military use could be exported would remain subject to the Arms Export Control Act 22 U.S.C. §2778, 22 C.F.R. 120-128. The full FSC export incentive would be provided only on military-product exports approved by the State Department.

Moreover, when a U.S. company supplies military equipment, it usually continues to have an influence over the use of the equipment. For example, the purchaser may be dependent on the U.S. manufacturer for training, spare parts, and upgrades. Particularly in a developing country, the U.S. manufacturer may even be responsible for maintaining operations. If necessary, U.S. support quickly could be reduced in response to changing circumstances.

Recommendation

The AIA recommends that Internal Revenue Code section 923(a)(5) be repealed.

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July 26, 1995

The Honorable Bill Archer
Chairman
House Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

I am writing in support of a proposal to include computer software as foreign sales corporation (FSC) export property that was considered as part of the Ways and Means Committee hearings on miscellaneous tax reforms, July 11-13, 1995. I respectfully request that this letter be included in the hearing record.

The American Electronics Association (AEA), which includes more than 600 software companies in its membership, strongly supports a legislative proposal that would make clear that exports of software are not denied the FSC benefits available to other exports. Specifically, we support a proposal to amend the FSC rules to make clear that exports of software qualify for FSC benefits even when accompanied by a right to reproduce.

Computer software includes both the system software and applications software that enable computers to perform faster and more varied functions. Today, the United States is the world leader in software development and employs over 400,000 people in the United States in high-paying software development and servicing jobs.

Congress enacted the FSC rules to encourage exports. However, due to a narrow IRS interpretation of the rules, the export of computer software that is accompanied by a right to reproduce the software is barred from receiving this export benefit. This narrow interpretation has the effect of denying FSC benefits to most software exporters because it ignores the way the software industry does business and how information technology is and will continue to be transmitted in the future.

Like other U.S. exporters, the software industry needs FSC benefits to remain competitive. FSC benefits also encourage small and medium-sized companies to enter the export market by helping them to equalize the cost of exporting. Thus, FSC benefits are extremely important to our smaller software members that are hoping to enter the export market.

We cannot emphasize enough that the failure to permit exports of computer software to qualify for FSC treatment is counterproductive and inconsistent with the U.S. interest in fostering the continued growth of this industry in the United States. In addition, there is no tax policy reason for denying exporters of software the tax benefits of the FSC rules that are available to other U.S. exporters and in particular the film and record industries, which operate in a similar manner. We respectfully request that Congress enact legislation which would clarify that the definition of FSC export property include the license of computer software to foreign distributors and customers with the right to reproduce.

Sincerely,

William T. Archey
President and CEO
American Electronics Association

STATEMENT
on
INCLUSION OF COMPUTER SOFTWARE AS
FOREIGN SALES CORPORATION EXPORT PROPERTY
before the
HOUSE COMMITTEE ON WAYS AND MEANS
as part of their hearings on
MISCELLANEOUS TAX REFORMS
on
July 11-13, 1995
on behalf of
The FSC Software Coalition

The Foreign Sales Corporation Software Coalition is comprised of all of the major trade associations representing the software industry, including the American Electronics Association (which includes more than 600 software companies in its membership), the Business Software Alliance (which includes nine of the leading business software publishers in its membership, the Information Technology Association of America (which includes more than 6,000 direct and affiliated information technology companies in its membership), and the Software Publishers Association (which includes more than 1,200 software companies in its membership). In addition, the leaders of the software industry are members of the coalition, including Autodesk; BMC Software, Inc.; Borland; Cadence; Cheyenne Software, Inc.; Computer Associates International, Inc.; Comshare; Lotus Development Corporation; Micrografx; Microsoft; Novell; Oracle Corporation; Parc Place Systems, Inc.; and Sybase, Inc. The FSC Software Coalition supports a legislative proposal that would make clear that exports of software are not denied the foreign sales corporation (FSC) benefits available to other exports. Specifically, the coalition supports a proposal to amend the FSC rules to make clear that exports of software qualify for FSC benefits even when accompanied by a right to reproduce.

High technology industries are important to the future economic strength of the United States. In the 1980's, the high technology industry focused on advancements in hardware. In the past few years, however, attention has turned to software. Computer software includes both the system software and applications software that enable the computers to perform faster and more varied functions. Today, the United States is the world leader in software development and employs more than 400,000 people in the United States in high-paying software development and servicing jobs. To stimulate the creation of more of these high-paying software industry jobs in the United States, the Commerce Department has been encouraging software companies to export. The Commerce Department estimates that every $1 billion of export trade is worth 19,000 domestic jobs.

Unfortunately, the IRS has taken a position in direct conflict with the Administration's position to encourage software companies to export. The tax code, through the FSC rules, currently allows a benefit for U.S. exporters of goods developed in the United States. The Congress enacted the FSC rules to encourage exports. However, due to a narrow IRS interpretation of the FSC rules the export of computer software that is accompanied by a right to reproduce the software is barred from receiving this export incentive. This interpretation appears to unfairly discriminate against exports of software since master recording tapes for reproduction outside the United States are not denied FSC benefits; it has the effect of denying FSC benefits to most software exporters because it ignores the way the software industry does business and how information technology is and will be transmitted in the future.

Computer software is an important and growing U.S. export. Congress should clarify that the FSC rules apply to exports of computer software, whether or not accompanied by a right to reproduce.

<u>**Contributions of the Computer Software Industry**</u>

The computer software industry makes significant contributions to the U.S. economy.

1. The computer software industry in the United States employs thousands of highly-skilled and highly-paid computer programmers to develop the computer software that is its

product. These high-wage, high-skilled jobs are the type of jobs that Congress and the Administration have emphasized they want to encourage through their economic policies.

2. The computer software industry in the United States invests heavily in research and development to create new products for its markets. This helps both to create new technologies and advance existing technologies, resulting in the United States being a world leader in the development of new technologies.

3. The software industry in the United States produces a product that is in high demand both in the United States and abroad. The demand for U.S. developed software outside the United States has led to a surge in the exports of U.S. software. These exports reduce the trade deficit of the United States and help expand the markets for American-made goods, resulting in more high-paying jobs for computer software programmers and others in the United States.

The computer software industry in the United States is currently a world leader in its industry. However, like other U.S. exporters, the software industry needs the FSC benefits to remain competitive. The FSC benefits also encourage small and medium-sized software companies to enter the export market, by helping them to equalize the cost of exporting. However, many foreign governments have realized the importance of the computer software industry today and in the future. These foreign governments are actively working to attract computer software developers to their countries by offering various incentives. If the efforts of these foreign governments are successful they will:

- take away the high paying jobs of U.S. workers,

- replace the United States as a leader in an important industry in the future, and

- transform an industry that produces a trade surplus for the United States into another industry the products of which we import from foreign manufacturers.

<u>How the Computer Software Industry Conducts Business</u>

Computer software programmers conduct research and development activities in the United States for the development of software products. These software programmers are highly-skilled and highly-paid employees who add significant value to the computer software product. The U.S. company licenses the software to customers in the United States and in foreign countries.

A U.S. company that markets its computer software usually licenses a master of the computer software to foreign subsidiaries, third party distributors, original equipment manufacturers (OEMs) and value-added resellers (VARs). The distributors may translate the software into the language of the local country and reproduce it for license to customers in that country. In addition, software may be licensed through OEMs who install the software on their hardware and sell the bundled package of software and hardware. In other cases, software may be licensed to VARs, who add their own software product to the purchased software and then reproduce the combined product for sale. These are all important distribution networks for exports of software and greatly enhance the exports of U.S. software. Because software programs are constantly evolving, large inventories of software are not maintained. Rather, distributors, OEMs and VARs often make individual copies of the computer software as needed.

Computer software manufacturers are increasingly entering into "site licenses" with some of their larger customers. A site license is the licensing of a master tape of the computer software directly to the customer. The customer may then make hundreds or thousands of individual copies of the master tape as required by its various employees and locations. Large foreign companies often prefer to do business with local corporations (i.e., foreign subsidiaries of U.S. companies). In these instances, the U.S. company will transfer the master to a foreign subsidiary that will enter into the site license with the foreign customer.

<u>Discussion</u>

In 1971, Congress enacted the Domestic International Sales Corporation (DISC) legislation to encourage the exportation of U.S. manufactured goods in order to help U.S. companies compete

in overseas markets and so improve the nation's balance of payments. Additionally, by encouraging the export of U.S. manufactured goods Congress hoped to keep high paying manufacturing jobs in the United States as well as create new manufacturing jobs. In 1984, the DISC provisions were replaced by the FSC rules. The FSC rules had the same purpose as the DISC rules, but eliminated some of the provisions in the DISC rules that our trading partners found objectionable.

Under the FSC provisions, the export of certain intangibles are not eligible for FSC benefits. Section 927(a)(2)(B). Specifically excluded are "patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property." This language is identical to the language contained in the DISC statute written in 1971 (see section 993)(c)(2)(B)). Neither the statute nor the legislative history contain any language that specifically precludes the application of the DISC or FSC to software. The legislative history to the FSC provisions provides no explanation of this section of the bill. The legislative history to the DISC provides only the following explanation of this section of the bill.

> Although generally, the sale or license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts. House Report No. 92-533, 92nd Cong., 1st Sess. 69 (1971), 1972-1 C.B. 498, 535; Senate Report No. 92-437, 92nd Cong., 1st Sess. 102 (1971), 1972-1 C.B. 559, 616.

Treasury regulations interpreting the DISC rely on this legislative history in providing that a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property. The regulations also state that a license of a master recording tape for reproduction outside the United States is qualified export property.

> Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, trade brand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property. Reg. §1.993-3(f)(3).

The eligibility of computer software for DISC export benefits was first questioned in 1985 when the IRS National Office was requested to provide technical advice on whether so-called "box top" or "shrink-wrap" computer software sold or leased outside the United States on a mass market basis qualified for DISC benefits. In Technical Advice Memorandum 8549003, the IRS stated:

> The "films, tapes records, or similar reproductions" language of section 993(c)(2)(B) is not limited as to subject matter. <u>Since copyrighted computer software is marked on magnetic tapes for commercial use, such tapes seem to specifically qualify based on the Code language</u>. However, it is unclear whether Congress intended this provision to apply to other than entertainment industry tapes. Based upon the earlier drafts of section 993(c)(2)(B), it could be argued that Congress intended qualification for only tapes that are like films or records, i.e., videotapes or musical tapes. See H.R. 18392, 91st Cong., 2d Sess. (1970) and H.R. 18970, 91st Cong. 2d Sess. (1970), in which the proposed version of the parenthetical exception of finally enacted section 993(c)(2)(B) only applied to films and tapes produced by the entertainment industry. However, one could also argue that since the finally enacted provision does not seem to be solely limited to the entertainment industry, such provision should not be interpreted in a restrictive manner. [Emphasis added].

Without concluding whether computer software on magnetic tape was meant to be within the parenthetical exception to section 933(c)(2)(B), the IRS concluded that the software in issue was eligible for DISC benefits because the provisions seemed to include as export property finished products or inventory items.

In a later technical advice memorandum, the IRS more decisively reached the conclusion that the parenthetical exception in section 993(c)(2)(B) did not seem to be limited to the entertainment industry, and , therefore, the provision should not be interpreted in a restrictive manner. However, in ruling that the computer program tapes in this case, which were produced in the United States and sold or licensed outside the United States on a mass market basis, were qualified property, the IRS relied on the regulations under the DISC rules, which permitted copyrighted books to qualify for DISC. (TAM 8652001)

Although it seems clear that computer program tapes qualify as "tapes" under sections 933(c)(2)(B) and 927(a)(2)(B), the phrase "similar reproductions" also is broad enough to include the licensing of computer software. This is because the production of a master computer software tape, the medium and the manner in which it is reproduced and distributed is very similar to the manner in which the entertainment industry distributes its product to the market. For example, it is common for both films and software master tapes to be exported to distributors who will translate the tape into the local language and reproduce it for distribution in that country. Additionally, more music and software are reproduced on compact disks, using almost identical equipment and production processes. Furthermore, the direction the technology is taking is that distribution of films, tapes, records, videos, software and any other type of digital information will be by electronic impulse rather than by shipping copies. Finally, the explosion of entertainment software onto the market provides strong evidence for consistent treatment. Thus, the language chosen by Congress for the parenthetical exception was intended to be broad enough to encompass exports, like computer software, that are exported in the same manner as films and records.

Despite these IRS opinions and the broad language of the statute, the temporary FSC regulations issued in 1987, interpreting language identical to that interpreted by these opinions, adopted a narrow interpretation of the parenthetical exception that the IRS interprets as denying any FSC benefits for the license of computer software if the license is accompanied by the right to reproduce the computer software. (TAM 9344002).

The FSC regulations substantially parallel the DISC regulations. However, regulation writers in 1987, now cognizant of the existence of the software industry, decided to specifically address software in regulations promulgated under FSC. The regulations writers made a determination to treat mass marketed computer software as a copyrighted article that is eligible for FSC benefits. They also made a decision not to treat a license of a software program for reproduction outside the United States like a master recording tape, which is also eligible for FSC benefits. In these regulations, the IRS effectively narrowed the scope of property eligible for FSC benefits to exclude a major portion of software exports -- licenses of computer software with the right to reproduce. Temporary Regulation §1.927(a)-1T(f)(3), which defines intangible property that is excluded from the definition of FSC export property, states:

> Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, trade brand, franchise, or other like property Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property Temp. Reg. § 1.927(a)-1T(f)(3). [Emphasis Added]

IRS effectively narrowed the scope of property eligible for FSC benefits to exclude a license of computer software with the right to reproduce.

The narrowing of the definition of export property to exclude computer software licenses that permit reproduction of the software has no basis in the statute or legislative history to the DISC or FSC rules, but was based on an administrative decision by the FSC regulation writers at the IRS that computer program tapes were neither "tapes" nor "similar reproductions" within the meaning of the statute. Despite the fact that the legislative history provides no basis for limiting these terms within section 927(a)(2)(B)'s parenthetical to the entertainment industry, the IRS regulation writers made a decision to do so. Not only does this ignore the way that

software is exported, it ignores the similarities between the film, record and computer software industries. The future direction, driven by technology, is that digital information, whether it be music, video, or computer software will all be transmitted in the same way. No logical distinction has ever been made between the two industries because there is none.

Congress' statute, specifically allowing for "similar reproductions" to qualify for DISC and FSC treatment, recognized the need for the legislation to address developing industries and means of doing business. The IRS regulations do not. The IRS' position for taking such a narrow view in their regulations is that computer software was not specifically mentioned in the FSC statute. But the FSC provision in this area is identical to the DISC provision in this area that was written in 1971 when software was in its infancy. We believe that the administrative decision not to treat software like recordings in the FSC regulations because software was not specifically mentioned in the 1971 DISC statute or regulations is incorrect.

The software industry is seeking a legislative clarification that exports of software, whether or not accompanied by a right to reproduce and whether or not patented, are eligible for FSC benefits. We believe this reflects Congress' original intent in enacting the FSC rules. We do not believe that Congress in enacting the FSC rules intended to provide a benefit to the entertainment industry but not to the software industry, which manufacturers and distributes its product in a similar manner. The industry believes that the regulations are invalid and will litigate their position, but we believe it will save both taxpayers and government time and money if this issue is clarified so that protracted and costly litigation can be avoided.

Summary

The computer software industry is important to the economy of the United States today and in the future. The computer software industry creates high-paying jobs in the United States, helps the United States to maintain its position as a world leader in the high technology field and is a large and growing source of U.S. exports, the revenue from which reduces the U.S. trade deficit. The failure to permit exports of computer software to qualify for FSC treatment is counterproductive and inconsistent with the U.S. interest in fostering the continued growth of this industry in the United States. In addition, there is no tax policy reason for denying exports of software the tax benefits of the FSC rules that are available to other U.S. exporters and in particular the film and record industries, which operate in a similar manner to reproduce and distribute similar products. There is a need for Congress to clarify the original intent of the DISC and FSC legislation to encourage U.S. exports, including software, in light of the Treasury Department's temporary FSC regulations and the IRS' subsequent interpretation of those regulations. Therefore, we respectfully request that Congress enact legislation that would clarify that the definition of FSC export property includes the license of computer software to foreign distributors and customers with the right to reproduce.

Statement of

Harris N. Miller
President
The Information Technology Association of America

Comments for the Record
In Connection with Hearings on Miscellaneous Tax Reforms

on
Inclusion of Computer Software As Foreign Sales Corporation Export Property

July 11 and July 12, 1995

On behalf of the Information Technology Association of America (ITAA), I would like to compliment Chairman Archer and the Committee on Ways and Means for addressing many ways to simplify and improve the current tax laws at the same time the Committee continues to pursue alternatives for fundamental reform of the nation's tax system.

The Information Technology Association of America is the leading trade association for our nation's computer software and services industry. ITAA's more than 6,700 direct and affiliated member companies provide business application and systems software for mainframe, midrange, and personal computers; custom and contract software programming services; information systems integration services; and information processing services.

ITAA supports passage of the proposal that would clarify that exports of software are eligible for foreign sales corporation (FSC) benefits, whether or not they are accompanied by a right to reproduce.

The U.S. information technology industry was the fastest growing major industry in the U.S. during the last decade and now contributes some $40 billion annually in value added to the economy. The industry has created thousands of high-paying, high-skill jobs in this country and has helped U.S. companies in other industries modernize, increase productivity, and compete more effectively both here and overseas.

Currently, the United States is the world leader in information technology development. Recognizing this, foreign governments actively solicit U.S. software companies to move their high paying software development jobs overseas. Providing FSC benefits to U.S. exporters of software will provide an incentive for retaining those jobs in the U.S. by helping to offset the costs of exporting.

To encourage exports of U.S. manufactured goods and assist businesses in competing with products made in other countries which have more favorable rules for taxing exports, Congress enacted the Domestic International Sales Corporation (DISC) rules, later augmented by the Foreign Sales Corporation (FSC) rules. The FSC legislation provides U.S. businesses with a partial tax exemption for income derived from the sale or lease of export property outside the U.S.

Under the statute, copyrighted films, tapes, records or similar reproductions qualify as export property and are therefore eligible for FSC benefits. The language does not restrict the particular content of the copyrighted intangible. However, due to an excessively narrow interpretation of the FSC rules by the Internal Revenue Service (IRS)(see Temp. Reg. Sec. 1.927(a)-1T(f)(3)), the export of software accompanied by the right to reproduce is prevented from receiving this export incentive. At the same time, the regulation provides this benefit to the export of motion picture films and master recordings even when they can be reproduced overseas.

This excessively narrow definition of export property has no basis in statute or legislative history. The software industry is exactly the kind of industry Congress wanted to assist when it enacted the FSC benefits. U.S. software companies do the majority of their software development work in the U.S. and employ over 400,000 people. The expansion of the industry is due in large part to the growth of its export market.

What is even more frustrating to us about the Treasury's narrow regulatory interpretation is that the statutory language, specifically allowing for "similar reproductions" to qualify for FSC treatment, recognized the need for the legislation to address developing industries and means of doing business.

The IRS' position for taking such a narrow view in their regulations is that computer software was not specifically mentioned in the FSC statute. However, when the DISC and FSC rules were developed, the issue of whether software qualified for the benefits was not raised because, to the extent that software was exported, it was bundled with computer hardware and included in the cost of the hardware. Therefore, computer manufacturers were eligible to receive the benefits on the sale of the bundled products. However, the way software is distributed has changed.

To be competitive in the global marketplace software developers often need to license their products with rights of reproduction. U.S. software companies often sell to foreign manufacturers which place software in their hardware and resell the combined product. They sell to value-added resellers who add their own software product and reproduce the combined product for sale. Perhaps most importantly, the ability to translate software to the local language is essential. In each of these instances, the right to reproduce the software must be provided to the foreign licensee.

The IRS regulations also ignore the similarities between the film, record and software industries. Software companies license their intellectual property. The terms of the license typically require that the licensee make payments based on the number of times the copyrighted software is reproduced and used (sublicensed) outside the U.S. This is not materially different from exporting the license to a movie or musical recording. Much of the software produced today is entertainment oriented. And, like films, computer data bases and programs may be embodied in tapes or disks. Today, CD ROM technology makes computer software virtually indistinguishable from a reproduction of a movie or recording. Even the significance of CD technology is beginning to fade, because in the future software and movies will be transferred through information highways --telephone lines, cablevision systems and wireless networks. Indeed, with the advent of multimedia products, software, films and recordings often are merged into one medium.

The narrow interpretation of the FSC rules by the IRS as it relates to software exports poses an impediment to the competitiveness of the U.S. software industry, the very exports the Administration otherwise encourages. Congress intended to remove this obstacle from U.S. manufactured goods when the FSC rules were adopted. Denying the FSC benefit to software is both economically counterproductive and inconsistent with the U.S. interest in encouraging the continued growth and leadership of this nation's software industry.

Extending FSC benefits to U.S. computer software manufacturers will enable them to continue to compete effectively in foreign markets and will assist the U.S. in maintaining its dominant position in this important industry.

ITAA and other members of the FSC coalition have met with Treasury officials on numerous occasions to discuss the need for changing the regulations. In addition, the coalition has convinced Secretary of Commerce Ronald Brown and over 100 members of Congress to write to Treasury urging modification of the regulations. Despite this broad support for amending the regulations, Treasury has declined to take action.

Although we believe that the problem created for software exports by the Treasury regulations can most easily be resolved by amending the regulation, we are concerned that the Department has taken no action on these regulations for six years. For these reasons, the software industry supports the enactment of legislation that would clarify that the definition of FSC export property includes the license of computer software to foreign customers and distributors with the right to reproduce.

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STATEMENT OF THE SOFTWARE PUBLISHERS ASSOCIATION (SPA)

Since 1971, the Congress has followed a policy of encouraging the export of U.S. products through special tax incentives. Beginning in that year, Congress enacted the Domestic International Sales Corporation (DISC) provisions. The policy was reaffirmed in 1984 when the DISC rules were updated with the Foreign Sales Corporation provisions. The revised rules were designed to bring U.S. export incentives into compliance with the General Agreement on Tariffs and Trade. Both the DISC and FSC export incentives work by exempting from U.S. income taxation a portion of the income earned by U.S. companies from the export of U.S. made products.

Encouraging U.S. personal computer software exports is important to our economy. However, due to erroneous regulations issued by the Treasury Department and administered by the Internal Revenue Service, certain types of U.S. developed computer software has been disqualified as export property eligible for the partial tax exemption allowed by the Foreign Sales Corporation (FSC) provisions. The Software Publishers Association supports the miscellaneous revenue proposals that would clarify the existing statutory definitions of "export property" for purposes of the FSC provisions to make it clear that exports of personal computer software are eligible for FSC benefits.

1. The Software Publishers Association.

The Software Publishers Association is the principal trade association for the PC software industry. Since 1984, it has grown to over 1170 members, representing the leading publishers in the business, consumer, and education software market sectors. The U.S. software industry accounts for 75% of the global market for PC software sales. The economic success of the software industry is, we believe, essential to the international competitiveness of the United States. In 1993, U.S. software industry had international sales of over $4.5 billion.

2. Characteristics of the Software Industry.

The U.S. personal computer software industry is characterized by three qualities that are particularly relevant to this issue: (1) it employs large numbers of highly skilled, highly paid workers, (2) it invests heavily in research and development of new products, and (3) it has exhibited high growth in exports of U.S. developed software. These three qualities justify clarification of the FSC statutory scheme to insure that the growth in exports continues, to offset other disincentives to export, and to offset incentives to locate development overseas.

First, there is no question but that the software industry has exhibited growth in its employment of highly skilled, high paying jobs. According to statistics developed by the U.S. Department of Commerce and the WEFA Group, in 1987, the software industry employed approximately 55,000 workers. By 1993, that number had nearly doubled to almost 100,000 workers. The annual rate of growth was 10.5 percent over the period. No other industry studied exhibited the level of growth exhibited by the software industry. Over the period, auto industry employment declined at an annual rate of 3.4 percent. The recorded music industry posted an anemic employment growth rate of 0.1 percent.

The same is true of the wages earned by those employed in the software industry. In 1992, the average compensation per employee in the software industry was over $55,000. Compensation grew an annual rate of 8.4 percent from 1987 to 1992. Auto industry compensation grew at the annual rate of only 4.6 percent, while the motion picture industry wages grew at the rate of only 0.7 percent. Total software industry payroll grew an at annual rate of over 20 percent from 1987 to 1992, going from a little over $2 billion to over $5 billion. By contrast, the recorded music industry grew at the rate of only 4 percent, going from $266 million to $328 million. The motion picture industry payroll grew at the relatively lackluster rate of 7.7 percent.

The success of the software industry, and its growth of high paying, high-skill jobs is attributable to its heavy investment in research and development of new products. Approximately 85 percent of the products sold by U.S. software companies are developed in-house. At the typical U.S. software company, the

largest department, in terms of number of employees, is the research and development department. U.S. software companies spend approximately 15 percent of their revenue on R & D, with half of R & D expenditures going to salaries and benefits for employees. Only by maintaining high levels of R & D spending can U.S. software companies retain their global technological leadership.

3. **Description of Foreign Sales Corporation Provisions and Treasury Interpretation**

Generally, a Foreign Sales Corporation (FSC) is a foreign company that maintains an office outside the United States

In order to correct the Treasury's erroneous regulations, Section 927(a)(2)(B) needs to be amended to clarify that exports of computer software, accompanied by a right to reproduce, qualify as FSC export property. This statutory change will invalidate the provisions of Temp. Treas. Reg. 1.927(a)-T(f)(3) denying export qualifications for the software exports. The provisions of the Temporary Regulation unduly restrict the definition of "export property" found in the statute. In addition, the erroneous Regulation has led to an administrative interpretation that reaches incorrect conclusions. Specifically, the Regulation interprets the statute as excluding from the definition of export property copyrighted computer software which is exported with a right of reproduction.

The temporary regulation provides that licenses for copyrighted computer software do qualify as export property so long as the licenses are not accompanied by a right to reproduce. In addition, the temporary regulation infers that only standardized, mass-marketed computer software qualifies as export property. There is no basis in the statute to impose such further limitations on the definition computer software as export property.

Also, a recent Technical Advice Memorandum (TAM 9344002, May 27, 1993), concludes that the term "tapes" used in the parenthetical exception in the Regulation refers to audio or video tapes used in the entertainment industry and

does not apply to the computer software industry. It is because of erroneous interpretation like the one contained in the 1993 TAM that it is imperative the FSC statute be amended to nullify these regulatory provisions.

4. **Description of Software Industry Business Practices.**

Personal computer software is a unique product from the standpoint of distribution. Possession of a single copy of a software product confers upon the possessor the ability (but not the right) to make quickly and cheaply as many perfect copies of the software as he or she desires. In short, possession of a copy of software gives the possessor the theoretical ability to manufacture the software. Of course, only the company that developed the software has any investment in the product. Putting issues of sales and marketing expense aside, the cost of making the first copy of the software is enormous, while the marginal cost of making the second and subsequent copies is negligible. Many times, in order to reduce distribution and manufacturing costs, a software company will license a big customer to use a large number of copies of its software, provide a single copy, and authorize the customer to make the requisite number of copies. Business is conducted in much the same way with computer hardware distributors who sell their products with popular software preloaded. The hardware seller will enter into an agreement with the developer of the software to resell the software loaded onto the hardware seller's computer. The hardware seller will periodically remit a royalty based on the number of computers sold with the developer's software. Problems of inventory shortages or overstock are eliminated because the hardware seller needs to maintain no inventory. Customers benefit because the cost of the software product is reduced.

In order to facilitate exports, most software companies utilize these advantages afforded by the unique nature of software. They enter into an arrangement with a foreign software distributor and transfer a master copy of the software to that distributor. The agreements between the U.S. developer and the foreign distributor allow reproduction of as many copies of the software as the foreign market demands. This method of distribution allows the U.S. developer and foreign distributor to have access to the latest version of the software

without the costs associated with recalling obsolete inventory and shipping new versions.

The software industry is not the only industry to make use of this type of distribution method. The recorded music and motion picture industries, because their products also are easy to reproduce, also transfer master copies of their works to their foreign distributors along with an agreement for the foreign distributor to make sufficient copies to satisfy the foreign market. As with computer software, the cost of making the first copy is enormous while the cost of making the each subsequent copy is negligible. In the case of motion pictures, cast and crew must be hired, scripts must be written, the movie must be produced and edited. In comparison, the cost of reproducing the film is de minimis. In cases of the U.S. software, motion picture and recorded music industries, substantially all of the initial costs of development are generally incurred in the United States. Thus, the parallels between the three industries with respect to production and foreign distribution are identical. All three industries produce their products in the United States and all three transfer master copies of their products to their foreign distributors along with an agreement allowing reproduction for resale.

5. The Current FSC Provisions allow FSC Treatment for Software Exports.

In order for export income to qualify for the partial exclusion provided by the FSC provisions, the income must be from the sale, exchange or other disposition of "export property," or from the "lease or rental of export property for use outside the United States." (I.R.C. Sec. 924(a)(1), (2)). Generally the term "export property" is defined as property that is manufactured or produced in the U.S. and held primarily for sale, lease, or rental in the ordinary course of trade or business to an FSC for direct use, consumption or disposition outside of the U>S. (I.R.C. Sec. 927(a)(1), (2)).

"Export property" does not include, *inter alia*,

> patents, inventions, models, designs, formula, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use) good will, trademarks, trade brands, or other like property, films, tapes, records, or similar reproductions, for commercial or home use

(I.R.C. Sec. 927(a)(2)(B)). There is no question whether the software produced by U.S. companies would be export property under Section 927(a)(1) but for the exception set forth in Section 927(a)(2)(B). The question is whether such software is covered by the parenthetical exception to the exception for "films, tapes, records, or similar reproductions, for commercial or home use." There can be no question but that the diskettes and CD-ROM's on which computer software is routinely reproduced are media that are similar to files and tapes. In fact, prior to the advent of the personal computer and the use of hard disks, floppy diskettes and CD-ROM's as storage media, computer software was stored on magnetic tape. The CD's and laser disks on which music recordings and motion pictures are now stored are similar to (if not identical to) the CD-ROM's used for computer software. Thus, there can be no question but that computer software qualifies as export property because is reproduced on media that is nearly identical to films and tapes.

6. The Erroneous IRS Interpretation.

Regardless of the plain language of the parenthetical exception contained in Section 927(a)(2)(B), the Internal Revenue Service in a Technical Advice Memorandum has interpreted the statute as applying to music and motion picture recordings but not to computer software. See TAM 9344002. Put another way, the Internal Revenue Service concludes that music and motion picture recordings are qualified export property for purposes of the FSC provisions, but that computer software is not so qualified. There is no legal or factual basis for distinguishing between entertainment based content (i.e. products made by the music and motion picture industries) and software content on identical reproduction media that are distributed overseas in an identical fashion. The

TAM appears to be based upon a misreading of Treas. Reg. Section 1.927(a)-T(f)(3).

The temporary Treasury Regulation at issue, Temp. Treas. Reg. Section 1.927(a)-T(f)(3), provides as follows:

> (3) **Intangible property**. Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions for commercial or home use), goodwill, trademark, trade brand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by as right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property.

This Regulation correctly concludes that computer software, regardless of the medium on which it is stored, could be qualified property if all the other requirements are met. This Regulation also provides that a copyrighted article such as a book or mass marketed software, if not accompanied by a right to reproduce for external use, would not qualify as export property. We believe that the Treasury Department has exceeded its authority in drafting an overly restrictive exception that applies only to computer software.

Nothing in the legislative history of Section 927(a)(3)(B) touches on any distinction based upon the presence or absence of a right to reproduce copyrighted articles. See H.R. No. 98-432, Part II, p. 971, 98th Cong. 2d Sess.; reprinted in 1984 U.S. Code Cong. & Admin. News, p. 1659. The language of Section 927(a)(3)(B) is identical to that of Section 993(c)(2)(B), the prior Domestic International Sales Corporation provision. Thus, it might be useful to examine

the legislative history to that statute, even though it was enacted prior to the advent of the personal computer. The House Ways and Means Committee report states as follows:

> Although generally the sale or license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts.

See H.R. No. 92-533, 92nd Cong., 1st Sess., reprinted in 1971 U.S. Code Cong. & Admin. News, p. 1883. This language does not support any conclusion that export property, for purposes of Section 927(a)(3)(B), does not include the license of a copyright accompanied by a right to reproduce.

Under the usual facts the income earned by the U.S. parent, and for which it pays a commission to its FSC, is royalty income earned from the sale by the foreign distributor of the U.S. parent's copyrighted software. Such income is no different from income earned by a U.S. record company from sales of musical recordings by foreign distributors in situations where the recordings are made by the foreign distributors from master recordings produced in the United States. Yet, under the temporary Treasury Regulation and IRS Technical Advice Memorandum,. the royalties earned by the record company from overseas sales would qualify for FSC treatment, while the software royalties would not.

There is no basis in the statute or its legislative history to conclude that Congress ever intended to exclude licenses of copyrighted computer software, if accompanied by a right to reproduce, from the benefits of the FSC provisions. There is no basis for the IRS's conclusion that there is such a distinction.

6. Conclusion

SPA knows of no policy to be served by denying the favorable tax benefits offered by the Foreign Sales Corporation provisions of the Internal Revenue Code to the software industry. We believe that the statute as written allows such benefits, even in cases where foreign distributors are given the right to reproduce

software from a master and to sell the copies. Royalty income from such sales should qualify for FSC treatment. Congress should clarify Section 927(a)(2)(B) to specifically include computer software within the parenthetical exception for copyrighted articles.

Statement of the

Information Technology Industry Council

Submitted for the Record

Committee on Ways and Means

U.S. House of Representatives
Hearings of July 11 & 12, 1995
on Miscellaneous Tax Reform

The Information Technology Industry Council (ITI) is pleased to submit these comments for the record, and urges the Committee to give them full consideration as it reviews recommendations for tax reform.

ITI represents the leading U.S. providers of information technology products and services. Its members had worldwide revenues of $277 billion in 1994, and employ more than one million people in the United States. ITI members are responsible for nearly 23% of all U.S. industrially-funded research and development, and over 63% of all information technology R&D.

ITI members derive more than 50% of their aggregate revenues from overseas. Thus, their economic health depends on U.S. policies aimed at facilitating their efforts to compete internationally. A key to this success is avoiding economic double taxation on international transactions and on the repatriation of foreign subsidiary earnings. The U.S. foreign tax credit system has in the past served this purpose quite well. However, in recent years the international tax rules affecting U.S. companies doing business abroad have become much more complex and have caused considerable uncertainty. The result has been an increase in multi-jurisdictional tax controversies that often take many years, if ever, to resolve. In addition, frequent changes in U.S. tax legislation and regulations in the foreign area have created a patchwork system of basketing and allocation rules that create great difficulties for companies to effectively use the foreign tax credit for its original and proper purpose: to avoid double taxation on foreign income.

ITI believes that H.R. 1690, the International Tax Simplification and Reform Act of 1995, introduced by Reps. Amo Houghton (R-NY) and Sander Levin (D-MI), will resolve the problems cited above. In our view, this comprehensive legislation will greatly simplify tax compliance, both for taxpayers and the Internal Revenue Service, and will improve the competitiveness of U.S. companies. We urge the Committee to give H.R. 1690 priority consideration during this session of Congress. However, in the event the Committee's schedule precludes a timely, comprehensive review and revision of the entire foreign tax area, in the interim, ITI urges the Committee to act favorably on the following proposals to make the foreign tax credit more effective:

1. Extend the Existing Foreign Tax Credit Carryforward of Excess Foreign Taxes to 15 years

This proposal is included in H.R. 1690. Fifteen year carryforwards are found in other sections of the tax code, such as carryforward provisions for net operating losses.

This provision to extend the existing carryforward from 5 to 15 years would allow U.S. companies a better chance to avoid double taxation. It would alleviate the timing problems caused by the lengthy period it takes to resolve double taxation disputes through the competent authority/treaty process. This problem is particularly harsh for taxpayers in cyclical industries that experience substantial operating losses in some years. For example, the years 1991 and 1992 were extremely difficult for our industry.

2. Increase the Reporting Threshold for Stock Ownership of a Foreign Corporation

Present law (IRC Section 6046), adopted in 1962, requires U.S. shareholders to file information returns reporting 5% or greater acquisitions or increases in investment amounts in foreign corporations, or reductions to an existing investment to under 5%. Extensive information must be provided on Form 5471 consisting of income statements, balance sheets, costs of goods sold, and

taxes paid or accrued. U.S. persons who become officers also have to file information returns. Ironically, this 5% investment threshold for filing is not relevant to any other U.S. tax purpose, and creates enormous administrative complexity for taxpayers and the IRS as well.

In contrast, there are existing requirements for similar information at the 10% level in the case of the indirect foreign tax credit. ITI believes that the reporting threshold should be raised to 10%. The resulting simplification and burden reduction for taxpayers would not jeopardize either Treasury or IRS informational interests. In addition to the increase to 10%, ITI recommends adding a de minimus dollar exception based on an investment of $500,000. The industry often has to take small equity positions in local distributors to insure access of our products to the market place. The paperwork on reporting these small amounts is quite burdensome. Raising the dollar exception will provide significant relief.

3. Modify the Current Subpart F Rules to Encourage Expansion into the European Community

H.R. 1690 would also remove a major obstacle to effective competition by U.S. multinational corporations in the emerging unified market of the European Community (EC). Under H.R. 1690, the subpart F rules of the Internal Revenue Code of 1986 would be amended to treat the European Community countries as a single country for purposes of determining foreign-base company sales and services income.

ITI's European and Japanese competitors are streamlining their EC operations to take advantage of the new unified markets, but under subpart F, U.S. multinationals must create costly and duplicative subsidiaries in each European Community country or be subject to a current U.S. tax on earnings before they are actually repatriated to the U.S. parent. The original purpose of subpart F — to deter U.S. companies from establishing subsidiaries in tax haven countries merely to avoid U.S. taxation of income — has been preserved in H.R. 1690, but the obstacles to competition have been removed.

4. Extend Indirect Foreign Tax Credits to Sixth Tier

H.R. 1690 extends the application of the indirect foreign tax credit to certain taxes paid or accrued by certain fourth, fifth and sixth-tier foreign corporations. As ITI members become more involved with foreign companies to be competitive in the world markets, it is important to allow foreign tax credits for situations where ITI members have at least a five percent voting stock position with these fourth, fifth and sixth-tier corporations.

5. Currency Translation

H.R. 1690 includes a proposal which would allow accrual-basis taxpayers to translate accrued foreign taxes using the annual average exchange rate. Current law requires foreign income taxes paid to be translated into U.S. dollar amounts using the exchange rate of the day of payment. This simplification provision will reduce significantly the administrative and recording burden for ITI members.

6. "10-50" Basket Rules

Since 1986, a U.S. corporation which owns ten percent but no more than fifty percent ("10-50") of the voting stock of a foreign corporation can not apply the "look-through" rule. The rule allows the foreign income to be categorized according to the nature of the underlying income, and where appropriate, is included in the general averaging of the tax payer's general foreign tax credit basket.

The globalization and maturation of expanded overseas markets requires alliances in joint ventures with foreign-owned companies. The current rule has placed major impediments on U.S. corporations investing in non-controlled foreign joint ventures. H.R. 1690 includes a provision which would repeal the "10-50" baskets. It would provide the current "look-through" rules for "10-50" foreign dividends, provided that the necessary information to categorize dividends among the other foreign tax credit

limitation categories is readily available to the taxpayer. If the information is not available, dividends from all non-controlled section 902 corporations would be subject to one separate foreign tax credit limitation. ITI supports this simplification provision of H.R. 1690.

7. 956A Earnings Invested in Excess Passive Assets

Section 956A of the Internal Revenue Code of 1986 eliminates the deferral of U.S. income tax for U.S. shareholders of controlled foreign corporations (CFC) to the extent the CFC's accumulated earnings are invested in excess passive assets (25%) rather than in active business assets. Section 956A rules create a tax obstacle to making good business decisions by U.S.-based companies since, at the margin, this provision may adversely impact how an international business decision is made. If there are roughly equal reasons to invest or expand within the U.S. or outside the U.S., Section 956A would virtually compel taxpayers to make the foreign investment. For many taxpayers, this provision creates a powerful incentive, effectively a 35% investment tax credit, to acquire foreign businesses, plant and equipment. This result is clearly contrary to the original legislative intent to force U.S. firms to repatriate earnings from foreign operations. Foreign governments do not impose provisions similar to Section 956A on foreign-owned companies, thus giving them better access to worldwide markets, since they are allowed to plan their cash flows and other operations without regard to such a provision.

ITI strongly supports repeal of 956A.

8. Remove Controlled Foreign Corporations from the Passive Foreign Investment Company Provisions

The Passive Foreign Investment Company (PFIC) provisions were adopted in 1986 for the purpose of preventing tax avoidance by U.S. taxpayers through use of offshore publicly-held mutual funds. They were never intended to apply to CFC's.

The effect of the PFIC provisions is to subject to current U.S. tax the invoice of a CFC to the extent more than 50% of the adjusted basis of its assets or 75% of its income are passive. Just like Section 956A, the PFIC provisions have the effect of a 35% investment tax credit for U.S.-based companies to invest in active foreign assets. This is clearly an inappropriate incentive to retain in the U.S. tax code.

9. Allocation for Foreign Tax Credit Calculations

ITI supports the provision of H.R. 1690 that would reinstate and make permanent section 864(f) as agreed to in the past by the Congress and Department of Treasury. It would increase the direct allocation and apportionment of research and experimental expenditures to U.S. sources or foreign sources from 50%, as now proposed by Treasury, to 64%.

ITI believes these recommendations will be very helpful to our industry, and indeed, to all of the U.S. business community competing in the international marketplace. Moreover, there should not be any appreciable revenue costs to achieve these simplifications and to make the foreign tax credit more efficient. We would be happy to provide further information in support of our recommendations, and to respond to any questions the Committee may have.

TESTIMONY OF THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

Statement Regarding Certain Proposals Relating to Foreign Tax Simplification

House Ways and Means Committee Hearings on Miscellaneous Tax Reforms July 11-13, 1995

Introduction

The United States Council for International Business (USCIB) wishes to express its views regarding certain foreign tax simplification proposals which were included in the above-noted hearing agenda.

The United States Council for International Business (USCIB) advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organisation of Employers (IOE). As such, it officially represents U.S. business positions in the main intergovernmental bodies, and vis-a-vis foreign business and their governments. The Council addresses a broad range of policy issues with the objective of promoting an open system of world trade, finance and investment in which business can flourish and contribute to economic growth.

While the USCIB supports nearly all of the foreign tax proposals under consideration at these hearings, and all those included in H.R. 1690, this statement will focus on a handful of proposals which we feel can achieve the most significant degree of simplification for a broad range of taxpayers, with minimal revenue impact. These are:

1. Repeal of separate foreign tax credit baskets for noncontrolled Section 902 ("10-50") corporations;
2. Exemption of U.S. shareholders of controlled foreign corporations from passive foreign investment company provisions;
3. Repeal of the excess passive asset provision (Section 956A);
4. Extension of periods to which excess foreign tax credits may be carried forward and carried back;
5. Extension of deemed paid foreign tax credit to dividends from, or Subpart F income of, CFCs below third tier.

1. Repeal of Separate Foreign Tax Credit Baskets for Noncontrolled Section 902 ("10-50") Corporations

Section 904(d)(1)(E) creates a separate foreign tax credit limitation for dividends received from each noncontrolled Section 902 corporation. (A noncontrolled Section 902 corporation is a foreign corporation which satisfies the stock ownership requirements of Section 902(a), yet is not a controlled foreign corporation under Section 957(a).) Only foreign taxes associated with that corporation's dividends may be credited against the U.S. tax on that income. In addition, the foreign tax credit "look-through" rules of Section 904(d)(3) do not apply to interest, rents or royalties received from a noncontrolled Section 902 company. As a result, such income is generally treated as passive income.

Dividends, interest, rents and royalties of controlled foreign corporations (CFCs) generally are subject to look-through rules which recharacterize these categories of income in accordance with

the underlying sources of income of the payor corporation. However, taxpayers are not allowed to look through dividends, interest, rents or royalties received from noncontrolled Section 902 corporations to recharacterize such income in accordance with the character of the underlying income.

Noncontrolled Section 902 corporation dividends, interest, rents and royalties are generally derived from overall limitation income that would normally be eligible for inclusion in the overall limitation income basket under look-through rules applicable to CFCs. However, as stated above, a taxpayer may not look through the dividend, interest, rents or royalties to the underlying character of the income and recharacterize the income.

The legislative history to the Tax Reform Act of 1986 provides two reasons for denying look-through treatment to noncontrolled Section 902 corporations: 1) that the minority shareholder lacks sufficient identity of interest with the corporations to justify allowing cross-crediting; and 2) that the minority shareholder may not be able to obtain sufficient information to make the computations. However, these points do not withstand critical analysis. For instance, if there is sufficient identity of ownership to permit a U.S. corporation to claim a Section 902 credit, it is difficult to understand why this identity is not also sufficient to permit cross-crediting. If the U.S. corporation had the identical ownership interest in a CFC or nonincorporated joint venture, the look-through rules would apply. In addition, if the foreign corporation has foreign oil and gas extraction income (FOGEI), the U.S. shareholder would be required to apply look-through rules to determine its Section 907 limitation on FOGEI.

The justification regarding shareholder information is also erroneous. Shareholders are already required to compute earnings and profits of foreign corporations to claim Section 902 credits and, as mentioned above, look-through rules already apply to such taxpayers for Section 907 purposes. If a taxpayer has sufficient information to compute earnings and profits out of which dividends are paid, it follows that that taxpayer must also have sufficient information to ascertain the character of these dividends for look-through purposes. For this reason, we take issue with the second provision of this proposal, which provides that if sufficient information is unavailable, the dividend and associated foreign taxes should be placed in a separate basket for dividends from all non-controlled corporations. Generally speaking, there should be no cases where such circumstances will exist.

Precluding cross-crediting of foreign taxes of noncontrolled Section 902 corporations will cause U.S. taxpayers to incur additional U.S. tax on foreign income usually associated with their business activities, and in turn to suffer a competitive disadvantage versus their foreign competitors, who do not suffer additional home country taxation. We therefore support the proposal to eliminate the separate foreign tax credit limitations for dividends paid by noncontrolled Section 902 corporations. We further recommend that the foreign tax credit look-through rules of Section 904(d)(3) should be expanded to cover dividends, interest, rents and royalties from all Section 902 corporations, with regulatory authority granted to the IRS to modify the look-through rules where appropriate.

2. Exemption of U.S. Shareholders of Controlled Foreign Corporations from Passive Foreign Investment Company Provisions

The United States generally imposes tax on U.S. shareholders only when the shareholders receive a dividend from the earnings of the foreign subsidiary involved. The Subpart F provisions provide exceptions to this general rule of deferral for, inter alia, personal holding company type income (passive income) of U.S. controlled foreign corporations (CFCs).

In 1986, provisions were added to the Tax Code which effectively tax on a current basis all the income of foreign corporations that have more than a designated amount of passive income or passive assets, even if the balance of the income is from active manufacturing operations. These Passive Foreign Investment Company (PFIC) provisions were intended to eliminate certain identified abuses relating to U.S. investors in overseas mutual funds; however, in drafting the legislation to eliminate these abuses, the Conference Committee inadvertently worded the statute

in such a manner as to also cover CFCs, even though such corporations were already subject to the full array of rules and regulations under the Subpart F provisions of the Code.

Subjecting CFCs to the PFIC rules creates needless and costly complexity for taxpayers, and does not accomplish any tax policy goal which is not already adequately accomplished under the Subpart F regime. Clearly, the Code should be amended to reflect the original intent of the PFIC legislation, and exclude from the PFIC provisions those companies subject to the Subpart F provisions of the Code. Thus, we support the proposal included in H.R. 1690 which accomplishes this change.

3. Repeal of the Excess Passive Asset Provision.

In addition to the Subpart F and PFIC provisions discussed above, the Omnibus Budget and Reconciliation Act of 1993 added a further restriction on the deferral principle. Under Section 956A, a U.S. shareholder is taxed on the undistributed earnings of a CFC to the extent of the corporation's investments in "excess passive assets."

Notwithstanding the provisions of Subpart F, which apply to certain passive income of a CFC, the Section 956A asset test can also taint the active income of a controlled foreign corporation. Moreover, current income can be tainted by passive assets which may have been accumulated prior to 1993. Thus, in addition to the competitive burden on U.S. companies created by the Subpart F rules, Section 956A creates another unnecessary burden on U.S. shareholders of CFCs which is not borne by their competitors in foreign parent corporations.

Further, Section 956A is misdirected from a tax policy standpoint, and adversely impacts decision making by U.S.-based companies. It creates incentives for making overseas investments that would not otherwise have been made, and disincentives for the retention of assets which would otherwise be disposed of in order to avoid the penalty of the section. As a result, revenue estimates for this provision have been largely overstated. For all of these reasons, we support the proposal to amend the Code to repeal the provisions of Section 956A.

4. Extension of Foreign Tax Credit Carryforward and Carryback Rules

Section 904(c) of the Tax Code currently provides that any foreign tax credits (FTCs) not used against U.S. tax in the current year may be carried back two years and forward five. In contrast, the rules for the general business tax credit and net operating losses (NOLs) provide a three-year carryback and a fifteen-year carryforward. In addition, the ordering rules for FTCs require that the current year's credit be utilized before any carryovers are taken into account.

Further, taxpayers may file an application for a tentative carryback adjustment of the tax for a prior taxable year affected by an NOL, business credit, research credit, or a capital loss carryback, but not for a foreign tax credit carryback.

The effect of these short time periods and the current ordering rules has been to cause FTCs to expire unused, thereby subjecting foreign source income to double taxation -- and frustrating the purpose of the credit. The current rules are especially harsh for taxpayers in cyclical industries which experience substantial operating losses. Moreover, under current administrative procedures, tax refunds resulting from foreign tax credit carryback cannot usually be made until a considerable period of time has elapsed after the close of the taxable year in which the carryback arose.

We strongly support the current proposal to extend the FTC carryforward period to 15 years; we also strongly recommend that the carryback period be extended to 3 years, as provided in H.R. 1690. In this way, both the carryforward and carryback periods would conform to the periods for net operating losses and general business tax credits. In addition, the FTC ordering rules should be amended to conform to the general business credit rules with any carryover credit taken into account before the current year's credit.

5. Expansion of Deemed Paid Credit to Sixth Tier Companies

Under current law, companies are prohibited from claiming deemed paid credits for foreign taxes paid by foreign subsidiaries below the third tier. However, many companies are now considering acquisitions which already have three or more levels of foreign subsidiaries. Restructuring these companies merely for tax purposes will require unnecessary costs for U.S. companies and may discourage some companies form making profitable acquisitions.

The current rules also are inequitable because, under Subpart F provisions, income of lower tier companies is included in the income of the U.S. shareholder without any allowance for a foreign tax credit for foreign income taxes paid in regard to such income.

For these reasons, we support the proposal, as provided in both H.R. 1690 and H.R. 3419, that the deemed paid credit rules should be expanded to the sixth tier. We also feel that all other ownership rules should remain unchanged.

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As stated earlier, these five proposals do not represent a substantial revenue loss to the Treasury; yet if enacted they would substantially alleviate the burden of tax code complexity which U.S. corporations now face with regard to the international area, and in so doing would enhance their international competitiveness vis-a-vis their foreign competitors. We therefore strongly urge the Committee to consider including the proposals described above in forthcoming legislation in connection with the Budget Reconciliation Act.

TESTIMONY OF GARY J. PERKINSON
BENEFICIAL CORPORATION

Beneficial Corporation is pleased to submit to the Committee on Ways and Means this statement with respect to certain foreign tax proposals under consideration by the Congress. We applaud Congress for addressing these issues and for affording us an opportunity to express our views on the current proposals.

While many of the proposals are interesting to us, we would like to limit our comments to four specific issues under consideration in which we have a strong interest: (1) the extension of the period to which excess foreign tax credits may be carried; (2) the exception from foreign personal holding company income and foreign base company services income for active financing income; (3) the repeal of the excess passive assets provision and modification of the passive foreign investment company provisions; and (4) the exemption of U.S. shareholders of controlled foreign corporations from the passive foreign investment company provisions.

Additionally, we would like to comment on one issue that is not addressed in any of the current proposals. Namely, we would like to support an amendment to section 865(j) for sourcing of losses on the sale of an affiliate's stock. The intended change would preclude Treasury from automatically sourcing such losses as foreign.

1. **Extension of Period to Which Excess Foreign Tax Credits May Be Carried.**

We support extending the period to which excess foreign tax credits may be carried under section 904(c) from two years back and five years forward to three years back and fifteen years forward.

The purpose of the foreign tax credit is to reduce international double taxation. The overall credit limitation under section 904 limits the foreign tax credit to foreign taxes imposed on foreign-source income to the extent that those taxes do not exceed the U.S. tax on foreign-source income. Therefore, the credit cannot exceed what the U.S. tax would have been on the foreign source income. In 1986, Congress enacted separate basket limitations under section 904 in addition to the overall foreign tax credit limitation. Congress was concerned that because the overall limitation permitted a cross-crediting of taxes among certain types of income, the United States was sometimes collecting little or no residual U.S. tax on those types of income. See General Explanation of the Tax Reform Act of 1986 at 862 (Joint Comm. Print 1987) ("1986 Bluebook"). The separate basket limitations were intended to alleviate that concern.

The separate basket limitations, combined with the overall limitation and the 1986 reduction in tax rate (as well as the interest allocation rules under the section 861 regulations) have caused more taxpayers to have excess foreign tax credits. Section 904(c) provides for a carryback of two years and a carryforward of five years for these excess credits. The carryback and carryforward provision was originally adopted in 1958 by the Technical Amendments Act, P.L. 85-866 (September 2, 1958) at a time when a country-by-country foreign tax credit limitation was in place. The carryback and carryforward provision was not amended in 1986 to take into account the increased excess credit situations created by the changes in the 1986 Code. Given the excess credit positions facing many taxpayers, the two year back and five year forward carryovers lapse quickly causing the excess credits to expire unused, and often resulting in double taxation. The legislative history to the 1958 Technical Amendments Act observes that the carryback and carryforward are necessary to avoid double taxation that could result because of timing differences between

the U.S. and foreign tax law. See H.R. Rep. No. 775, 85th Cong. 1st Sess. (1957), 1958-3 C.B. 811, 836.

To appropriately reflect the separate basket limitations and the increases to excess credit positions created by the 1986 Act, the carryback and carryforward provisions should be extended to three years back and fifteen years forward. This would reduce the negative impact that expiring credits has had on U.S. business, and would further the original goal of section 904(c) to reduce the impact of double taxation.

2. **Exception from Foreign Personal Holding Company Income and Foreign Base Company Services Income for Active Financing Income.**

We support the proposal to provide an exception from foreign personal holding company income and foreign base company services income for certain active financing income.

Subpart F (sections 951-964) was enacted as part of the Revenue Act of 1962, P.L. 87-834 (October 16, 1962) to eliminate tax deferral on investment-type income. See H.R. Rep. No. 1447, 87th Cong. 2d Sess. (1962), 1962-3 C.B. 405, 461. In enacting subpart F, Congress recognized the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries. That need is not served by tax deferral on portfolio type investments, hence such investments were the target of subpart F. Id. at 466. The legislative history to the 1962 Act recognized that interest and similar income of banks and bank subsidiary organizations do not result in passive investments. Id.

When an entity is engaged in an active business within the same country that it is organized, to be competitive with other businesses organized in that country, it should be taxed in the same manner as the other businesses in that country. This principal has already been recognized in the Code. See, for example, the same country exception for shipping income, section 954(b)(6), and the same country exception for related-person dividends, interest, rents and royalties, section 954(c)(3). American controlled foreign corporations ("CFCs") engaged in active financing in foreign countries are at a competitive disadvantage to the extent that they are subject to subpart F inclusion, whereas non-American companies organized in the same country are not. Moreover, to the extent that such income is considered to be foreign personal holding income to the CFC, it could subject the American company to the additional onerous anti-deferral regime of the passive foreign investment company ("PFIC") rules. See sections 1291-1297.

The proposed legislation appropriately creates an exception from foreign personal holding company income and from foreign base services income for certain active financing income derived from sources within the country in which the CFC is created or organized. The types of income include income from the active conduct of a banking, financing, or similar business by a CFC that is predominately engaged in such activity. This income clearly is not the type of income for which subpart F was originally intended to eliminate deferral. The proposal also appropriately excepts from the definition of foreign personal holding company income dividends, interest, and gains from the sale or exchange of stock or securities derived from certain investments made by a CFC that is a qualifying insurance company. Again, such income is not the investment-type income to which the competitive benefits of deferral should have no application.

The exceptions provided by the proposal would have the additional benefit of relief from the PFIC rules for these types of income. To the extent that the foreign company is actively engaged in a financing-type business, the anti-abuse PFIC regime should not apply. This relief would be greatly welcomed by financing companies who were largely inadvertently burdened by this additional taxing regime.

3. **Repeal of Excess Passive Assets Provision and Modification of PFIC Provisions.**

We support the proposal to repeal the excess passive assets provisions of section 956A and to modify the PFIC provisions with respect to CFCs.

CFCs are subject to four different regimes that attack passive activities of the CFC: (1) section 956 which taxes U.S. shareholders on the undistributed earnings of a CFC to the extent of the increase of current or accumulated earnings (other than subpart F income) invested in certain U.S. property; 2) section 956A which requires a U.S. shareholder of a CFC to include in income currently an amount with respect to the CFC's earnings invested in excess passive assets, which exist if more than 25 percent of the CFC's total assets are passive assets; (3) subpart F current inclusion of certain passive investment income under sections 951 to 964 for a 10 percent or greater U.S. shareholder; and (4) the PFIC rules under sections 1291-1297 which apply if 75 percent or more of the CFC's income or 50 percent or more of the CFC's assets (as determined by the adjusted bases of the assets) are passive without regard to the percentage of stock owned by the U.S. person and give the taxpayer the choice of deferral with an interest charge on the deferral or current inclusion of its share of the PFIC's income.[1]

The overlap in these four rules is unnecessary and unduly burdensome. Subpart F and the PFIC provisions are more than adequate to treat any perceived abuses that section 956A could address. Section 956A merely adds an additional layer of complexity to the anti-deferral regime. This is particularly true for entities engaged in the financing business for which passive asset tests are virtually always met. Additionally, section 956A encourages increased investment in active foreign assets with funds that otherwise could be invested in the United States. Therefore, section 956A should be repealed.

Subpart F and the PFIC provisions both target U.S. tax deferral on passive income. The PFIC provisions, which apply whether or not an entity is a CFC, focus on investment in foreign funds; therefore, unlike the excess passive assets rule of section 956A, there is independent utility to the PFIC provisions. However, because the deferral on passive income of a CFC is addressed by subpart F, CFCs should be excluded from the PFIC provisions. This is especially the case for entities engaged in the financing business because virtually all of their assets are "passive," causing them to be subject to the PFIC rules. We strongly support the proposal that would provide such a PFIC exclusion for CFCs.

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[1] Other anti-deferral rules potentially applicable to foreign corporations with some degree of U.S. ownership are the foreign personal holding company rules of sections 551 _et_. _seq_. and the foreign investment company rules of section 1246. Additionally, foreign (as well as domestic) corporations are also subject to the accumulated earnings tax of section 531 _et_. _seq_. and the personal holding company tax of section 541.

4. **Exemption of United States Shareholders of CFCs from PFIC Provisions.**

Because of many of the concerns described in section 3 of this testimony, we support the proposal that would provide an exemption from the PFIC provisions for a taxpayer's interest in a foreign corporation if the corporation is a CFC and the taxpayer is a United States shareholder of the CFC.

If an entity is a PFIC, the PFIC rules of section 1291 to 1297 apply to cause a U.S. shareholder, regardless of the percentage of ownership, to incur an interest charge or to elect current inclusion. Moreover, the rules apply regardless of the character of the income to the PFIC. The focus of these rules was to level the playing field between domestic and foreign investment funds. In application, however, the rules often affect financing businesses because such businesses often only have passive assets.

The PFIC rates were intended to curb incentives for investment in foreign funds. Current inclusion should only be mandated with respect to passive investment-type income. See H.R. Rep. No. 1447, 87th Cong. 2d Sess. (1962), 1962-3 C.B. 405, 466. If a person is a U.S. shareholder subject to inclusion for such types of income under subpart F, that person should not also be subject (on the rest of its income, for example) to the PFIC rules. The passive income, which is the target of these anti-deferral rules, will have already been adequately addressed.

5. **Amending Section 865(j) for Sourcing of Losses on Sale of Affiliate's Stock.**

Although the current Description of Miscellaneous Tax Proposals does not include amendments to section 865(j), we strongly support amending that section for sourcing of losses on the sale of an affiliate's stock to preclude Treasury from automatically sourcing such losses as foreign. Our suggestion is to add a new paragraph to section 865(j) as follows:

> "(4) providing that losses incurred on the sale of stock in an affiliate which is a foreign corporation shall be sourced in the same manner as any gain would have been sourced pursuant to paragraph (f) of this section."

Because the current Description of Miscellaneous Tax Proposals does not include this proposal, we believe that the issue warrants a more detailed discussion than the other proposals we have supported herein. The following discussion will illustrate that losses recognized by a U.S. resident on the sale of stock of a foreign subsidiary should be allocated and apportioned to the same class of income that would have resulted if a capital gain had been realized on the sale of the stock. Any regulations issued pursuant to section 865(j) should provide for the same result.

a. Current Law.

Regulation § 1.861-8(e)(7), which generally applies for foreign tax credit purposes, provides for the following allocation of losses on the sale, exchange, or other disposition of property:

> The deduction allowed for loss recognized on the sale, exchange, or other disposition of a capital asset or property described in section 1231(b) shall be considered a deduction which is definitely related and allocable to the class of gross income

> to which such asset or property ordinarily gives rise in the hands of the taxpayer.

Although regulation § 1.861-8(e)(7) indicates that any loss sustained on the sale of stock of a foreign subsidiary should be allocated on the class of gross income to which such stock ordinarily gives rise (e.g., foreign source dividends), section 904(f)(5)(E)(iii), as added by the Tax Reform Act of 1986, leads to a different conclusion in an analogous context with respect to the oil and gas industry.

Since stock of a foreign subsidiary would ordinarily give rise to foreign source dividend or subpart F income, regulation § 1.861-8(e)(7) would indicate that a loss on the sale of stock of the foreign subsidiary should be allocated to foreign source income. However, section 904(f)(5)(E)(iii), which was enacted after the adoption of regulation § 1.861-8(e)(7), supports a different conclusion, i.e., that any loss recognized on the sale of stock of the foreign subsidiary should be allocated and apportioned to the same class of income that would have resulted if a capital gain had been realized on the sale of the subsidiary's stock. This is a more appropriate result.

Section 904(f)(5)(E)(iii) addresses the treatment of "separate limitation losses", i.e., losses from each separate category of income described in section 904(d)(1). Pursuant to section 904(f)(5)(E)(iii), a separate limitation loss is to be "determined under the principles of section 907(c)(4)(B)." Section 907(c)(4)(B) defines "foreign oil extraction loss" to mean foreign oil and gas extraction gross income less "the sum of the deductions properly apportioned or allocated thereto." (Emphasis added.) One of the principles of section 907(c)(4)(B), as reflected in regulations § 1.907(c)-1(e)(4) and (f)(2), is that deductions are to be allocated and apportioned under "the principles of § 1.861-8" except in the case of losses on the sale of stock. In the case of a loss on the sale of stock, regulation § 1.907(c)-1(e)(4) provides that:

> If, under § 1.861-8(e)(7), a loss on the sale, exchange, or disposition of stock is considered a deduction which is definitely related and allocable to FOGEI or FORI, then notwithstanding § 1.861-8(e)(7) and paragraph (f)(2) of this section, this loss shall be allocated and apportioned to the same class of income that would have been produced if there were capital gain from the sale, exchange or disposition.

Thus, notwithstanding regulation § 1.861-8(e)(7), a loss on the sale of stock should be allocated and apportioned pursuant to the principles of regulation § 1.907(c)-1(e)(4) for section 904(f)(5) purposes.

The relevant legislative history supports this conclusion. In discussing the separate limitation loss provisions, both the House Ways and Means Committee Report (No. 426, p. 346) and the Senate Finance Committee Report (No. 313, p. 324) state that:

> For purpose of the bill's foreign loss allocation and separate limitation loss recharacterization provisions, the amount of a loss in a separate . . . basket is determined under the principles of the present law provision that defines foreign oil and gas extraction losses for purposes of the overall foreign extraction loss recapture rule (Code sec. 907(c)(4)(B)). Thus, a loss in the

> separate limitation basket or the overall limitation basket is the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to income in that basket is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (under code sec. 862(b) or 863).

(Emphasis added.) The first sentence quoted above specifically provides that "for purposes of the bill's foreign loss allocation and separate limitation loss . . . provisions, the amount of a loss in a separate . . . basket is determined under the principles of" section 907(c)(4)(B). (Emphasis added.) A determination of the amount of a foreign loss or a separate limitation loss would necessarily involve the application of any section 907(c)(4)(B) rules for the proper allocation and apportionment of deductions.

If the allocation and apportionment principles of section 907(c)(4)(B) are to be applied for purposes of determining separate limitation losses under section 904(f)(5), they should also be applied for purposes of determining separate limitation income under section 904(d). It would be inconsistent with the purpose and function of section 904 to conclude that deductions were to be allocated and apportioned in one manner for purposes of calculating a separate limitation loss under section 904(f)(5) and in another manner for other section 904 purposes, i.e., to conclude that regulation § 1.907(c)-1(e)(4) applied for purposes of section 904(f)(5)(E)(iii) but not for purposes of section 904(d) or (f)(5)(E)(ii). In fact, the above-quoted legislative history makes it clear that the principles of section 907(c)(4)(B) are to apply not only for purposes of the separate limitation loss provisions, but also for purposes of the "foreign loss allocation . . . provisions." Thus, for foreign tax credit purposes, any loss on the sale of stock, including stock of a foreign subsidiary, should be allocated and apportioned pursuant to regulation § 1.907(c)-1(e)(4), i.e., to the class of income that would have been produced if there were capital gain from the sale of stock.

This conclusion is supported by section 865(j) of the Code, as interpreted by the Staff of the Joint Committee on Taxation. See 1986 at 922-923. The Joint Committee staff's explanation of this provision (p. 923) states that:

> It is anticipated that regulations will provide that losses from sales of personal property generally will be allocated consistently with the source of income that gains would generate but that variations of this principle may be necessary.

Regulation § 1.907(c)-1(e)(4) represents precisely the type of regulation in this explanation.

b. Reason for the Change.

The proposed section 865(j)(4) would preclude Treasury from automatically sourcing losses on the sale of an affiliate's stock as foreign. Rather, the rule will look to where the gain would have been sourced. The rule would provide fairness by eliminating the whipsaw potential discussed below.

Since any capital gain resulting from the sale of a foreign affiliate by a U.S. taxpayer will normally be treated as U.S. source income under section 865(a) (assuming section 865(f) is inapplicable), such a consistency rule is needed to protect a taxpayer from the whipsaw that would result if losses on the sale of stock of a foreign affiliate were allocated to foreign source income. For example, if a taxpayer sells the stock of a foreign affiliate and recognizes a $100 U.S. source capital gain on the sale of some shares and a $100 foreign source capital loss on the sale of other shares, it may have, in effect, a $100 taxable gain and a $100 nondeductible capital loss. It is difficult to see any justification for the adoption of a regulation under section 865(j)(1) that would create such a whipsaw situation, particularly since section 865(j)(1) was apparently enacted with a view to avoiding such a problem. The proposed section 865(j)(4) would foreclose that possibility.

Since a taxpayer may under certain circumstance structure a sale of stock of a foreign subsidiary so that any capital gain recognized on the sale would qualify as foreign source income by virtue of section 865(f), the Service may be concerned about the government's whipsaw exposure in these situations. That is, if a taxpayer is going to recognize a capital gain on the sale of stock of a foreign subsidiary, it will sell the stock in the foreign country where the subsidiary does business so as to qualify the gain as foreign source under section 865(f). On the other hand, if the taxpayer is going to recognize a loss, it will sell the stock outside such country. However, the government's whipsaw potential in this situation seems quite limited since any capital gain recognized would normally be passive income for foreign tax credit purposes. See Reg § 1.904-4(b)(1)(A). As a result, in many (probably most) cases, there would be no U.S. tax benefit resulting from such a sale and in some cases there might actually be a tax detriment. Thus, it seems unlikely that the Service would have any serious whipsaw exposure.

Taxpayers, however, would continue to have a whipsaw exposure if the Service adopted a regulation that automatically allocated losses sustained on the sale of stock of a foreign subsidiary to foreign source income, albeit passive foreign source income, in situations where a sale resulting in a capital gain could have been arranged to generate foreign source income.[2] In many cases, foreign source passive gains will be subject to full U.S. taxation whereas foreign source passive losses could, in effect, be nondeductible because of the application of section 904(f). For example, if the taxpayer had insufficient foreign source passive income, foreign source passive losses might result in an offset against high tax foreign source income in other baskets, albeit subject to the section 904(f)(5) recharacterization rules. The proposed amendment to section 865(j) would alleviate this exposure.

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[2] If capital gain recognized on the sale of stock of a foreign subsidiary would be passive income, presumably any consistency rule adopted pursuant to section 865 would allocate any loss on the sale of such stock to the passive basket.

SARA LEE CORPORATION

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July 27, 1995

VIA HAND DELIVERY

The Honorable Bill Archer
Chairman, House Committee on Ways and Means
1105 Longworth House Office Building
Washington, D.C. 20515

Re: Extension of Indirect Foreign Tax Credits to Sixth Tier Controlled Foreign Corporations

Dear Mr. Chairman:

This statement is submitted for the record of your July 11 through 13 hearings on miscellaneous tax proposals. I am writing in my capacity as Vice President, Taxes, of Sara Lee Corporation, a Chicago-based U S. multinational with subsidiaries around the world.

Background

Current U.S. tax law presents U.S.-owned multinational companies with numerous time-consuming, inefficient and ill-considered administrative burdens. In particular, under sections 902(b) and 960, a U.S. taxpayer is not entitled to foreign tax credits on either Subpart F income attributable to or dividends received from its foreign subsidiaries below the third tier.1/ As a consequence, such income is taxed at least twice at the corporate level (once abroad and once in the U.S.) and, of course, a third time at the shareholder level. There is no known policy reason for the third-tier restriction.

In an effort to remedy this problem, most of the major tax legislation proposed in the last few years has included provisions which would allow U.S. taxpayers to use the generally applicable foreign tax rules for income attributable to fourth-, fifth-, and sixth-tier CFCs. A provision identical to that now under consideration was included in both H.R. 11 (section 4414) and H.R. 4210 (section 4414), passed by Congress in 1992 (but subsequently vetoed on other grounds), and in the Tax Simplification and Technical Corrections bill (section 413 of H.R. 3419), passed by the House in 1994.

The Current Third-Tier Limitation Harms U.S. Companies and Has No Apparent Justification

Congress has repeatedly recognized the current third-tier limitation is "arbitrary", "may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructurings", and "contributed to decisions by U.S. companies against acquiring foreign subsidiaries". See, for example, the attached excerpt from a 1993 House report.

1/ For these purposes, the controlled foreign corporation ("CFC") in which the U.S. Person directly holds its interest is considered the first tier corporation. Its subsidiary would be considered the second tier corporation and so on.

As these statements suggest, it is difficult and sometimes impossible to structure holdings to conform to the third-tier requirement. Foreign structures can be complex and multi-layered for business, regulatory, or local tax or accounting reasons, or simply because of the general complexities of operating as part of a large company in a multinational environment. A U.S. corporation may, for example, acquire a European group of companies that has subsidiaries in 10 or more layers. In such cases, there are many impediments, including significant foreign tax costs, in attempting to restructure these operations so that no companies are below the third tier. In addition, regulatory constraints and foreign investment restrictions often impede the required restructurings.

The third-tier limitation makes U.S.-owned companies organized and operating in foreign markets less competitive. By not permitting the foreign tax credit on imputed and paid dividends of companies below the third tier, a double corporate tax is imposed on the repatriated earnings of such companies. This double tax effectively raises costs for U.S. owned multinationals. Similarly, acquisitions of foreign multi-tiered corporate groups are less advantageous to U.S. purchasers than they are to foreign acquirers. Moreover, since the payment of taxable dividends can often be controlled by the U.S. parent, the present rule encourages corporations below the third-tier to reinvest their earnings abroad at no U.S. tax cost rather than repatriate them for use in the U.S. Under either outcome, U.S. economic interests are sacrificed without any apparent rationale.

Finally, the previously approved proposal will simplify matters for taxpayers without complicating administration for the IRS. CFCs at any tier are subject to Subpart F under present law. As a result, U.S. shareholders must currently be able to obtain the required information to file information returns and determine Subpart F income. Similarly, such taxpayers have, or can obtain, the necessary information to compute the deemed paid foreign tax credit by a CFC at any tier.

Conclusion

For these reasons, the previously approved proposal to extend the deemed paid foreign tax credit under sections 902 and 960 to dividends from, or Subpart F income of, CFCs below the third tier should be adopted.

Respectfully,

Donald L. Meier
Vice President - Taxes
Sara Lee Corporation

103D CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPORT
103-353

TAX SIMPLIFICATION AND TECHNICAL CORRECTIONS ACT OF 1993

REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ON

H.R. 3419

[Including cost estimate of the Congressional Budget Office]

NOVEMBER 10, 1993.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Indirect foreign tax credits

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). A U.S. corporation may also be deemed to have paid taxes paid by a second- or third-tier foreign corporation. That is, where a first-tier foreign corporation pays a dividend to a 10-percent-or-more U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the first-tier foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first-tier foreign corporation owns at least 10 percent of the voting stock, and from which the first-tier foreign corporation received dividends. The same principle applies to dividends from a second-tier or third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first- or second-tier foreign corporation, respectively, unless the product of the percentage ownership of voting stock at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Under present law, foreign taxes paid below the third tier of foreign corporations are not eligible for the indirect foreign tax credit.

An indirect foreign tax credit generally is also available to a U.S. corporate shareholder meeting the requisite ownership threshold with respect to inclusions of subpart F income from controlled foreign corporations (sec. 960(a)).[35] Moreover, an indirect foreign tax credit may also be available to U.S. corporate shareholders with respect to inclusions of income from passive foreign investment companies.

REASONS FOR CHANGE

The committee believes that complexities are caused by uncertainties and gaps in the present statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of exces-

[35] Unlike the indirect foreign tax credit for actual dividend distributions, the indirect credit for subpart F income inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962).

sive tax--for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

The committee understands that, as a general matter, other aspects of the tax system may interfere with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[36] The committee believes that in the context of tax simplification, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

In light of the bill's provisions extending section 1248 treatment to dispositions of stock in lower-tier companies, the committee believes it is appropriate to repeal the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation but the dividend recipient was not a U.S. shareholder of that corporation. By extending section 1248 treatment to dispositions of stock in lower-tier controlled foreign corporations, the committee believes that earnings and profits (and related foreign tax credits) of such lower-tier companies cannot readily be transferred from the control of one U.S taxpayer to another. Moreover, the committee believes that repeal of this limitation on look-through treatment will avoid significant complexity that would otherwise be engendered by practical application of the limitation.

The committee also understands that certain arbitrary limitations placed on the operation of the indirect foreign tax credit may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructurings. In other cases, there is concern that these limitations may have contributed to decisions by U.S companies against acquiring foreign subsidiaries. The committee deems it appropriate to ease certain of these restrictions in cases where the administration of the foreign tax credit rules by taxpayers and the IRS will not be significantly impaired.

EXPLANATION OF PROVISIONS

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions.

[36] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986*, at 6 et seq. (1987) ("General Reasons For The Act").

STATEMENT OF
XEROX CORPORATION
SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
HEARINGS ON JULY 11, 12 and 13, 1995

Introduction

I am pleased to submit this statement on behalf of Xerox Corporation regarding the need to modify the current subpart F rules of the Internal Revenue Code to remove certain barriers imposed upon U.S. businesses operating in the European Union ("EU") member countries. We believe that the EU, the world's largest integrated market, presents extraordinary opportunities for U.S. businesses to expand their global operations. For U.S. businesses to have an equal opportunity to compete with other foreign companies in the EU, however, the U.S. tax and international trade laws must be reconciled with the emerging new laws and economics of the EU. Appropriate and limited reform of the subpart F rules would reduce tax and administrative obstacles to U.S. companies' ability to compete on an equal footing in the EU but also would include safeguards to prevent tax avoidance opportunities.

Background on Xerox Corporation

Xerox Corporation ("Xerox") markets its products in every state and in over 100 countries. Its corporate headquarters are located in Connecticut, and its products are manufactured principally in New York, California, and Oklahoma. Xerox also operates major research and development facilities in New York and California.

Xerox maintains majority ownership, control or management, either directly or indirectly, of virtually all of its more than 100 subsidiaries. These subsidiaries perform sales, distribution, manufacturing and service functions primarily in Europe, the Far East, Canada, Central and South America and the Caribbean. Xerox's operations in these countries are essential to the absorption of base costs, including research and development investments, incurred in the United States and to reducing its unit cost of production, thereby increasing the competitiveness of its products in both the United States and in foreign markets.

The Problem: Treatment of Subpart F Income under Current Law

As we are all aware, the United States has continued over recent years to be burdened with enormous trade deficits, notwithstanding the increased attention focused on this issue by Congress, the Administration and the business community. In this context, the development of the EU single market presents U.S. multinational corporations with a unique opportunity to develop and expand their markets in the EU's 15 member countries and also provides companies greater access to the emerging markets in Eastern Europe. Unfortunately the subpart F rules create significant obstacles to taking full advantage of this opportunity by U.S. companies.

Generally, a U.S. corporation is not taxed on the earnings of its foreign subsidiaries until those earnings are distributed. However, under subpart F of the Internal Revenue Code, U.S. multinational corporations can be subject to a current U.S. tax on certain undistributed earnings of their foreign subsidiaries. The subpart F rules provide strong incentives for U.S. multinationals to create separate operating subsidiaries in every EU country into which the U.S. parent markets its products. This produces inefficiencies and additional costs for U.S. businesses that foreign-owned competitors avoid by centralizing their European operations.

One example of the operation of subpart F is where a U.S. corporation may be taxed immediately on its U.K. subsidiary's income attributable to the subsidiary's purchase of goods manufactured in the United States by the parent and sold to an unrelated buyer in another EU country. In contrast, if the U.K. subsidiary resold the item to another buyer within the U.K.,

subpart F would not apply. Therefore, by establishing a separate subsidiary in each EU country in which it does business, rather than establishing a single consolidated subsidiary, a U.S. multinational can defer the tax on income received from similar transactions. The formation and maintenance of such separate subsidiaries, however, results in duplicative selling, technical and general and administrative expenses. Nevertheless, the foreign base company rules operate to encourage these inefficient operations.

The subpart F rules were enacted more than thirty years ago to deter U.S. corporations from establishing base companies to artificially shift income on U.S. manufactured goods from the U.S. to tax-haven countries before the goods were resold to the country of ultimate destination. These rules have not kept pace with developments in world trade and the critical need for the United States to compete internationally. In fact, when applied to subsidiaries of U.S. corporations within the EU, subpart F no longer serves its intended purpose. The EU countries have corporate tax systems generally comparable to the U.S. corporate tax system. As such, the subpart F rules have little tax effect on U.S. companies since, to the extent that subpart F tax is generated, it is offset by the foreign tax credit for taxes paid on the income to the EU country. The real burden for U.S. companies is the requirement to trace each cross border sale to determine if the subpart F regime is triggered. In industries with a broad array of products (often including hundreds of different replacement parts) in inventory, cross border tracking is both complex and expensive. It is not required for any EU purpose, and because of U.S. tax credit rules, rarely, if ever, results in any subpart F income from EU country-to-country sales or services transactions.

Effect on U.S. Competitiveness in the Single Market

With the EU's efforts to promote efficient intra-European investment through the elimination of trade and tax barriers, the ability of U.S. multinationals to effectively compete in the unified European market is becoming increasingly important. The EU has enacted a number of tax and corporate law initiatives designed to create a uniform European legal structure. European businesses are able to centralize ownership of inventory to achieve savings of overhead and operating costs in areas ranging from warehousing to invoicing. In contrast, their U.S. counterparts must choose between two poor alternatives: streamlining and centralizing foreign operations to lower costs and improve efficiency while triggering the U.S. tax administrative burdens under subpart F; or, continue selling from the U.S. to separate subsidiaries in each EU country. Under either option, U.S. industry is at a disadvantage in competing with its foreign competitors.

Proposal

To eliminate the handicap imposed on U.S. businesses by the current subpart F rules, and to promote U.S. exports through further expansion of U.S. businesses into the EU, member countries of the EU would be treated as a single country for purposes of determining whether a foreign subsidiary of a U.S. multinational corporation has foreign base company sales or services income taxable under subpart F. To avoid any potential for abuse, this unified treatment would not apply in any EU country that the Secretary of the Treasury determines has tax laws that are likely to promote the evasion or avoidance of US income tax.

Proposals to reform the subpart F rules have received bipartisan support since 1990. The current approach is designed to address questions and issues raised in the course of the legislative process, which includes hearings by the full Committee on Ways and Means in 1990 and by the Subcommittee on Select Revenue Measures in 1993. When similar "EU-one country" proposals have been considered in previous Congresses, there was widespread recognition of the value of simplifying these tax rules that apply to our corporations operating in the EU. At the same time, some staff concern was expressed that any such proposal must be designed to ensure that U.S. tax avoidance opportunities were not thereby created. The current proposal addresses such concerns by giving the Secretary of the Treasury broad discretion to rule that any EU country that allows businesses to avoid U.S. tax is ineligible for the proposal's EU-one country

treatment. In fact, this proposal would allow the Treasury Secretary greater opportunity to work with EU-member countries to ensure that their tax laws are consistent with those of the United States and that such laws and policies do not create opportunities for U.S. tax avoidance.

Summary

To take full advantage of the benefits offered by the unified EU market, U.S. multinationals must be able to consolidate their EU-country operations and eliminate current inefficiencies. The U.S. tax laws must be modified now where appropriate to provide U.S. corporations an opportunity to successfully compete with their foreign-owned competitors. European and Japanese business have already begun to implement the necessary corporate structural changes that will allow them to operate more efficiently in the EU market.

The current definitions of foreign base company sales and services income present an unnecessary and costly obstacle to U.S. corporate planning and management in the EU. No important policy objective is served by subjecting to current U.S. tax the income of U.S.-controlled EU-country corporations from sales to and services rendered to customers located in other EU countries. This treatment is not consistent with subpart F's original policy goal -- to prevent the use of tax haven subsidiaries to avoid current U.S. taxation -- that led to the enactment of these rules.

Reforming subpart F will permit U.S. businesses to develop and expand their roles in the developing EU market. Accordingly, we strongly urge Congress to allow U.S. companies to make the rational economic decisions that will enable them to better compete in the EU.

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July 27, 1995

VIA HAND DELIVERY

The Honorable Bill Archer
Chairman, House Committee on Ways and Means
1105 Longworth House Office Building
Washington, D.C. 20515

Re: Restoration of Exclusion of Foreign Base Company Shipping Income from Subpart F Income

Dear Mr. Chairman:

This statement is submitted for the record of your July 11 and 12 hearings on miscellaneous tax proposals. I am writing as a current Director and former CEO and Vice Chairman of Birdsall, Inc. ("Birdsall"), a U.S. corporation which owns 100 percent of the stock of Tropical Shipping & Construction Co., Ltd. ("Tropical"), a Bahamian shipping corporation.

Tropical was established thirty-three years ago when my father bought a small "Roll-on Roll-off" vessel from a Tampa shipyard and initiated a service to carry construction materials and equipment between South Florida and the Bahama Islands. Since then, Tropical has become a major carrier in the Caribbean region. The company owns 14 container ships and serves 23 locations throughout the Bahamas and the Caribbean Basin. Last year, through Tropical, Birdsall transported more than a billion dollars worth of various U.S. exports to the Caribbean basin, competing against both foreign- and other U.S.-owned carriers.

Our vessels are engaged in a liner-type service -- meaning they depart for various destinations on a fixed schedule from Riviera Beach, Florida, where we maintain substantial terminal facilities for the receiving, handling and loading of cargoes. We also operate a cargo depot in Miami, Florida, and through agency relationships, maintain cargo-receiving locations in Roselle Park, New Jersey and Houston, Texas. Birdsall's headquarters are in Riviera Beach, and we employ over 500 people in the South Florida region.

U.S.-Owned Shipping Operations Cannot Continue To Compete with Foreigners Under Current U.S. Tax Law

Despite our past success, Birdsall's ability to continue competing with foreign owners under the current tax rules is seriously threatened. From the time we started our business until 1975, we were taxed, like our major foreign competitors, only when shipping income was repatriated. In 1975, however, changes in the tax code placed us at a serious disadvantage when shipping income which was not reinvested in shipping assets was included in Subpart F and taxed currently. That disadvantage was expanded in 1986 when the tax law was further amended to subject U.S. owners to an immediate tax on all shipping income from their controlled foreign corporations. These rules are unquestionably the harshest of any major maritime nation. Our foreign competitors either pay no tax or are permitted to defer tax

GENERAL SHIPS AGENT, STEVEDORE, I.C.C. CARRIER

indefinitely. This means that we are subject to an immediate tax of 35 percent while our competitors pay no current tax.

Birdsall, and, I believe, others, cannot compete under this yoke. Since the law was changed, U.S.-owned shipping companies operating international flags have lost a significant portion of their markets. According to an attached recent Price Waterhouse survey, from 1975 to 1993, the size of the U.S.-controlled open-registry fleet in gross tonnage (in absolute terms) has shrunk in half while the foreign-controlled fleet virtually tripled in size. During the same period, the U.S. share of the open-registry fleet has declined from more than 25 percent to approximately 6 percent. Prominent industry members -- for instance, Skaarup Shipping (a bulk operator headquartered in Greenwich, Connecticut) -- have either sold majority interests in a sizable portion of their fleets to non-U.S. persons or otherwise "decontrolled" their operations in order to maintain their companies' ability to compete. Unless Congress corrects this problem soon, Birdsall will be forced to sell out to foreign competitors who operate free of any current income tax.

I am also convinced that, if Congress fails to act, other U.S.-owners will have no choice but to follow suit. When that happens, foreigners will control who carries all U.S. imports and exports and, as a result, will wield substantial control over our country's economic well-being. This would be particularly ironic given that international trade is expected to expand significantly with new trade agreements in effect The likelihood is that U.S.-owned shipping operations will carry almost none of that increased trade. Whatever the original motivation for the current tax rules, it does not make sense to continue this trend and concede carriage of our waterborne trade to foreign control.

The devastating impact of the tax changes has been decried in newspapers from around the country. Two examples, an April 26, 1993 editorial in the Tampa Tribune and a commentary by economist Gary Hufbauer published on May 6, 1993 in the Port Arthur News, are attached.

I note with particular concern the statement by Assistant Secretary Samuels in 1993 when this proposal was last the subject of hearings (then before Subcommittee on Select Revenue Measures) that it "would be premature to propose any change in these rules at this time" because "an inter-agency task force is reviewing our shipping program". Another two years has passed since that statement and, to my knowledge, the Administration has not proposed any reform. With all due respect, evidence of the harm caused by the repeal of the reinvestment rule is clear and convincing. By the time additional Administration studies are done, Tropical and others will be in foreign hands. The time to act is now!

Restoring the Subpart F Exclusion Will Level the Playing Field and Permit U.S.-Owned Shipping Operations To Compete

The proposal before the Committee would put U.S.-owned shipping operations back on a competitive footing with foreign competitors. As described by the Staff of the Joint Committee on Taxation (JCS-19-95, p. 154), the proposal essentially would restore the tax law in effect until 1975 by requiring U.S. owners to pay tax on the shipping income of their controlled foreign corporations when that income is repatriated. Unlike the pre-'75

law, however, the exclusion would be available only for (i) owners that operate at least four U.S. flag ships of 10,000 deadweight tons or more or (ii) derive at least 90 percent of their income from operations in the Caribbean.

Although prior proposals advocated simply restoring the law in effect prior to 1986 (under which the exclusion from Subpart F was conditioned on reinvestments in qualified shipping assets), such half-measures would be inadequate. In many markets, there may be little or no opportunity for economic reinvestment in a given year. For U.S.-controlled carriers operating in such markets, simply restoring pre-'86 law would mean that income held in reserve or put to some other business use would automatically be subject to current U.S. tax. Because foreign competitors do not operate under any such restrictions, the limitation would unfairly penalize those operations that are not in a position to reinvest every year. Finally, for financial accounting purposes, a U.S. company must currently recognize deferred tax liabilities on reinvested amounts under the pre-'86 law which, in turn, would decrease earnings. Under the pre-'75 law, however, tax liabilities should only be "booked" upon repatriation. Both aspects of the pre-'75 law are important to the continued viability of U.S.-controlled shipping.

Exclusion From Subpart F Would Be
Consistent With General U.S. Tax Principles

The changes made in 1975 and 1986 regarding the taxation of shipping income were contrary to general U.S. tax principles. Stated simply, stockholders typically are not taxed until corporate earnings are distributed. This straight-forward general rule is based on the fundamental principle that one should not be taxed on income until it has been received. This same rule applies to an individual who owns a few shares of AT&T and Ford Motor Company's ownership of foreign manufacturing subsidiaries. Thus, the restoration of the pre-'75 law would simply bring U.S. controlled shipping back within general U.S. tax principles.

The requirement that recipients generally operate at least four large U.S. flag ships is intended to help preserve the dwindling U.S. flag fleet and those businesses and seaman who rely on it. The provision for Caribbean-based operations recognizes the special attributes of shipping in that region, among them America's historical dominance of trade in that region. The Caribbean is the one area in the world where U.S.-owned shipping operations continue to carry the majority of goods and, not coincidentally, it is also the one area where the U.S. enjoys a favorable balance of trade.1/ Without the ability to compete against our foreign competitors, these collateral benefits of U.S. controlled shipping will almost surely also fade away.

1/ U.S. carriers act as salesmen for U.S. exports in an effort to increase the demand for their shipping services. Foreign owners who replace the likes of Birdsall are more likely to market exports from their own nations, and thus further erode our balance of trade.

Conclusion

If Congress restores the exclusion of foreign base company shipping income from Subpart F, I am confident that Birdsall will not only hold its own, but also expand its operations over time. More generally, this will permit the U.S.-owned fleet to save itself from foreign acquirors and to participate in expanding world trade. These opportunities will all disappear, however, if Congress waits much longer to act.

Respectfully,

John H. Birdsall, III

Merchant Shipping Fleet in Open-Registry Countries: 1975, 1986, and 1993
(thousands of gross tons)

Ownership by Registry	1975	1986	1993	Percentage Change 1975-86	1986-93	1975-93
Total Fleet in Open-Registry Countries:						
Panama	13,667	41,305	55,053	202	33	303
Liberia	65,820	52,649	54,919	(20)	4	(17)
Cyprus	3,221	10,617	21,665	230	104	573
Bahamas 1/	-	5,985	20,920	n/a	250	n/a
British Dep. Territories	1,887	12,928	16,491	585	28	774
Malta	36	2,015	12,584	5,497	525	34,856
Honduras	n/a	555	1,081	n/a	95	n/a
Total Open-Registry Fleet	84,631	126,054	182,711	49	45	116
U.S.-Owned Fleet in Open-Registry Countries:						
Panama	2,558	2,884	475	13	(84)	(81)
Liberia	19,145	11,360	6,867	(41)	(40)	(64)
Cyprus	0	2	0	n/a	n/a	n/a
Bahamas 1/	-	2,075	2,798	n/a	35	n/a
British Dep. Territories	59	752	1,159	1,175	54	1,864
Malta	0	0	32	n/a	n/a	n/a
Honduras	47	23	0	(51)	n/a	n/a
Total U.S.-Owned	21,809	17,096	11,331	(22)	(34)	(48)
U.S.-Owned Share of Open-Registry Fleet	**25.8%**	**13.6%**	**6.2%**			

1/ Bahamas was part of the British Dep. Territories in 1975.

Sources: Price Waterhouse LLP calculations based on Lloyd's "World Fleet Statistics," and the Maritime Administration's "Foreign Flag Merchant Ships Owned by U.S. Parent Companies," and "Merchant Fleets of the World;" various years.
Figures are mid-year values except for U.S.-owned fleet figures for 1975 which are as of December 31.

THE TAMPA TRIBUNE

The Tampa Tribune, Monday, April 26, 1993

6-Nation/World

EDITORIALS

Fair play for U.S. shipping

The American shipping industry is sinking. Since 1986, the U.S.-owned registry fleet has declined by 42 percent. Foreign-owned shipping companies carry more than 75 percent of America's waterborne trade.

The scuttling of the ship industry has eliminated thousands of job, hurt hundreds of related businesses and cost the nation millions of dollars in local, state and federal tax revenues.

While a number of factors may be involved, there is no doubt that the major culprit is the federal tax revision of 1986.

It is another case of how government meddling, and money-grabbing, throttles American competitiveness.

Some background:

In the Tax Reform Act of 1986, Congress killed the tax deferral on the foreign earnings of the U.S. shipping fleet. Previously, companies had been able to defer foreign shipping income that was reinvested in fleet improvements. The elimination of the deferral, which slipped through the House with no debate, was supposed to raise $40 million a year.

Instead, it virtually scuttled the industry. The reason? Foreign countries do not tax the foreign earnings of their shipping corporations.

Companies in the capital-intensive shipping industry now must set aside about a third of their income for U.S. taxes before they can put money back into their fleets. Not surprisingly, they are dead in the water in global competition.

None of America's shipping competitors, which include Japan, Taiwan, Britain, Norway, Germany and Greece, must meet such an expense. In other nations, the shipping industry is either untaxed or tax-deferred.

Studies by the Institute for International Economics, the Massachusetts Institute of Technology, Price Waterhouse and even the government's General Accounting Office document how the elimination of the deferral instigated the decline of the U.S. fleet.

The solution is simple. Restore the deferral. This would not represent a tax break. It would simply allow companies to defer paying taxes on income that is used for maintenance and expansion.

The change would cost the federal treasury little, since the tax has not generated nearly what was expected.

The 1991 MIT study, which was funded by the shipping industry, concluded, "The cost to the U.S. society of helping the U.S.-owned flag fleet is probably zero or close to it, since tax revenues from the industry segment have actually decreased since the passage of this act."

Indeed, without a tax revision, the nation's fleet likely is doomed, and with it many ancillary businesses.

Important, too, is that the return of the tax deferral would bolster the nation's anemic shipbuilding industry, since it would give shipowners an incentive to use U.S. shipyards for maintenance and drydocking. This obviously would help Tampa's shipbuilding industry and generate more local jobs.

But there is more than parochialism involved. If the United States is to remain a economic powerhouse, if it is to be internationally competitive, and if it is to stop the exporting of American jobs, it must put an end to foolish and self-destructive policies and taxes. Congress can begin the march to economic sanity by reviving the tax deferral for the shipping industry.

Port Arthur News
In our 97th year of publication

Thursday, May 6, 1993

Editorial

Tax on foreign earnings sinking U.S. shipping

GARY HUFBAUER
Opinion

WASHINGTON — As Congress struggles with the first Clinton budget, it should recall a lesson from 1986 when members last wrestled with major changes in the U.S. tax system.

Congress presumably did not want to tax the U.S. ocean-going shipping fleet out of business. It just wanted to raise a little extra money. But Congress forgot the laws of international competition, and the result was to push the U.S.-controlled shipping fleet rapidly toward extinction.

Arthur Laffer may have claimed too much for his famous curve when he argued that lower tax rates would raise U.S. tax revenues across the board. Yet Laffer was surely right about one thing: In important instances, higher tax rates actually curtail the amount of tax collected. This happens because the tax base shrinks as employees and owners play avoidance games, reduce their work effort or simply go out of business.

In the Tax Reform Act of 1986 Congress managed to enact a tax that vindicates Laffer's basic proposition. In its last minute rush to balance the revenue figures (if only on paper) Congress enacted a gaggle of complex foreign tax provisions, all designed to squeeze revenue out of offshore activities. Most of them were misguided.

Among those measures, the most conspicuous failure was the tax on foreign earnings of the U.S.-controlled shipping fleet. According to a study by the General Accounting Office, the new shipping tax failed miserably to raise the revenue promised — an additional $160 million to $240 million over five years, or about $40 million a year. Instead it nearly sank the last vestiges of the U.S.-controlled merchant fleet.

(T)he new shipping tax failed miserably to raise the revenue promised — an additional $160 million to $240 million over five years, or about $40 million a year. Instead it nearly sank the last vestiges of the U.S.-controlled merchant fleet.

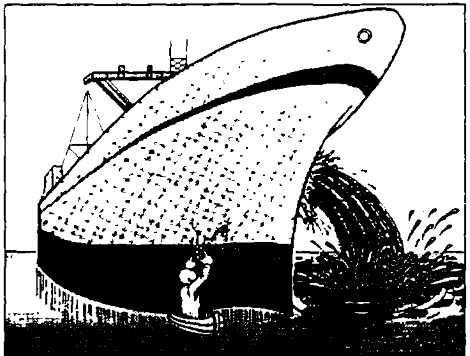
While the tax details are mind-numbing, and mainly of interest to insomniacs, they are:

• Before 1986, under Subpart F of the U.S. Revenue Code, U.S.-controlled ships paid U.S. tax on their foreign earnings at the normal corporate rate if not reinvested.

• But in 1986 the United States disallowed deferral (i.e., postponement, but not forgiveness) of U.S. taxes for earnings reinvested in the shipping industry.

This change was rushed through Congress on the superficial argument that shipping should be taxed like any other industry. The problem is that shipping is not any other industry. U.S.-controlled ships compete for cargo with ships controlled by Taiwanese, Danish, British, German, Norwegian, Japanese, Greek and other owners. The shipping industry is highly capital intensive, so collection of the U.S. tax, whether or not earnings are reinvested, significantly adds to the cost of business.

While the details of foreign tax codes are almost as mind-numbing as the U.S. revenue code, the bottom line is exceptionally simple: Foreign countries simply do not tax the foreign earnings of their shipping corporations.



Hence, with repeal of the reinvestment rule in 1986, the U.S.-controlled fleet has operated at a significant cost disadvantage in comparison with its foreign competitors — not because it is less efficient, but purely because of the hasty-drawn U.S. tax rules.

The outcome is not surprising. Shortly after the United States repealed the reinvestment rule and started to tax its merchant ships, the U.S.-controlled fleet began to vanish. Between 1986 and 1991 it dropped from 17.1 million gross tons to 12.3 million gross tons, a 18 percent decline.

The problem was not a shrinking shipping industry worldwide. During the same period the world fleet rose 25 percent, from 126 million gross tons to 157 million gross tons. Today only 10 of the top 100 container carriers that transport general cargo in the U.S. foreign trade are still U.S.-owned.

With quick action, the endangered U.S.-controlled fleet can be saved. Congress can undo the damage inflicted in 1986 with a simple step: Reinstate the reinvestment rule. Since the 1986 law raised little revenue, its reversal should be scored as costing little revenue.

But if a careful evaluation shows an offsetting revenue pickup is needed, there is one way that taxes might be gathered without decimating the U.S. shipping industry. A very low excise tax on gross tonnage could be imposed on all vessels clearing U.S. ports, whatever the flag and whatever the ownership. For example, a tax of 10 cents per ton would raise about $50 million annually.

There is not such thing as a perfect tax, but a 10 cent tonnage tax, coupled with the reinvestment rule for the U.S.-controlled fleet, would at least solve the problem of vanishing ships and disappearing revenue.

Gary Hufbauer is a senior fellow at the Institute for International Economics. He is a former director of the international tax staff of the U.S. Treasury Department. This column was distributed by the Scripps Howard News Service.

Testimony of James R. Border on Behalf of
Carnival Corporation
Before the House Committee on Ways and Means
Hearings on Miscellaneous Tax Proposals
Concerning the Exclusion of Foreign Base Company Shipping Income
July 11, 1995

Mr. Chairman and members of the Committee, I am James R. Border, Vice President - Taxation of Carnival Corporation. On behalf of Carnival Corporation, I appreciate the opportunity to comment on the proposal regarding the exclusion of foreign base company shipping income from Subpart F income for certain controlled foreign corporations. Carnival Corporation and its subsidiaries (the "Company") is the world's largest multiple-night cruise company based on the number of passengers carried and revenues generated. The Company offers a broad range of cruise products, serving the contemporary cruise market through Carnival Cruise Lines ("Carnival" - a division of Carnival Corporation), the premium market through Holland America Line and the luxury market through Windstar Cruises and the Company's joint venture, Seabourn Cruise Line. The ten Carnival ships have an aggregate capacity of 16,796 passengers with itineraries in the Caribbean and Mexican Riviera. The seven Holland America Line ships have an aggregate capacity of 8,795 passengers with itineraries in the Caribbean and Alaska and through the Panama Canal, as well as other worldwide itineraries. The three Windstar ships have an aggregate capacity of 444 passengers with itineraries in the Caribbean, the South Pacific, and the Mediterranean. Seabourn Cruise Line operates two 204 passenger cruise ships in the luxury market with itineraries in the Caribbean, the Baltic, the Mediterranean and the Far East.

Background

The Company is a controlled foreign corporation which owns at least 75 percent of the foreign-registered, United States-controlled passenger vessels of more than 5,000 gross registered tons. The Company's ships carry 29.9 percent of North American cruise passengers. The Company competes for these passengers with numerous cruise lines throughout the world. None of the Company's direct competitors operate vessels registered in the United States and none of its principal competitors are controlled foreign corporations.

Changes Necessary to Joint Committee Description of the Proposal

As described by the Staff of the Joint Committee on Taxation, the proposal would permit the deferral of earnings for only "a [controlled foreign corporation] which (1) operates at least four U.S.-flag ships of at least 10,000 deadweight tons or derives at least 90 percent of its income from operations in the Caribbean and (2) is not principally engaged in the business of exploring for, or extracting, refining, or marketing petroleum or related products or byproducts." Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995 at 154. We strongly oppose this proposal as it would affect only a very select group of shipping companies and, as such, constitutes a "rifle shot" which the Chairman has indicated is unacceptable. In addition, the proposal as currently written is highly discriminatory and unfair. We urge your Committee to reject the proposal as described by the Staff of the Joint Committee on Taxation.

The proposal does nothing to bolster the overall competitiveness of the United States-controlled maritime industry or to stem the decline of United States-controlled vessels. Further, it fails to recognize that those corporations that still operate vessels have recently made, or are currently in the process of, expensive capital projects to comply with new requirements of the Convention for the Safety of Life at Sea ("SOLAS") and the Oil Pollution Act of 1990 (including retrofit for tankers).

Thus, we believe it appropriate to reinstate the pre-1987 provisions which permitted the deferral of reinvested foreign base company shipping income and the following discussion is premised on the proposal being changed accordingly. Furthermore, to recognize the difference between the time when capital is invested and profit from that capital is generated, we recommend that investments in shipping assets since 1986 be eligible to defer subpart F income earned after the date of enactment.

History

Prior to the Tax Reduction Act of 1975, foreign base company shipping income did not exist.[1] Instead, earnings derived from the international operation of vessels were deferred until repatriated.

In the 1975 Act, Congress classified income derived by a controlled foreign corporation from the operation of vessels as subpart F income. The Act provided that immediate taxation of United States Shareholders could be deferred if the income was reinvested in qualified shipping assets.[2] Earnings previously deferred would be deemed distributed to United States Shareholders when the level of a company's shipping assets declined for any reason, such as depreciation. Through this reinvestment deferral, Congress encouraged United States-controlled shipping corporations to make financial commitments which target future earnings for investment in controlled shipping operations.

The ability to defer current taxation of shipping earnings was repealed in the Tax Reform Act of 1986.[3] Thus, any earnings derived by a foreign-owned, United States controlled vessel are subject to current taxation in the hands of United States shareholders.

Effect of Current Law

The taxation of international shipping operations controlled by United States citizens and residents is unique in the world market. Those jurisdictions with a true interest in developing both their domestic fleet and the international fleet controlled by their residents and citizens have done so through exemption of income derived from the operation of vessels or other incentives which minimize the tax burden on their operations.

In a report prepared by Price Waterhouse for the Federation of American Controlled Shipping,[4] the incentives offered by governments other than the United States were summarized.

> Among the tax benefits provided by jurisdictions in which key competitors [to the United States as a ship registry] are located (and which are not available under U.S. tax law to U.S.-controlled foreign shipping companies) are:
>
> (1) the ability to compute taxable income using highly accelerated methods of depreciation;
>
> (2) the ability to deduct reserves on account of anticipated future expenses;
>
> (3) the ability to defer tax on gain realized on the sale of ships;
>
> (4) the ability to deduct construction period interest;
>
> (5) the ability to use losses generated in international shipping activities (whether directly or through controlled foreign shipping corporations) to shelter income from other sources; and
>
> (6) the ability to defer tax on income earned by controlled foreign shipping companies until actually repatriated.[5]

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[1]Pub. Law 94-12, 94th Cong., 1st Sess. (1975) §602.

[2]IRC §955.

[3]Pub. Law 99-514, 99th Cong., 2d Sess. (1986) §1221(c).

[4]Price Waterhouse, Taxation of the International Maritime Industry: A Comparative Study (Feb. 5, 1990).

[5]Id. at 7.

Since all vessel operating companies are governed by the same, or similar, foreign tax laws, the only difference in the profitability of the enterprise results from the taxes imposed on the owners. The disadvantageous tax treatment of United States shareholders as a result of the repeal of the subpart F deferral regime in 1986 places United States-controlled shipping ventures at a competitive disadvantage.

The magnitude of the disadvantage to the United States-controlled industry can easily be seen by comparing two identical shipping companies, one which is a controlled foreign corporation and one which is not. If each earn $100x annually, the controlled foreign corporation is required to distribute approximately $40x to its shareholders so they can pay United States income tax.[6] Thus, the Company controlled by United States interests must operate with sixty-cent dollars whereas its competitor has one hundred-cent dollars to invest.[7]

This is precisely the situation facing the Company. None of its principal competitors are controlled foreign corporations and they are free to operate without the millstone of subpart F current inclusion. They have more capital to invest in new vessels, market expansion and operations. For every dollar earned by the Company it has only sixty cents to invest in the business or, stated differently, the Company must be sixty-six percent more efficient that its competitors to retain the same funds for capital additions.

Our competitors have not avoided this additional cost associated with United States control accidentally. We believe that, as a direct result of the repeal of deferral, recent acquisitions and capital restructuring in the cruise industry have been accomplished in such a manner as to avoid characterization of the vessel operator as a controlled foreign corporation. For example:

> Royal Caribbean Cruises Ltd. United States' shareholders retain 49 percent of its stock. The remaining shares are foreign-controlled and publicly traded.
>
> Celebrity Cruise Lines Inc. recently acquired a United States investor. Following the transaction, Chandris, a privately-held Greek company owns 51 percent of Celebrity and Overseas Shipholding Group, a United States corporation, owns 49 percent.

In addition, one of the cruise lines, which is a controlled foreign corporation, has recently ceased to operate one of its vessels, chartering it to a third party.

The economics demonstrated within the cruise industry are but a microcosm of the shipping industry in general. In terms of overall impact, the repeal of deferral of reinvested earnings primarily affects

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[6]In addition to Federal income taxes, many states will also impose income and franchise taxes.

[7]The Company advises its shareholders of both the need to distribute earnings and the effect of current United States tax law on its operations in its Form 10-K filed with the Securities and Exchange Commission, stating:

> Payment of future quarterly dividends will depend, among other factors, upon ... certain tax considerations of [the Principal Shareholders], some of whom are required to include a portion of the Company's earnings in their taxable income, whether or not the earnings are distributed. The Company may also declare special dividends to all shareholders in the event that the Principal Shareholders are required to pay additional income taxes by reason of their ownership of the Common stock....

Carnival Corporation, Form 10-K for the year ended November 30, 1994, at 16.

Thus, the Company has stated that tax considerations of its principal shareholders resulting from their control of the Company may cause the depletion of its capital, even when that capital would be better applied towards the construction of new vessels, expansion of operations or responding to competitive pressures.

those companies involved in the transportation of goods which are controlled by United States interests.[8] As a result, the United States-controlled fleet has declined by one-third between 1986 and 1993.[9]

The direct correlation between the increased burden imposed on United States-controlled shipping and the changes wrought by the Tax Reform Act of 1986 is one issue on which the commentators strongly agree.

> While the 1986 Act was intended to improve the performance of the US economy, there is concern that the Act creates a competitive disadvantage for US companies controlling vessels registered abroad, and encourages the transfer of vessels from US control to foreign owners. The precipitous loss of market share has adverse consequences for US competitiveness.[10]

> The cost to the US society of helping the US-owned foreign flag fleet [by reinstating the Subpart F reinvestment deferral] is probably zero or close to it, since tax revenues from the industry segment have actually decreased since the passage of this act.[11]

Thus, at a time when the United States is striving to enhance its competitiveness in the world market, the policy of current taxation of shipping earnings, reducing the effective capital of United States-controlled shipping companies by 40 percent, is the equivalent of making an athlete compete with one leg hobbled and an arm tied behind his or her back.

Revenue Impact

From all public information it appears that the revenue estimate for the repeal of deferral contained in the 1986 Act was in error. According to the 1990 GAO study, actual tax revenues on account of foreign base company shipping income declined from $50 million in 1986 to $47 million in 1987, rather than an increase of $40 million as projected by the Treasury Department's Office of Tax Analysis.[12]

If the fact that the United States-controlled fleet has declined by 40 percent is factored into the equation and it is considered that interest and dividends earned by a shipping company are no longer considered foreign base company shipping income (and not eligible for deferral), the true impact of the 1986 Act was a significant decrease in revenue. Furthermore, if deferral had remained the law, would Royal Caribbean Cruises Ltd. and Celebrity Cruise Lines Inc. become controlled foreign corporations instead of opting for foreign control? If so, was the loss to the Government fisc far greater than that which can be measured traditionally?

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[8]According to a 1990 GAO study, United States-controlled passenger vessels accounted for only 3.4 percent of the total fleet and 0.3 percent of deadweight tonnage. United States General Accounting Office, Tax Policy: Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income (GAO/GGD-90-35), (March, 1990) at 18.

[9]United States Council for International Business, A Policy Framework for Global Business: Recommendations to The Clinton Administration and to The 103rd Congress (March, 1993) at 29. Since issuance of this report, the best estimates indicate that the fleet has declined by an additional seven percent.

[10]Price Waterhouse, Decline in the US-controlled Share of the Open Registry Merchant Shipping Fleet Since 1986, (Feb. 22, 1993).

[11]Massachusetts Institute of Technology, US-Owned Merchant Fleet: The Last Wake-up Call? (July 19, 1991).

[12]Supra. note 8 at 12 and 29.

Conclusion

Carnival Corporation urges the Committee to reject the proposal as currently drafted and strongly supports the Committee's adoption of a proposal to restore the reinvestment deferral for foreign base company shipping income with credit for post-1986 investments. Mr. Chairman, this concludes my remarks.

STATEMENT OF PHILIP J. LOREE, CHAIRMAN
FEDERATION OF AMERICAN CONTROLLED SHIPPING (FACS)
BEFORE
HOUSE WAYS AND MEANS COMMITTEE
ON
MISCELLANEOUS TAX PROPOSALS SCHEDULED
FOR HEARING ON JULY 11-13, 1995

I appreciate the opportunity to submit this statement on behalf of the Federation of American Controlled Shipping (FACS) for the record of your Committee's hearing on miscellaneous tax proposals.

The membership of FACS comprises American based companies with an economic stake in owning, operating, managing, chartering, financing, or otherwise utilizing open registry vessels, and which share a common interest in preserving competitive open markets in international shipping. As a consequence the fair and equitable tax treatment of American companies which control foreign flag ships through controlled foreign corporations ("CFC's") is a matter of critical importance to FACS members.

Thus we are extremely concerned with the proposal described by the Joint Committee on Taxation Staff Report of July 11, 1995 (Report No. 132) under the heading "Exclusion of foreign base company shipping income from Subpart F income for certain controlled foreign corporations." (Emphasis added.) We strongly favor the exclusion for all CFC's but we strongly oppose the proposal that the exclusion be provided only for "certain" CFC's. The best that can be said for such a distinction is that it is not only illogical and arbitrary but also highly discriminatory and unfair.

The Joint Committee staff describes the proposal which your Committee has been asked to consider as follows:

> "The proposal would allow a CFC that meets certain eligibility requirements to exclude foreign base company shipping income from subpart F income. The exclusion would apply to a CFC that is part of a controlled group of corporations which (1) operates at least four U.S. flag ships of a least 10,000 deadweight tons or derives at least 90 percent of its income from operations in the Caribbean and (2) is not principally engaged in the business of exploring for, or extracting, refining, or marketing, petroleum or related products or byproducts."

As we point out in this statement, there is no rational linkage between maintaining a minimum U.S. flag fleet and operating open registry vessels in international trade. Nor is there any reason why an American controlled fleet of foreign vessels trading in the Caribbean should be treated more favorably that similar American controlled fleets trading in the Atlantic, Pacific, etc. The competition is international wherever the ships may be trading. Finally, it an affront to fairness and common sense to propose that fleets operated by American oil companies should for some inexplicable reason be treated differently than fleets operated by non-oil companies. The American oil companies in FACS rank among the finest ship operators in the world, and the type of ships in their fleets--oil tankers--are in some respects much more important in meeting U.S. emergency sealift needs than certain other types of vessels operated by non-oil companies.

As the following paragraphs explain, there are compelling reasons for restoring reinvestment deferral under Subpart F for all American companies seeking to compete against foreign shipowners in the international trades.

A. BACKGROUND ON REINVESTMENT DEFERRAL UNDER SUBPART F

Beginning in the early 1920's American companies sought to compete against lower cost foreign shipping in the international commercial trades by either of two means. Liner companies were able to operate U.S. flag vessels, offsetting their higher costs by direct and indirect federal subsidies. The same subsidies were not available to nonliner companies, and thus the only means by which they could compete in the international trades was by operating "open registry" vessels whose costs approximated those of foreign owned vessels.

Following World War II, in which American controlled open registry vessels provided 2,000,000 gross tons of sealift and suffered substantial losses, the Joint Chiefs of Staff formalized Effective U.S. Control ("EUSC") policy, recognizing that American controlled vessels in certain open registries (today the recognized registries are Liberia, Panama, Bahamas, Honduras and Marshall Islands) are emergency sealift assets available for requisition, use or charter on the same terms as U.S. flag vessels in time of war or national emergency.

Over the past two decades the U.S. tax treatment of American companies controlling EUSC vessels underwent two major changes which affected their international competitiveness and caused the EUSC tonnage to decline at an alarming rate. In 1975 Congress did away with the traditional deferral available to most American investments in enterprises abroad and taxed unrepatriated CFC shipping income on a current basis except to the extent of reinvestment in certain shipping assets.

The 1986 Tax Reform Act was much more onerous for American controlled shipping CFC's by reason of the fact that it eliminated any possibility of deferring tax on unrepatriated shipping income of CFC's earned after 1986, thereby placing American controlled shipping at a capital cost disadvantage in competing against foreign shipowners in the world marketplace.

As documented by the 1990 study on shipping tax laws which Price Waterhouse undertook for our organization, the 1986 Act subjected American controlled open registry shipping to current U.S. tax, while all of the key foreign shipowning competitors remained able to plow either untaxed or tax deferred earnings and profits back into their shipping enterprises.

The situation today is that foreign controlled shipping companies can reinvest each $1.00 they earn if their business judgment so dictates. But in order to match the reinvestments of their foreign competitors, American controlled companies, because of the 1986 Act, have to earn $1.54 in order to reinvest each $1.00 in shipping assets.

Clearly the 1986 Act made acquisition of newly purchased vessels (whether newbuildings or used vessels) much more difficult and problematic for American companies. Shipping is a capital intensive business requiring enormous investments to replace, modernize and expand fleet capacity, and to amortize loans on existing vessels. As a consequence, the cost of capital necessarily is a critical factor for shipowning companies. There is a constant pressure to replace or upgrade older vessels because of approaching obsolescence, fuel and design inefficiencies, technological developments, new safety and pollution prevention requirements, new cargoes and trading patterns and various other factors. In the years since 1986 these capital cost pressures have been exacerbated by sharp rises in the costs of new ship construction as the worldwide demand for available shipbuilding capacity has intensified.

The unfortunate fact is that as the capital pressures in shipping were about to accelerate, the 1986 Act effectively reduced the internal funds available to American controlled shipping by subjecting shipping income targeted for reinvestment in the business to current taxation -- while foreign owners have continued to be able to use their tax deferred or, in some cases,

tax free income to modernize and expand their fleets.

The results of disadvantaging American controlled shipping in such a fashion were summarized in a 1990 study by Price Waterhouse on the impact of the 1986 Act, as follows:

> "The survey results show that U.S. ship acquisitions have been reduced, use of foreign owned vessels has increased, and that a portion of the U.S. controlled fleet has been sold to foreigners. Thus, the net effect of the 1986 Act has been to diminish the competitive position of the U.S. fleet."

The 1990 summary by Price Waterhouse is even more applicable today. The EUSC fleet has lost more than 40% of its 1986 carrying capacity. Any suggestion that the decline was attributable to a shrinking demand for tonnage in the world marketplace must be judged in the light of the fact that carrying capacity of the remainder of the world fleet increased over the same period.

B. ECONOMIC AND TAX CONSIDERATIONS

As American investment in open registry shipping has declined and as the business has shifted to foreign owners unaffected by the 1986 Act, private sector jobs and expertise have been whittled away not only from American vessel operating companies which have either retrenched or left the maritime sector entirely, but also from the broad range of support services that make up the maritime infrastructure in the United States. These services include naval architecture, vessel classification and surveying, ship sales and purchase brokerage, cargo brokerage, marine insurance, admiralty and maritime law, marine accountancy, ship finance, ship management, maritime consulting, maritime arbitration, and various other specialties linked to the maritime sector.

The nature of the maritime business is that shipping companies tend to retain the maritime support services located in their own country, relying on persons with whom they are familiar in business and social relationships. Consequently as American investments in open registry shipping have waned, so have the demands for services of Americans offering support services.

It is also noteworthy that in April 1993 the Shipbuilders Council of America, representing U.S. shipyards performing ship construction, conversion and repair, publicity supported reinvestment of Subpart F deferral, doubtless recognizing that a revitalized American controlled open registry fleet could be a positive factor in their efforts to compete in the international commercial arena. The shipbuilders group stated in part:

> "It is time that the U.S. tax system be changed to encourage, rather than discourage, American business from making long term, productive capital investment, including reinstating the shipping reinvestment rule for American shipowners. Such a move would be supported vigorously by American shipyards."

The nation's maritime infrastructure and the expertise that it entails are vital national assets especially in time of national emergency, and also provide shoreside employment opportunities for thousands of Americans. Restoration of Subpart F reinvestment deferral would aid substantially in revitalizing the maritime infrastructure in the United States.

There is good reason to believe that the overall impact of the elimination of reinvestment deferral under Subpart F on tax revenues has been increasingly negative, and that the negative impact will continue unless reinvestment deferral is restored. In this regard, we urge your Subcommittee to request the Treasury Department to analyze Subpart F shipping tax revenues produced in recent years and to compare such revenues to tax revenues

produced in years prior to 1987. We believe that the results of such a comparison will indicate that restoration of reinvestment deferral would enhance, not detract from, future tax revenues.

Some years ago the General Accounting Office (GAO) reported that Subpart F shipping tax revenues for 1987, the first effective year of the 1986 Act, aggregated about $47 million, actually less than the $50 million in revenues which the GAO reported was produced in 1984 by reinvestment deferral (and higher tax rates). Since 1987, as discussed earlier, the American controlled EUSC fleet has declined sharply, thereby presumably dampening the potential for future tax revenues.

The 1984 revenues underscore the basic consideration that deferral on shipping income is not tax forgiveness but rather tax postponement which, depending on each taxpayer's reinvestment program, should sooner or later produce taxable income, assuming that market and other conditions are favorable.

From the standpoint of sound tax policy it would seem that such a result is much more desirable than that produced by the elimination of reinvestment deferral in the 1986 Act, which was essentially a message to American shipowning companies that they could no longer expect to compete with foreign owners on a level playing field.

C. NATIONAL DEFENSE AND NATIONAL SECURITY CONSIDERATIONS

There are readily identifiable national security interests in preserving and promoting a significant American ownership presence in international shipping. Certainly paramount is the need to have ample privately owned merchant vessels subject to call by U.S. defense authorities in time of war or national emergency in order to provide both direct and indirect support to the armed forces and to maintain the flow of critical raw materials needed to fuel the American economy under emergency conditions. A corollary interest is to maintain in this country an adequate maritime infrastructure of companies and personnel with the highly specialized expertise and experience needed to build, operate, maintain, manage and otherwise service merchant vessels under emergency conditions.

Even if national emergency contingency needs are not taken into account, there can be little doubt that the national interest would be better served by encouraging and maintaining American control over a significant segment of oceanborne transportation services upon which trade and commerce with other nations is dependent, rather than abandoning these trades to essentially foreign domination and control. A healthy American presence can be justified by a number of ancillary considerations, including future tax revenues, control over future energy transportation, enhanced environmental protection, antitrust regulation, the balance of payments, and economic opportunities for American firms such as brokerage, insurance, ship classification, ship management, ship finance, law, accounting, etc.

Under ideal conditions the privately owned vessels would be commercially viable, be owned and manned by Americans and be registered in, and thus fly the flag of, the United States. However, the real world of international competition in no way approximates these ideal conditions. Regrettably, the bottom line is that U.S. flag vessels have much higher costs than competitive foreign vessels, and thus there are virtually no domestic flag vessels which can compete head to head in the international arena with foreign owned vessels in the absence of direct and indirect subsidies, the availability of which today are subject to even greater budgetary and other constraints.

Faced with this reality, defense planners have looked beyond the optimum and have continued to rely on additional emergency sealift coverage from internationally competitive EUSC vessels.

The most recent reaffirmation of reliance on EUSC vessels occurred on October 5, 1989 when the President approved the National Security Sealift Policy prepared by the National Security Council. The NSC released an unclassified summary of the Policy which states that "sufficient military and civil maritime resources will be available to meet defense deployment, and essentially economic requirements in support of our national security strategy." The summary lists policy guidelines approved by the President, including the following:

> "First, the US-owned commercial ocean carrier industry, to the extent it is capable, will be relied upon to provide sealift in peace, crisis, and war....
>
> "Secondly, we must be prepared to respond unilaterally to security threats in geographic areas not covered by alliance commitments. <u>Sufficient US-owned sealift resources must be available to meet requirements for such unilateral response.</u>
>
> "Thirdly, in addition to the US flag fleet <u>we will continue to rely on US-owned</u> and allied shipping resources to meet strategic commitments to our established alliances. The Department of Transportation is responsible for <u>ensuring that the appropriate control over 'effective U.S. control' ships are in place...</u>" (Emphasis added.)

EUSC vessels offer some unique advantages as a supplement to available U.S. flag tonnage. They are not subject to federal budgetary constraints. They are, for the most part, in active service with many deployed in the U.S. import/export trades. Unlike NATO vessels, they are controlled and operated by American companies, which have supported EUSC policy since its inception, and thus their availability is not problematic in emergencies where U.S. actions conceivably might not be supported by its NATO partners.

For national defense reasons alone, maintaining the international competitiveness of the EUSC fleet makes eminent good sense.

D. <u>REINVESTMENT DEFERRAL FOR ALL AMERICAN COMPANIES</u>

Restoration of Subpart F reinvestment deferral only for companies that just happen to operate a minimum fleet of U.S. flag vessels or just happen to operate foreign flag vessels in the Caribbean area--provided in any case that the companies are not oil companies--is the quintessential example of an unfair and discriminatory tax provision. It would produce a "Rube Goldberg" approach to tax policy, because its selectivity is irrational, reflecting only the particular interests of certain clients of certain lobbyists. It is akin to a tax law that would apply only to left-handed citizens with red hair, but excluding in any event all citizens over 40 years of age. It is wrong to pick and chose among American shipowning companies on the basis of criteria that are totally irrelevant to the problem of American controlled vessels seeking to complete on a level playing field in the international arena.

<u>Minimum U.S. flag fleets</u>

There is no rational reason why restoration of Subpart F should be limited to companies controlling foreign flag vessels and also having minimum U.S. flag fleets of at least four vessels of at least 10,000 tons each, while denying such relief to American companies operating EUSC vessels but not operating four U.S. flag ships as well.

There is little, if any, interrelationship between American controlled EUSC vessels and U.S. flag vessels. The EUSC vessels must compete against foreign controlled vessels in the intensely competitive global marketplace without benefit of any direct or indirect U.S. subsidies. On the other hand, there are some U.S.

flag ships which trade internationally, but they do so only because of many hundreds of million of dollars paid annually by U.S. taxpayers in various forms, including (1) operating subsidies averaging about $3 million per ship per year, (2) exclusive entitlement to carry U.S. military cargoes at attractive rates, (3) charter hire for privately owned vessels chartered by the Military Sealift Command, and (4) guaranteed shares of government generated or financed cargoes at rates much higher than world market rates. The remaining U.S. flag commercial fleet operates in the domestic or cabotage trades where competition from foreign flag vessels is prohibited by law, thus creating a supply/demand equation and a rate structure totally unrelated to the international marketplace.

Thus, EUSC ships and U.S. flag ships rarely, if ever, would be operating in the same trades and competing against each other. Some American companies with EUSC vessels (perhaps as many as half of the EUSC companies) have concentrated their maritime operations exclusively in the international nonliner commercial trades and thus would have no reason to become involved in U.S. flag operations.

Nor could these EUSC operators readily become U.S. flag operators in order to qualify for reinvestment deferral under the proposal. The operating subsidy program has been generally limited to liner vessels (plus a limited and declining number of bulk vessels built under a 1970 law). Even more significantly, the subsidy program itself has been frozen for many years and is presently being phased out for lack of funding. At the same time, military cargoes and government cargo preference programs are declining and are of limited significance. A similar barrier exists in the domestic trades. The demand for cabotage tonnage is contracting, and new opportunities for investment are virtually nonexistent.

In short, the realities facing any American company with EUSC vessels but without a minimum fleet of four U.S. flag vessels are that economic opportunities for investing in U.S. flag tonnage are almost nonexistent.

Consequently, the proposed minimum U.S. flag fleet limitation would reward only those companies, which by reason of pure happenstance and/or federal support programs have existing fleets unrelated to the marketplace in which EUSC ships must compete, and whose U.S. flag vessels have received the benefit of either taxpayer funding or protected trades. At the same time the proposed limitation would unfairly deny relief to EUSC owners who have no meaningful economic opportunities to meet the proposed minimum and arbitrary fleet level.

In terms of fashioning a sound U.S. maritime policy, the concept of establishing a minimum fleet size of four vessels would also make very little sense. The companies with larger U.S. flag fleets would be under no incentive to maintain their fleet sizes, other than not to reduce their U.S. flag fleet levels below four vessels, which probably would be justified in any event by the availability of government cargoes and charters. A few companies with very small U.S. flag fleets might be encouraged to maintain or attain the minimum level, but in the final economic analysis even those decisions would ultimately be made on the basis of the need for tonnage in the cabotage or cargo preference trades.

During deliberations on the 1986 Act there were those who believed that the elimination of reinvestment deferral would prompt American companies to transfer their EUSC vessels to U.S. registry--even though the cost differentials of millions of dollars per ship per year clearly made such decisions economically impossible. The empirical evidence is that in the years following enactment of the 1986 Act not a single EUSC ship was so transferred to U.S. registry. Ships were instead scrapped or sold or otherwise transferred to foreign ownership and control. The proposal to link restoration of reinvestment deferral to

minimum U.S. flag fleet levels is clearly grounded on an equally erroneous premise which would only reward those companies which qualified for reasons totally unrelated to the need for reinvestment deferral.

Caribbean Trade

It is spurious to argue that foreign flag vessels trading in the Caribbean are operating under conditions that would somehow entitle the controlling American company to be more favorably treated tax-wise than American companies whose vessels trade elsewhere. The level of competition provided by foreign owned tonnage is essentially the same for American companies throughout the world, since the international trades are generally open to all vessels regardless of registry or ownership. There may be a national interest in having American controlled shipping in the Caribbean trade, but there is an equally compelling national interest in having an American controlled presence in our maritime trades with other trading partners. In sum, regional trading is not a rational basis on which to differentiate between American companies for purposes of restoration of Subpart F deferral.

Exclusion of American oil companies

Traditionally the American oil companies have been among the world's premier tanker operators and their once large fleets accounted for the predominant share of the tanker tonnage available to the United States in event of war or national emergency. In recent years, spurred on in part by the impact of repeal of Subpart F reinvestment deferral, some oil companies have moved away from vessel ownership and its unsatisfactory return on invested capital in favor chartering tankers owned by foreign controlled independent shipping companies. It would be myopic for the United States to enact a tax law that would discriminate against those oil companies still involved in vessel ownership and operation. Such a law would only serve to hasten the exodus of those remaining oil companies with proprietary tanker fleets, and thus would benefit primarily, if not exclusively, foreign owners. It is only fair that American oil companies be treated exactly the same as other American companies.

CONCLUSION

We urge your Committee to reject the proposal to restore Subpart F reinvestment deferral on an arbitrary, unfair and discriminatory basis which favors certain American companies but not others. Instead we ask your Committee to report out an amendment that would restore Subpart F reinvestment deferral to all American companies.

STATEMENT OF

INTERNATIONAL SHIPHOLDING CORPORATION,

OMI CORP., AND

OVERSEAS SHIPHOLDING GROUP, INC.

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 27, 1995

I. Introduction and Summary

This statement is submitted by a coalition of three U.S. shipping companies with substantial U.S.-flag and foreign-flag fleets: International Shipholding Corporation ("ISC"), OMI Corp. ("OMI"), and Overseas Shipholding Group, Inc. ("OSG").

ISC, a Delaware corporation listed on the New York Stock Exchange with headquarters in New Orleans, Louisiana, is engaged through its subsidiaries in ocean and inland waterborne freight transportation throughout the world. ISC's fleet consists of LASH (Lighter Aboard Ship) vessels, car carrier, roll-on/roll-off vessels and similar liner-type vessels.

OMI Corp., a Delaware corporation listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OMI charters its vessels to commercial shippers and to U.S. and foreign governmental agencies for the carriage of crude oil, petroleum products, chemicals, liquefied natural gas, grain, and other dry bulk commodities.

OSG, a Delaware corporation also listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OSG is the largest independent owner of unsubsidized U.S.-flag bulk tonnage, including over 10% of the unsubsidized U.S.-flag fleet. The company also has a substantial presence in the foreign trades. OSG charters its ships to commercial shippers and to U.S. and foreign governmental agencies for the carriage of bulk commodities, principally petroleum and related products, grain, coal, and iron ore.

In 1975, Congress adopted a new tax rule that severely penalized U.S. shipowners and undermined their ability to compete in international markets. Specifically, the inclusion of foreign base company shipping income in the "Subpart F" provisions of the Internal Revenue Code (the "Code") subjects shipping income earned by foreign subsidiaries of U.S. corporations to current U.S. taxation. This represented a departure from the general U.S. tax rules applicable to international subsidiaries of U.S. corporations. Given the capital intensive and highly competitive nature of the international bulk shipping trades, current

taxation places materially greater tax burdens on U.S. shipowners than are imposed on our principal competitors.

This tax change has had a measurable effect on the vitality of the U.S.-owned international shipping fleet, which has declined substantially. Moreover, the pace of that decline is likely to accelerate over time. For instance, just since 1986, the U.S.-owned foreign flag bulk fleet has declined from 36 million deadweight tons ("dwt") to 26 million dwt, while the world bulk fleet has grown from 462 million dwt to 502 million dwt as of the end of 1991 (the most current data). The U.S.-owned foreign-flag portion of the world bulk fleet now is only 5%, one third smaller than in 1986.

OSG, OMI, and ISC respectfully urge Congress to restore the prior law taxation for shipping companies that operate both U.S. and foreign-flag fleets. Exclusion from Subpart F would place these enterprises on the same tax footing as other U.S. multinational corporations engaged in active, capital-intensive businesses around the globe as well as our primary foreign competitors.

II. The Competitive Environment and Taxation of Shipping

A. Shipping Operations of OSG, OMI and ISC.

OSG, OMI, and ISC operate in both worldwide and domestic markets. We believe that ownership of a diversified fleet, with vessels of different flags, types and sizes, provides operating flexibility and permits maximum usefulness of vessels. For a variety of business reasons, each of our vessels is owned by a separate corporate subsidiary, many of which are organized in foreign countries.

OSG's U.S.-flag bulk fleet consists of 16 vessels aggregating approximately one million deadweight tons. ISC's U.S. flag fleet consists of 16 vessels as well. OMI's U.S.-flag fleet consists of 15 vessels aggregating approximately 930,000 dwt. All three companies operate substantial fleets in the foreign trades as well.

By law, U.S. coastwise and noncontiguous shipping is primarily reserved for U.S.-flag vessels built here without subsidies and operated without them. The preference trades, primarily grain shipments to foreign governments, employ both subsidized and unsubsidized vessels. OSG's U.S.-flag vessels, for example, are employed in the Alaskan oil trade and other domestic petroleum trades, by the U.S. government, in the transportation of motor vehicles and for transporting dry bulk cargo, primarily under P.L. 480. The domestic trade is very competitive, and is principally affected by the levels of domestic crude oil production and oil imports, the volume of oil refining, and the government's requirements for military and grain shipments.

Competition in the foreign bulk shipping markets also is extremely keen. Demand generally is dependent upon international economic conditions, as well as on world oil production and consumption, steel production and grain shipments. Charter rates

are determined by market forces and are highly sensitive to changes in supply or demand. Any change in costs, including taxes, can have a direct and adverse impact if it is borne by some but not all carriers.

The economic viability of the international flag fleet has special importance to shipowners operating in both domestic and international trades. For them, income from the international flag fleet provides support for the U.S.-flag fleet when domestic markets are under pressure.

B. Taxation of U.S.-Controlled Shipping Income.

Under tax principles of long-standing application, the United States generally does not tax the income earned abroad by separately incorporated controlled foreign subsidiaries of U.S. corporations until such income is repatriated (e.g., as a dividend by the foreign subsidiaries to the U.S. parent corporation). The "Subpart F" provisions of the Code are an exception to this general tax principle and only apply current taxation to narrowly defined types of income. Under the Subpart F exception, which was first enacted in 1962, the principal U.S. shareholders of a U.S. controlled foreign corporation ("CFC") are taxed on the "Subpart F income" of the CFC in the year such foreign income is earned. Subpart F treats such income as if it had been paid by the CFC as a current dividend to those U.S. shareholders whether or not such income is then (or ever) in fact repatriated. If Subpart F income is repatriated by the CFC in a subsequent year, it is classified as "previously taxed" and is not subject to what would otherwise be a second U.S. tax.

From 1962 until the enactment of the Tax Reduction Act of 1975, foreign shipping income was not classified as Subpart F income. Therefore, in accordance with the generally applicable U.S. tax principle of deferral, the income attributable to the foreign operations of the effectively U.S. controlled foreign flag (EUSC) fleet continued to be subject to U.S. tax only when and to the extent it was actually or constructively repatriated to the United States.[1] In the Tax Reduction Act of 1975, Congress redesignated the foreign shipping income of a CFC as Subpart F income, but provided that such foreign shipping income would not be subject to the basic Subpart F current taxation rule if and to the extent such income was reinvested by the CFC in its foreign shipping operations. When the 1975 legislation was enacted, the "reinvestment rule" was acknowledged to be necessary given the capital-intensive nature of the foreign shipping business and the importance to the nation of a viable U.S.-owned maritime fleet.

Consequently, notwithstanding the redesignation of foreign shipping income as Subpart F income in 1975, for all practical purposes the general U.S. tax principle of deferral continued to apply to the foreign income of the CFC which was attributable to EUSC fleet operations where such income was reinvested in those foreign shipping operations.

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[1] "Effectively U.S.-controlled" foreign-flag vessels are typically owned by foreign subsidiaries of U.S. corporations and are generally flagged under the laws of "open registry" countries that permit the United States to exercise control over the vessels in time of war or other national emergency.

The repeal of the reinvestment rule (and the resulting elimination of tax deferral) in the Tax Reform Act of 1986 consummated a fundamental tax law change initiated in 1975 that reversed more than half a century of U.S. tax policy. As explained below, these changes have had and will continue to have a severe adverse effect on the long-term viability of the EUSC fleet. Moreover, repeal does not conform to the tax policies of other key countries; it was not needed to protect the U.S.-flag merchant marine fleet from deterioration; it is not in the national interest; and it is not sound tax policy.

III. Severe Adverse Effects of the 1975 and 1986 Act

The international shipping business is capital intensive and highly competitive. The capital intensive nature of the business requires an almost continual reinvestment of a high percentage of income to remain economically viable. The acceleration of the timing of U.S. taxation imposes a substantially higher cost of capital on the EUSC fleet (i.e., reinvestments must be financed for the first time with after-tax dollars). This is particularly significant because most "home countries" of the international flag vessels with which the EUSC fleet competes do not impose current taxes on the unrepatriated income of international shipping subsidiaries.

The following countries do not impose a comparable current tax on unrepatriated foreign shipping income: Greece, Hong Kong, the Netherlands, the Philippines, Taiwan, Italy, Korea, Denmark, and France. Under the tax laws of the United Kingdom, tax deferral is permitted with respect to 50 percent of unrepatriated foreign shipping income. While other countries (including Japan and Germany) have adopted tax regimes similar to Subpart F, their use of particular organizational structures, availability of tax and nontax concessions, or other arrangements significantly reduce the impact of such taxes.[2] Significantly, approximately four years ago Canada liberalized the taxation of foreign shipping earnings of foreign corporations. This change was intended to attract to Canada the owners of Hong Kong-based shipping companies, and also to encourage those owners of foreign shipping operations that had relocated to other countries (and other shipping companies) to establish bases in Canada (see Journal of Commerce, February 22, 1991).

U.S. investors in the EUSC fleet effectively now pay a "premium" on investments in that fleet because those investments must be made with after-tax dollars, while a substantial portion of their foreign controlled competitors still invest with pretax dollars. Over time, these premiums on investments in the EUSC fleet would require EUSC vessels to command higher charter rates than their competition in order to maintain overall rates of return that are comparable to those earned by their foreign controlled competitors. To the extent such comparatively higher charter income cannot be obtained--and it will be virtually impossible to do so on a continual basis--the overall economic posture of the EUSC fleet will continue to be eroded. As a

[2] The information with respect to tax regimes of other countries is based in part on a November 1990 study conducted by Ernst & Young for OSG.

consequence, owners of the EUSC fleet are being forced to adopt measures that will further erode the U.S. maritime industry.

The responses to the current taxation of foreign company shipping income include using joint ventures with foreign persons or other techniques to avoid the majority U.S. ownership that will trigger the application of the Subpart F exception, or relocating to another country, such as Canada. As these or other similar options are pursued, there is an increased likelihood that a well-maintained EUSC fleet, both in terms of numbers of vessels and their state of repair, will be unavailable for requisition by the United States when the need arises. Indeed, these results have already begun to materialize. Few new tankers have been registered in the EUSC fleet since 1986, and majority ownership of some EUSC vessels has been transferred to foreign interests so that the vessel owning foreign corporation will not be classified as a "controlled foreign corporation" for purposes of the Subpart F exception (see Fairplay, Page 10, February 8, 1990).

IV. National Security Issues

The competitive viability of the EUSC fleet is a matter of national concern. The EUSC fleet has been deemed by the defense authorities to be a national security asset in times of war or other national emergency.

The National Sealift Policy, signed by the President on October 5, 1989, as National Security Directive 28, states in part:

> Sealift is essential both to executing this country's forward defense strategy and to maintaining a wartime economy . . . . The United States' national sealift objective is to ensure that sufficient military and civil maritime resources will be available to meet defense deployment, and essential economic requirements in support of our national security strategy.

The experience with Desert Shield and Desert Storm vividly demonstrates the continued importance of our sealift capability even as the Cold War has ended. Restoration of the prior law for dual-flag operators will help ensure the viability of the EUSC fleet and advance the country's sealift policy.

V. Restoration of the Exclusion of Foreign Base Company Shipping Income from Subpart F

In light of the severe adverse consequences to the EUSC fleet of the 1975 and 1986 tax law changes (and the importance of the EUSC fleet to the nation), Congress should restore the prior law for companies operating a qualified U.S.-flag fleet.

Eliminating foreign base company shipping income from Subpart F would not constitute a special tax break or insulate companies like ISC, OMI, and OSG from the rigors of international competition. The deferral of U.S. tax on unrepatriated earnings is the general norm of U.S. tax policy. The current inclusion rule of Subpart F is the exception to the historic principle of

deferral. The income from the EUSC fleet, with its substantial required investment in tangible assets, differs from other types of income covered by the Subpart F exception. Restoration of the prior law would be consistent with the general scheme of U.S. taxation applicable to the active business operations of many other U.S. controlled foreign corporations.

Moreover, returning to pre-'75 law is necessary to promote cross-border tax equality between the U.S. owners of the EUSC fleet and many of the foreign owners of the foreign vessels with which the EUSC fleet competes. In short, from a tax policy perspective, restoration of the prior rule would simply give the affected U.S. owners of foreign shipping corporations parallel treatment with the U.S. owners of many other types of controlled foreign corporations and with major foreign-based shipping competitors.

For the reasons set forth in this statement, Congress should reinstate the exclusion for shipping income earned abroad by U.S. operators of dual-flag fleets. Healthy EUSC operations can provide a source of financial strength to weather difficult market conditions by the U.S. merchant marine industry; and the health of both is critically important to the national interest.

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July 27, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Archer:

As the premier organization of corporate tax professionals in North America, Tax Executives Institute has long been concerned about the complexity of the tax law, especially with respect to the Internal Revenue Code's international tax provisions. We believe that the Code's foreign provisions are in need of fundamental reform and simplification, and for this reason we support H.R. 1690, the International Tax Simplification and Reform Act of 1995, which was recently introduced by Congressmen Houghton and Levin.

TEI believes H.R. 1690 represents a large step in the right direction by generally reducing the costs of preparing and auditing U.S. corporate tax returns for American companies engaged in international trade without any material diminution in tax dollars flowing to the Treasury. Enactment of the bill would not only reduce compliance costs — thereby enhancing the country's competitiveness — but it would also signal Congress's commitment to the simplification of the tax law generally. The bill will also bring long overdue reform to the foreign tax credit area.

TEI recognizes that Congress is in the midst of a debate on the basic structure of the U.S. tax system. We also recognize that, in light of the impetus for a major overhaul, some may question the efficacy of the targeted, incremental changes proposed in H.R. 1690. The Institute believes, however, the prospects for major reform should not detract from the important goal of bringing immediate and constructive reform to the international arena. With this in mind, we include our support for, or recommendations to improve, certain provisions of the bill.

Simplification of the International Tax Provisions

The international provisions of the Internal Revenue Code have grown enormously in length and complexity during the past decade. Change has been piled upon change, with inadequate attention being paid to the administrative burdens spawned by the changes. H.R. 1690 would simplify the Code's international provisions by stripping away needless complexity in several areas:

- *Reform of the PFIC Rules.* When enacted in 1986, the passive foreign investment company (PFIC) rules were intended to limit the economic benefit of tax deferral available to U.S. investors in foreign investment funds, as well as to restrict the ability of such investors to convert ordinary income into capital gain. In addition, Congress was concerned that the tax rules not provide undue incentives to make investments outside the United States.

  Unfortunately, when the PFIC provisions were enacted, the definition of a PFIC was so distended that it resulted in the classification of many corporations with active businesses as PFICs. The PFIC rules stand as an excellent example of overkill — taxing not only passive income but also the operating income of controlled foreign corporations (CFCs), which are already subject to tax on their passive income under Subpart F of the Code.[1]

  Even a corporation with a modest number of active subsidiaries is required to devote substantial time to analyzing the applicability of the PFIC rules. Such a compliance burden is not warranted, particularly in connection with CFCs whose U.S. shareholders must include the CFCs' passive income in their taxable income under the rigorous rules of Subpart F. H.R. 1690 would redress the legislative overkill of the current PFIC provisions by exempting controlled foreign corporations from those rules. The remedy offered by the legislation is overdue and should be promptly enacted.

- *Use of GAAP for E&P Calculations.* The concept of "earnings and profits" (E&P) has relevance in the foreign tax area for several reasons. For example, E&P is used in measuring the amount of Subpart F inclusions, the portion of a distribution from a foreign corporation that is taxable as a dividend, the amount

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[1] U.S. tax law generally allows taxpayers to defer paying tax on income earned abroad until that income is repatriated. Under Subpart F, however, certain types of income received by CFCs are currently taxed as a constructive dividend to U.S. shareholders. Subpart F income is generally income that is considered relatively "movable" from one taxing jurisdiction to another and that is subject to low rates of tax. There are elective exceptions from taxation under Subpart F, for example, for income that is subject to a high rate of tax in the foreign country (the "high-tax" exception).

of foreign taxes deemed paid for purposes of the deemed-paid foreign tax credit, and the amount of section 1248 gain taxable as a dividend.

The Code currently provides that the E&P of a foreign corporation is to be computed in accordance with rules substantially similar to those applicable to domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute E&P in the same manner as a domestic corporation. Although a domestic corporation generally calculates E&P by making adjustments to U.S. taxable income, a foreign corporation necessarily uses *foreign* book income as its starting point. The ensuing adjustments become especially difficult in the case of noncontrolled foreign corporations since the U.S. shareholder of such companies may be unable to obtain all the information required to compute E&P.

Although foreign corporations do not compute U.S. taxable income, they frequently do adjust foreign book income to conform with U.S. generally accepted accounting principles (GAAP) for financial reporting purposes. There are numerous differences between GAAP and E&P, but most relate to timing differences and have at most a transitory and nominal effect on a company's U.S. tax liability, especially in light of the requirement of the Tax Reform Act of 1986 that taxpayers compute their deemed-paid credit on the basis of a "pool" of post-1986 undistributed earnings.

Enactment of this provision is needed to simplify calculations of E&P in the foreign area. Accordingly, we recommend that taxpayers be generally permitted to elect to use U.S. GAAP in computing the E&P of foreign corporations. Although the Institute believes the Code currently provides the Treasury Department and IRS with adequate authority to prescribe such rules, H.R. 1690 would clarify that such authority exists. We therefore strongly endorse the adoption of this provision.[2]

- *Limitation on UNICAP Rules.* As enacted in 1986, section 263A of the Code requires the uniform capitalization of certain direct and indirect costs, including interest, incurred with respect to property produced by the taxpayer or acquired for resale (the "UNICAP rules"). The Treasury and IRS have taken the position that section 263A applies in the foreign context.

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[2] Regulations proposed in 1992 would eliminate the need to adjust financial statements prepared in accordance with GAAP, but only with respect to uniform capitalization and depreciation for purposes of computing a foreign corporation's E&P. The proposed regulations do not address the computation of E&P for Subpart F purposes because the IRS and Treasury question whether they have the authority to effect such a change by regulation.

The revenue raised by application of the UNICAP rules to foreign subsidiaries, however, is small compared with the administrative burden they impose on taxpayers. H.R. 1690 would redress this problem by providing that the UNICAP rules of section 263A apply to a non-U.S. person only to the extent necessary for purposes of determining the amount of tax imposed on Subpart F income or on U.S. effectively connected income. It is a simplifying provision that should be adopted.[3]

- *Treatment of EU Countries as One Country*. In 1992, the European Community created a single market now comprised of 15 countries that led to the consolidation of many European business opportunities. The resulting reduction of operating costs enhanced the competitiveness of EC-based corporations, often to the detriment of U.S.-based companies that are subject to Subpart F.

  Under the current Subpart F rules, certain sales and services income that is earned *outside* a CFC's home country is taxable, while income earned *inside* the home country is exempt from current taxation (the "same-country exception"). Computing Subpart F income significantly increases the administrative costs for U.S.-based companies; because of the generally high European tax rates, there is most often no increase in revenues for the United States. Thus, U.S. multinationals may be forced to choose between the potential for cost-efficient consolidation of operations in Europe and higher administrative costs.

  H.R. 1690 would provide one solution to the problem by treating the EC countries as a single country for purposes of the same-country exception. This would permit the efficient consolidation of U.S. multinationals' European operations, thereby enhancing their ability to compete in the European Union. TEI urges the adoption of this provision.

- *Permanent Extension of R&D Allocation Rules*. In 1977, the Treasury Department issued regulations under section 861 relating to the allocation of U.S. research and experimental (R&E) expenses against foreign income. To encourage U.S.-based R&E, in 1981 Congress enacted a temporary moratorium on the application of the Treasury regulations. During the past 14 years, that moratorium has been extended and modified nine times. The most recent statutory rule permits taxpayers to allocate 50-percent of U.S.-based R&E expenses to domestic-source income, and 50 percent of foreign-based research expenses to foreign-source income.

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[3] The adoption of the GAAP E&P rules discussed on page 3 of this submission would render this change unnecessary.

H.R. 1690 would adopt a 64-percent allocation rule (which was the applicable percentage for many years) and make the formula permanent. TEI believes there is a need for certainty and stability in this area. We recognize that recently proposed regulations would adopt a 50-percent allocation rule. Given the yo-yo treatment of these expenses, however, the Institute strongly believes that a *permanent*, legislative solution is warranted and urges the adoption of H.R. 1690's provision.

- *Increase in Filing Thresholds.* Section 6046(a) of the Code requires U.S. shareholders of five percent or more of the stock of a foreign corporation to file such information returns as are required by the Secretary of the Treasury H.R. 1690 would increase the ownership requirement for filing from five to ten percent. This provision would lessen the administrative burden on U.S.-based corporations and should be adopted.

Reform of the Foreign Tax Credit Rules

The core purpose of the foreign tax credit, which has been part of the Internal Revenue Code for almost 80 years, is to prevent double taxation of the same income by both a foreign country and the United States. In recent years, the enactment of myriad and overlapping limitations has eroded the overall effectiveness of the foreign tax credit in alleviating double taxation. Provisions such as the foreign tax credit rules will never be truly simple, but compliance burdens associated with the credit can be eased through the enactment of *de minimis* rules and provisions that reduce the volume of paperwork and technical computations. More fundamentally, competitive disadvantages can be ameliorated by the elimination of artificial barriers to trade. H.R. 1690 is a good start in the reform process; its enactment would benefit not only taxpayers, but also the government without sacrificing sound tax policy goals or material amounts of revenue:

- *Expansion of FTC Carryovers.* Section 904(c) of the Code currently provides that any foreign tax credits (FTCs) not used against U.S. tax in the current year may be carried back two years and forward five. In contrast, the rules for the general business tax credit (section 39) and net operating losses (section 172(b)) provide for a three-year carryback and a fifteen-year carryforward.

  H.R. 1690 would conform the FTC carryover rules to those allowed for net operating losses and general business tax credits (*i.e.*, three years back and fifteen years forward). The provision not only furthers the goal of simplifying the Code, but also limits the situations where the purpose of the FTC — the elimination of double taxation — is frustrated by unrealistically short carryover periods. The provision should be adopted.

- *Translation of Foreign Taxes.* TEI has long advocated a change in the manner in which foreign taxes are translated into U.S.-denominated funds under section 986 of the Code. The current system, which uses the exchange rate in effect on the date the taxes are paid, places considerable administrative burdens on taxpayers to collect and analyze information on a voluminous number of foreign tax payments.

  Prior to the enactment of the Tax Reform Act of 1986, deemed-paid foreign taxes arising with respect to dividends from foreign corporations were translated at the exchange rate in effect on the date of the dividend distribution, in accordance with the seminal decision in *Bon Ami Co.*, 39 B.T.A. 825 (1939). Accumulated profits were translated using the spot rate on the dividend date. By using the same rate to translate foreign taxes and accumulated profits, the *Bon Ami* approach preserved the historical ratio between those two items.

  Section 986(a)(1) was added to the Code in 1986 to address a perceived inconsistency between the rules applicable to taxpayers operating through branches and those operating through foreign subsidiaries. This change, however, exponentially increased a U.S. corporation's administrative burdens in respect of translating foreign taxes. Multinational corporations now find it difficult, if not impossible, to literally comply with the statutory requirements for translating their myriad foreign tax payments. To our mind's eye, the administrative burdens engendered by section 986 are totally disproportionate to any practical or policy purpose that may be served, especially since the Code translates foreign taxes into dollars as of the date the taxes are paid, but still translates accumulated profits using the spot rate on the dividend date. The simplest and easiest way to remedy this problem would be to return to the *Bon Ami* rule — a solution that would translate taxes in the same manner as all other costs of doing business.

  H.R. 1690 adopts an alternative approach, under which foreign taxes would be translated at the average exchange rate in effect for the year that the foreign taxes accrue for FTC purposes. While not perfect, this approach marks a significant improvement over current law and hence seems a reasonable compromise. We recommend that it be adopted.

- *"Look-Through" Rules for Dividends from 10/50 Companies.* The 1986 Act categorized foreign affiliates that are owned between 10 and 50 percent by a U.S. shareholder as a "noncontrolled section 902 company" and created a separate FTC limitation for each such company. The requirement that dividends from each noncontrolled section 902 company be placed in a separate "basket" has generally been recognized as among the most maddeningly, mind-numbingly complex rules of the 1986 Act's provisions. H.R. 1690 would permit taxpayers

to elect a "look-through" rule for dividends similar to the one provided for CFCs under section 904(d)(3) — a significant improvement over current law. Dividends from so-called 10/50 companies, where information to comply with a look-through rule is not available, would be placed into a single basket. TEI recommends enactment of this provision.

- *Extension of FTC to Sixth-Tier CFCs.* Under sections 902 and 960 of the Code, the deemed-paid FTC applies only to dividends paid by (or the Subpart F income of) a first-tier corporation, 10 percent or more of the voting stock of which is owned by a U.S. corporation. The credit also applies to second- and third-tier subsidiaries, as long as the product of the percentage ownership of voting stock at each level equals at least 5 percent.

  The "three-tier" limitation on the deemed-paid FTC was adopted more than two decades ago as a matter of administrative convenience.[4] There is no tax policy reason for restricting the indirect credit to three tiers. Indeed, sound tax policy favors expansion: It would further alleviate the double taxation of U.S. companies operating abroad. Moreover, it would not increase the administrative burden on CFCs, which are now required to provide this information for purposes of Subpart F. H.R. 1690 would expand the FTC to sixth-tier subsidiaries and TEI endorses this provision.

- *Treatment of Overall Domestic Loss.* Section 904(f) of the Code provides for the "recapture" of "overall foreign losses" where the taxpayer sustains a foreign-source loss in one year and there is foreign-source income in a subsequent year; the recapture is accomplished by treating income in the later years as domestic-source income. The law does *not*, however, provide for similar recapture treatment when there is an overall domestic loss that is offset against foreign income in one year and in a subsequent year there is sufficient domestic income to otherwise absorb the domestic loss.

  H.R. 1690 would apply a resourcing rule to U.S. income where the taxpayer has suffered a reduction in the amount of its FTC limitation due to a domestic loss. The bill would recharacterize into foreign-source income U.S.-source income earned in a year subsequent to a year in which an overall domestic loss offset foreign source income. Adoption of this provision not only would provide parallel treatment for foreign and domestic losses, but would also foster U.S.

[4] In 1970, the deemed-paid credit was expanded to domestic corporations claiming a foreign tax credit for foreign taxes paid through a third-tier subsidiary. In making this change, Congress found that expanding the credit through the third tier would not create administrative problems for the IRS because of the reporting requirements and the imposition of the burden of proof on taxpayers to substantiate the credits. S. Rep. No. 91-1527, 91st Cong., 2d Sess. 2 (1971).

competitiveness. This epitomizes equity and simplicity. TEI recommend enactment of the provision.[5]

* * *

Tax Executives Institute appreciates this opportunity to present our views on H.R. 1690 If you have any questions, please do not hesitate to contact me at (412) 553-4153 or Timoth J. McCormally of the Institute's professional staff at (202) 638-5601.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

By: [signature]
Linda B. Burke
International President

[5] An alternative approach would be to eliminate the recapture of overall foreign losses.

STATEMENT FOR THE RECORD
SUBMITTED BY:

AIRTOUCH COMMUNICATIONS
CITICORP
CLOROX COMPANY
CSX CORPORATION
DANA CORPORATION
DRESSER INDUSTRIES
EMERSON ELECTRIC CO.
NYNEX
SBC COMMUNICATIONS INC.
UNOCAL CORPORATION
US WEST

HEARINGS ON MISCELLANEOUS TAX REFORMS
COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES

JULY 27, 1995

I. Introduction.

This statement is submitted by a coalition of U.S. companies interested in simplifying and reforming the U.S. tax rules in order to improve our Nation's ability to compete effectively for business in foreign countries. The coalition represents many diverse industries and collectively provides tens of thousands of jobs for American workers.

Our ability to expand U.S. markets and sell products and services overseas is being impeded by a rule that imposes a separate foreign tax credit limitation for every foreign venture in which the U.S. corporation owns no more than a 50 percent interest. Further, the coalition believes that this problem can be easily remedied through a simple, incremental reform to the U.S. international tax rules.

Specifically, the coalition proposes treating income from these joint venture entities based upon the underlying character of the income earned by such corporations. This is referred to as the "look-through" rule, and would not discriminate between income earned from foreign business ventures in which U.S. companies own a noncontrolling or controlling interest, as long as the U.S. company has a substantial interest in that business venture.

The coalition applauds the efforts of Congressmen Houghton and Levin, who have suggested a number of beneficial changes to the tax laws as part of H.R. 1690, the International Tax Simplification and Reform Act of 1995, including a proposal allowing look-through treatment of income from U.S. joint ventures in foreign countries. Most of the proposals in the Houghton/Levin bill carry little or no cost to the Federal Treasury. They represent sensible and much needed changes that will improve the ability of both large and small U.S. companies to compete in the global marketplace. The coalition hopes that the Congress can seriously consider many of these proposals this year.

II. Explanation of Current Law

The United States has a worldwide system of taxation for citizens and resident corporations. U.S. companies, however, are permitted to credit taxes paid to foreign governments, subject to a limitation preventing the credit from exceeding the U.S. tax liability on the foreign source income. Accordingly, the effect of the foreign tax credit is that foreign source income is taxable at the higher of the foreign or the U.S. tax rate.

Additionally, U.S. rules effectively impose special limitations on the credit for taxes on certain types of foreign income, generally to prevent different types of foreign income, some typically subject to high foreign taxes and some to low taxes, from reducing U.S. liability in a

collective manner, so-called "cross-crediting". These separate limitations, or "baskets", generally apply to the type of income received by the U.S. company, such as passive income or financial services income. The Tax Reform Act of 1986 also expanded these limitations and imposed a separate limitation to dividends received from a foreign corporate joint venture in which the U.S. owner holds less than a majority interest in such operations.

Technically, this separate limitation applies to dividends received by a U.S. corporation from each foreign corporation -- or "noncontrolled section 902 corporation" -- in which the U.S. corporation holds at least 10 percent, but no more than 50 percent, of the stock. Such a corporation, also known as a "10-50 corporation," qualifies for a foreign tax credit under section 902 because of the U.S. corporation's 10 percent holding. The corporation is considered "noncontrolled" because the U.S. corporation's holdings fall below a majority ownership level.

In contrast, a U.S. corporation that receives dividends from a foreign corporation that is more than 50 percent owned by U.S. persons each of whom own 10 percent or more of the voting stock of the corporation -- a controlled foreign corporation (CFC) -- may use a "look-through" rule to aggregate income from all such CFCs according to the type of earnings from which the dividends are paid.

III. Problems With the 10-50 Regime

In many countries, U.S. investors face significant legal and political obstacles to taking a controlling interest in a foreign company, particularly when the host government has a share in the foreign venture. Thus, many times, the U.S. partner owns a significant interest, but not a controlling majority, of that joint venture entity. This is particularly the case in emerging markets such as the countries of the former Soviet Union and People's Republic of China, but it is also true in many developed countries.

Such joint venture activity has steadily been increasing as U.S. companies seek to explore new markets and compete effectively abroad. The so-called 10-50 foreign tax credit rules, however, discourage corporate joint venture activity, even when foreign laws require that U.S. companies take minority ownership interest in cooperative arrangements with local companies in order to do business.

For example, a U.S. company will form a joint venture with a local foreign company and bid for a particular project or license. Many times, because of local law restrictions, the U.S. company can own no more than 49 percent of the joint venture. When the U.S. company figures the bid for the project, typically such financial projections would take into account the fact that a substantial portion of the joint venture's earnings could be subject to double taxation. That is, the earnings would be taxed by the host country and again be subject to tax in the United States because the 10-50 rules limit the U.S. company's ability to claim a tax credit for the foreign tax paid in the host country. If the U.S. corporation were permitted to own more than a 50-percent interest in the local company, this 10-50 limitation would not apply and, in most cases, the foreign taxes would be fully creditable and would not be subject to U.S. and foreign taxes on the same income.

U.S. corporations have also experienced significant problems in developing fair pricing with joint venture partners. Absent the formulation of complicated business structures, which are many times not permitted in the foreign country or may be resisted by joint venture partners, the U.S. company pricing structure must be higher than many joint venture partners in order to secure similar rates of return from investments because of the potential for significant double taxation. U.S. businesses are therefore in the position of having U.S. tax rules, rather than valid business needs, dictate the form in which they seek to do business.

IV. Reasons for Changing the 10-50 Rules

A. Current law impedes the ability of U.S. companies to compete abroad.

The 10-50 regime imposes a penalty tax on U.S. companies involved in foreign corporate joint ventures, resulting in a significant competitive disadvantage. Business trends during the

past decade and a half have made joint ventures an essential part of the global business environment. Among other things, foreign corporate joint ventures, which are singularly affected by the 10-50 basket requirement, have become increasingly important in recent years in penetrating markets in foreign countries that require significant participation in businesses by local nationals. In writing the 1986 Tax Reform Act, Congress did not fully take into account the dimensions of this business imperative and, by imposing the separate limitation requirement, placed a major obstacle in the path of U.S. corporations trying to expand overseas by investing in foreign corporate joint ventures.

The treatment provided under current law prevents the active income and associated foreign tax credit from one corporate joint venture from being averaged with active income of other noncontrolled foreign corporations *and other active controlled foreign corporation income*. Because foreign income taxes on such income can not be averaged with taxes paid on other types of active business income, the 10-50 regime imposes an unfair penalty tax on U.S. corporate shareholders of such entities. Foreign-based competitors, meanwhile, can enter into minority-owned joint ventures at lower tax and compliance costs than U.S. multinational companies, putting U.S. investors at a disadvantage in emerging markets.

B. The separate foreign tax credit basket has no tax policy basis in the case of a foreign joint venture.

The separate foreign tax credit limitations added by the 1986 tax law generally were intended to apply to specific categories of income for one of three reasons: the income's source (foreign or U.S.) easily can be manipulated; the income typically bears little or no foreign tax; or the income often bears an abnormally high tax rate or a rate that is higher than the rates on other types of income.

These three principles underlying the separate limitation categories are based on the character of the income earned outside the United States; they are not related to the type of entity from which the income is earned. But for the fact that a foreign business entity is a non-majority-owned foreign corporation, its dividends would qualify for the same look-through treatment that applies for active business income earned by CFCs. If look-through treatment applied to these joint venture dividends, the dividend income would be subject to the existing separate limitation categories. This would ensure that tax credits for certain types of income could not shelter other types of foreign source income from U.S. taxes in an "abusive" manner.

In the case of a foreign corporation that is not majority U.S.-owned, it has been argued that U.S. shareholders with relatively small interests in foreign ventures may not have access to the information on income and taxes that would be necessary to apply a "look-through" rule. However, this concern is undermined by the existing requirement that U.S. shareholders receiving dividends from a 10-50 corporation must obtain earnings and profits, and foreign tax payment information from the 10-50 corporation in order to claim the deemed paid credit under section 902. Both of these requirements mandate that detailed information be obtained from the 10-50 corporation. Other sections of the tax Code also apply "pass-through" treatment to these companies. For example, under section 904(d), a U.S. taxpayer, even in the case of non-controlled foreign corporations, must "look through" to identify income constituting foreign oil and gas extraction income and high withholding tax interest, which fall in their own limitation categories. Moreover, in a typical joint venture, the participants have their own strong interest in being fully apprised of the venture's affairs and negotiations typically focus on the provision of detailed financial information to the participants.

The business activities of one 10-50 joint venture can, and often are, integrated with those of another 10-50 joint venture operating in similar or complementary product lines. However, the 10-50 basket limitation harms the competitive position of the U.S. company vis-a-vis its foreign competitors by disallowing aggregation of such related business income for foreign tax credit purposes.

In addition, under current law, look-through treatment applies to a U.S. person that owns at least 10 percent of a foreign partnership. There is no policy reason for adopting a higher ownership threshold for foreign corporations.

C. The 10-50 regime has created difficult compliance burdens for U.S. companies.

The requirement for separate foreign tax credit "baskets" for each 10-50 corporation imposes substantial complexity and higher administrative costs on U.S. shareholders. These separate calculations mean that a U.S. corporation owning non-controlling interests in many foreign corporations must establish and keep track of numerous separate foreign tax credit baskets. U.S. corporations and their affiliates may have dozens or even hundreds of investments in these non-controlled foreign corporations.

Due to the complexities of the rules involving noncontrolled corporations, taxpayers may face hundreds of separate foreign tax credit calculations for both regular and minimum tax purposes with respect to their 10-50 corporations. Moreover, because of the relationship among baskets, the adjustment of a single item, such as a nominal adjustment in the earnings and profits of one company, will have a rippling, flow-through effect on all the others -- not only for the current year, but for carryback and carryforward purposes as well.

For each 10-50 company, for example, taxpayers (1) must allocate and apportion deductions such as interest, research, and other expenses incurred by the U.S. group; (2) must allocate loss incurred in any one basket to income in other baskets; (3) must keep track of separate pools of earnings and previously taxed income; and (4) must make numerous other adjustments.

D. The necessity to compete abroad has caused U.S. taxpayers to enter into needlessly complicated arrangements to plan around 10-50 treatment.

Substantial resources are consumed in attempting to transform simple 50-50 joint venture corporations into CFCs merely to accommodate U.S. tax considerations. The 10-50 rules thus violate the overriding tax principal that the form or character of a business be driven by business necessity rather than tax policy considerations.

For example, partnership entities have multiplied to avoid the 10-50 provision. However, even these structures may not be available when foreign governments or other joint venturers refuse to accommodate U.S. tax rules. In addition, such structures may require the use of complicated partnership arrangements that could create other negative tax consequences for the U.S. parent -- an extreme price to pay for obtaining look-through treatment.

The coalition would like to emphasize that in petitioning for the repeal of the 10-50 rules, U.S. companies are not trying to engage in fancy tax planning or sophisticated avoidance techniques in order to limit or eliminate U.S. taxes. U.S. companies desire to compete abroad in an environment in which a significant competitive disadvantage is not imposed under the U.S. tax rules.

V. Explanation of Proposal Repealing the 10-50 Rules.

The solution to this anticompetitive problem in the U.S. tax rules is not very complicated. The coalition proposes that income from 10-50 entities be computed for purposes of the foreign tax credit limitation based on the underlying character of the income earned by such corporations. This so-called look-through rule would not discriminate between income earned from foreign business ventures in which U.S. companies own a controlling or a noncontrolling interest.

The bill introduced by Congressmen Houghton and Levin, H.R. 1690, would allow look-through treatment of income from 10-50 companies. The provision would be effective generally for taxable years beginning after December 31, 1995, and would be applicable for earnings of the joint venture in any year. Additionally, under H. R. 1690, the taxpayer would not be required to utilize the look-through rules if information necessary to make the calculations is not "readily available" to the U.S. company. The coalition strongly supports these provisions.

If revenue constraints force reconsideration of the H.R. 1690 provisions, the coalition would also support a provision allowing look-through treatment only for earnings and profits

accumulated in taxable years of 10-50 corporations beginning after 1995. For administrative simplification, dividend distributions made from earnings and profits accumulated during pre-effective date tax years would be categorized in one separate 10-50 foreign tax credit basket.

Additionally, the H.R. 1690 provision could be viewed as elective in that it would require taxpayers to apply look-through treatment only in cases where sufficient information is "readily available". The coalition would support a non-elective provision that would take into account the fact that, in some limited circumstances, U.S. companies will not have access to sufficient information from the joint venture to make the calculations under the look-through rules.

Further, the coalition believes consideration should be given to a provision that would insure that hybrid entities would be treated on an equal footing with 10-50 corporations under a look-through regime.

VI. Conclusion

In many instances, U.S. companies competing vigorously abroad must do business in foreign countries in which the local government prohibits control of the local business entity. But when the U.S. company enters into a joint venture with a local company, the U.S. tax rules impose a significant penalty. It is simply unfair and anti-competitive for the current tax rules to increase the effective tax rate on the foreign operations of U.S. businesses by carving out one slice of active business income -- income earned by 10-50 companies -- and subjecting that income to a potentially higher rate of taxation than other foreign income.

The coalition would be happy to assist the Members of the Committee in answering any questions or providing further information related to these issues.

July 27, 1995

Written Statement Submitted for Hearing Record
Coordinating Committee for International Tax Reform
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

Ways and Means Committee
U.S. House of Representatives
Hearings on Miscellaneous Tax Reforms
Tuesday, July 11, 1995, and Wednesday, July 12, 1995

Proposal: Repeal of Excess Passive Asset Provision and Modification of Passive Foreign Investment Company Provisions (Foreign Proposal #20 on Committee Advisory No. FC-8, Dated June 30, 1995)

The Coordinating Committee for International Tax Reform is comprised of corporations urging repeal of Internal Revenue Code Section 956A and seeking an exclusion for controlled foreign corporations from the tax law provisions dealing with passive foreign investment companies (PFICs). The companies making up the Coordinating Committee are: Intel Corporation; Hewlett-Packard Company; Novell, Inc.; Microsoft Corporation; Johnson & Johnson; and Schering-Plough Corporation. Correspondence to the Coordinating Committee may be directed to: Nicholas Giordano; Ernst & Young LLP; 1225 Connecticut Avenue, NW; Washington, D.C. 20036. The telephone number is: (202) 327-9660.

Summary of Argument

The Coordinating Committee for International Tax Reform urges the House Ways and Means Committee to repeal Section 956A and eliminate controlled foreign corporations (CFCs) from application of the PFIC rules. These provisions reflect a misunderstanding of how businesses make investment decisions, and of the need of many multinational firms--particularly research intensive companies--to accumulate capital before making major investments. Section 956A and the PFIC rules are hindering the international competitiveness of U.S.-based multinationals and distorting investment decisions that properly should be governed by economic considerations alone. The real-world effect of Section 956A and the PFIC provisions is to create an incentive for building or modernizing overseas plants rather than U.S. plants. The long-term effect is likely to be a loss of jobs in the United States.

Background on Section 956A and PFIC Provisions

The tax law provisions dealing with passive foreign investment companies (PFICs) were put in place in the Tax Reform Act of 1986. The purpose was to eliminate tax deferral on income earned by passive investors through investments in publicly held foreign mutual funds. Under these provisions, an entity is a PFIC if more than 50 percent of its assets are passive or if more than 75 percent of its income is passive. Once a company becomes a PFIC, all of its income is permanently subject to tax on a current basis as if these earnings were repatriated.

This PFIC regime was not intended to apply to CFCs, which were covered by a separate regime (Subpart F) designed to tax passive income on a current basis. Indeed, neither the House-passed legislation nor the Senate-passed legislation called for application of the PFIC rules to CFCs. Inexplicably, application of the PFIC rules to CFCs was added in the House-Senate Conference Committee.

The Omnibus Budget Reconciliation Act of 1993 made matters worse by revising the PFIC asset test, but only for CFCs. Now, a CFC whose *tax basis* in its passive assets exceeds 50 percent of its tax basis in all of its assets will be a PFIC. Prior to this change, the asset test was employed based on the valuation (rather than basis) of passive assets compared to total assets. Since profitable CFCs generally would have had valuable active operations

generating these profits, the PFIC regime did not generally impact CFCs--other than to create a valuation nuisance.

Prior to the 1993 Act (apart from the PFIC provisions), the United States did not tax the active income earned by a U.S. corporation's controlled foreign corporation (CFC) until that income was repatriated as a dividend or as a loan to the U.S. parent. This tax deferral enabled U.S.-based multinational corporations to compete on a reasonably level playing field with foreign-based multinationals, which typically do not face any additional home country tax burden on their foreign operations.

The Clinton Administration proposed in 1993 a limitation on tax deferral which subjects to current U.S. tax a portion of a CFC's active income to the extent it has an "excessive" accumulation of passive assets. This provision, set forth at Section 956A of the Internal Revenue Code, subjects to current tax the excess of the CFC's tax basis in its passive assets over 25 percent of its tax basis (i.e., cost less depreciation or expense deductions) in all of its assets. Accordingly, the tax is assessed on the total value of excess assets, *not income*, a most unusual basis on which to impose a tax.

Since the 1993 change, the PFIC rules largely overlap with the excess passive asset rules of Section 956A, providing unnecessary duplication. However, the excess passive asset rules apply a 25 percent test and the PFIC rules apply a 50 percent test.

Perverse Incentive for Foreign Investment

Quite contrary to the legislative intent underlying these provisions, they create an incentive in many cases for U.S.-based multinationals to favor investment abroad over investment in their U.S. operations. Since the deemed repatriation of earnings only occurs to the extent that passive assets (i.e., cash) exceed 25 percent (or 50 percent for PFICs) of total assets, these provisions encourage companies to increase their "active" assets abroad. Because investing in active foreign assets will reduce a multinational's tax liability, the provisions essentially provide a 35 percent investment tax credit for foreign investment.

Consider again for a moment that last sentence. *The tax law now provides a 35 percent investment tax credit for foreign investment.* While business

considerations will always win out when they conflict with tax considerations, the facts cannot be ignored--this is a powerful incentive.

Corporations devoted large amounts of energy trying to take advantage of the investment tax credit, when the benefit provided under that incentive was only 10 percent, less than a third of the bang for the buck provided under this new incentive. Moreover, the investment credit was available only for a far more narrow range of investments. Is there any reason not to believe that at least the same amount of energy will be devoted to tax planning in this case? And is there any justification for allowing such an incentive to remain on the books, when it jeopardizes U.S. jobs so unnecessarily?

The real-world effect of these provisions is not just to distort business decisions and to force corporate officials to devote resources to tax planning that otherwise could be devoted to productive investment. It is to pressure companies to invest overseas when an analysis of economic factors alone might point to U.S. investment as a better business decision.

International Competitiveness of U.S. Firms Undermined

Both Section 956A and the PFIC provisions impair the international competitiveness of U.S.-based businesses, reducing their ability to penetrate foreign markets and to increase sales, and thereby diminishing their ability to generate jobs in the United States. The global economy requires many American industries to have facilities abroad to develop markets and compete effectively with foreign competitors. Foreign governments generally do not impose provisions similar to Section 956A and the PFIC provisions. Thus, foreign-owned companies enjoy enhanced access to world markets and can better plan their cash flows.

Joseph H. Guttentag, International Tax Counsel at the Treasury Department, addressed this point in testimony to a July 21, 1995, hearing of the Senate Finance Committee. Guttentag stated: "Countries have different tax rates and tax bases. Therefore, it should come as no surprise that various countries have different approaches to the individual components of international taxation. Nevertheless, in looking at the totality of the U.S. tax system, our rules are similar to our major trading partners, whose tax laws provide for general deferral of tax combined with a foreign tax credit and anti-abuse provisions. Accordingly, many foreign competitors of U.S. multinationals are subject to tax regimes similar to the U.S. tax system."

This statement does not present a complete picture, in our view. Like the United States, most other major countries grant deferral on income earned abroad until such income is repatriated to the resident country, generally in the form of dividends. Generally, other countries' rules for restriction of deferral of home-country taxation are much narrower in application than the U.S. rules. By placing more restrictions on deferral, the United States has put U.S. firms at a competitive disadvantage.

Other countries' rules for restriction of deferral of home-country taxation are much narrower in application than the U.S. rules. Some countries have a subjective test that operates as an exception to current taxation, similar to pre-1986 U.S. rules that allowed deferral if the primary purpose of operating abroad was not tax deferral. Moreover, countries such as Japan also enter into tax sparing treaties granting tax credits in the home country even when subsidiaries operate abroad in a country under a tax holiday. (For example, Japan has a tax-sparing treaty with Singapore.)

Business Realities Ignored in Treasury Testimony

Section 956A and the PFIC provisions undercut efforts of CFCs to accumulate earnings overseas to finance foreign investments. Such investments are generally not made consistently each year because it can take several years to accumulate the capital needed to build state-of-the-art manufacturing facilities and to purchase the sophisticated equipment needed to compete effectively in today's markets.

Disproportionate harm is done to research intensive companies because they are prone to the use of equity rather than debt to finance expansion and frequently need to accumulate earnings over several years before making expansion investments. These are the very companies that can least afford the tight reinvestment schedule required to avoid the impact of Section 956A and the PFIC regime.

Guttentag stated in his recent testimony that, prior to the enactment of Section 956A, "the opportunity for extended deferral of tax enhanced the incentive to locate business operations abroad. It also created a distinct incentive to retain an amount of earnings in excess of the reasonable working capital and expansion needs of the foreign business." Moreover,

Treasury is "satisfied that the 25-percent threshold generously accommodates working capital needs of most CFCs."

Guttentag undercuts his own argument on whether deferral creates an incentive to retain "excess" earnings elsewhere in his prepared testimony. He states that: "the choice of an active foreign investment...depends not only on the tax results but also on the availability and suitability of investment opportunities and business objectives. Those taxpayers that chose passive over active foreign investment before enactment of Section 956A may not have had active investment opportunities; *given the relatively low rates of return on passive versus active assets, one could assume that CFCs would have exploited any genuine opportunities for active investments* rather than passively investing an amount of earnings that far exceeds the reasonable needs of the business and that now exceeds the Section 956A threshold." (emphasis added)

Guttentag is right to believe that business executives would rather invest in expansion of their businesses than have assets held in passive form. After all, few shareholders are satisfied with a company plan to produce earnings roughly comparable to amounts being paid on low-risk money market funds. All corporations seek to achieve the highest rate of return on investments possible, and the rate of return on passive investments is indeed usually low compared to what can be earned on an expansion of the core business.

The problem is that corporations can not always follow the precise schedule for making new investments that the tax law is demanding. It may take several years to put aside sufficient assets to finance development of a new plant. Or non-tax business considerations may argue in favor of holding off on an investment until conditions justify the investment in economic terms. Guttentag's point--that companies would rather make active investments than passive investments--is correct. But why then does he want to penalize them for making passive investments when circumstances argue for a delay in making the preferred form of investment?

We also agree with Guttentag that the choice of an active investment "depends not only on the tax results but also on the availability and suitability of investment opportunities and business objectives." Precisely so. Corporations who are complaining that Section 956A and the PFIC provisions may force them to invest in an overseas plant rather than a U.S. plant are not arguing that they make such decisions solely as a result of tax

considerations. In close cases, however, the tax considerations can tip the scales against the result that would be obtained were business considerations alone being weighed.

Tax ramifications are not the only business consideration, but they sometimes are an important business consideration. The best tax policy is to use taxes to collect revenue, not to influence business decisions. As explained below, Section 956A and the PFIC provisions seem designed to create the greatest possible amount of interference in business decision-making while collecting the least possible revenue for the government.

As for the Treasury view that the Section 956A threshold "generously accommodates working capital needs of most CFCs," this statement is revealing of the mindset that gave rise to the distortions resulting from Section 956A and the PFIC provisions in the first place. Every corporation is different, every time period is different, the competitive environment in every country in which U.S. firms are struggling to compete is different. Treasury simply cannot make a blanket determination as to the working capital needs of the hundreds of firms trying to compete in international markets.

In some cases, the threshold will provide for adequate working capital. In some cases, it will not. In some cases, firms will find it proper to store assets in passive form (and pay the U.S. tax under Subpart F until the funds can be effectively utilized in the business). In other cases, they will currently expand their corporate operations where appropriate. The determining factor should be business considerations, not tax considerations. And there is no reason to believe, in those cases in which a firm allows passive assets to build up, that there is some nefarious tax consideration behind the decision that Treasury must try to thwart.

As Guttentag himself noted, the firm might well prefer to make an active investment, but the time may not be right. One firm's working capital needs may be somewhat larger than the needs of others, at least at a given time period. And when economic considerations justify converting the passive assets into active investments, presumably the firm will then make that conversion. There is no place in the tax law for micro-managing business decisions of this sort.

Provisions Generate Little Revenue

Tax writers in the House and Senate have asked the Joint Committee on Taxation staff for estimates of the revenue effect of repealing Section 956A and eliminating CFCs from application of the PFIC rules. These estimates have not been completed. However, discussions with executives of a number of multinationals indicate that revenue collections from the changes made in 1993 are likely to be far less than expected, and that revenues may even diminish as a result of the provisions.

While the provisions force companies to put more focus on tax planning than they would prefer when making decisions as to where to invest and expand, there are a variety of means by which companies seeking to avoid the tax can do so. The problem is not that companies will be paying more tax. It is that the government will be collecting little if any additional revenue from provisions encouraging business decisions otherwise not economically justifiable. Indeed, to the extent that companies respond to these provisions by converting existing cash reserves into active business assets earlier than otherwise would be the case, *federal revenues will decrease because of a drop in existing Subpart F income.*

Because foreign investments in active business assets are effectively given a 35 percent tax credit as compared to U.S. investments, foreign factories will be modernized more rapidly than U.S. factories. Over time, this can cause a snowballing effect because in poor economic times or business cycle downturns, older, less efficient plants will be closed first and those plants will likely be U.S. facilities. The long-term effect is reduced U.S. economic activity, which can only decrease revenue to the U.S. Treasury.

Conclusion

The Coordinating Committee for International Tax Reform urges the committee to eliminate the current law's perverse incentive on U.S. multinationals' business decisions, and to increase their overall competitiveness in the global marketplace, by repealing Section 956A and eliminating CFCs from application of the PFIC rules.

TESTIMONY OF FRANK ZARB
THE NATIONAL ASSOCIATION OF INSURANCE BROKERS

Mr. Chairman, thank you very much for the opportunity to testify before the Ways and Means Committee concerning the proposal now before the Committee to clarify the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") to remedy the anomalous treatment of insurance brokers under the Passive Foreign Investment Company ("PFIC") rules and Internal Revenue Code section 956A.

Mr. Chairman, my name is Frank Zarb, and I am Chairman and Chief Executive Officer of Alexander & Alexander Services, Inc., a major insurance broker headquartered in New York City. I am testifying today not only on behalf of my own company, but also on behalf of the National Association of Insurance Brokers ("NAIB"). NAIB consists of over 30 member companies with offices throughout the United States and the world. The NAIB Tax Committee is comprised of representatives of Alexander & Alexander Services, Inc., Willis Corroon Corporation, Johnson & Higgins, Marsh & McLennan Companies, Inc., Minet (a subsidiary of the St. Paul Companies, Inc.), Rollins Hudig Hall Co., and Sedgwick Inc.

At the outset, Mr. Chairman, I wish to thank you for your leadership on this issue. As you know, the proposal which is the subject of this testimony is identical to H.R. 4626, the "Insurance Broker Foreign Source Income Clarification Act of 1994", which you introduced in the 103rd Congress along with Congressman Cardin. If enacted, H.R. 4626 would have amended the Internal Revenue Code of 1986 (the "Code") to provide that income derived from insurance brokerage activities is not treated as passive income, thus effectively exempting insurance brokers from both the PFIC rules and section 956A.

Because the problems which H.R. 4626 sought to address remain unmitigated, a similar provision merits inclusion in upcoming legislation. On behalf of all the member companies of NAIB, I wish to affirm our strong continued support for a provision similar to H.R. 4626.

For the benefit of other members of the Committee less familiar with the issue, I would like to take this opportunity to review the problems presented for insurance brokers by the 1993 Act, and explain why the solution you, along with Congressman Cardin, proposed during the 103rd Congress remains sound tax policy.

I. OVERVIEW.

As an unintended consequence of the 1993 Act, a U.S.-owned insurance broker's foreign subsidiaries erroneously may be treated as a predominantly "passive" rather than "active" businesses. That designation harms insurance brokers in two ways.

First, U.S.-owned foreign insurance brokers, unlike other financial intermediaries, may be subject generally to the PFIC rules. Prior to the 1993 Act, all financial intermediaries--including banks, insurance companies, and securities brokers and dealers as well as insurance brokers--generally were not affected by the PFIC rules.

Second, pursuant to Code section 956A, a new provision enacted as part of the 1993 Act, the unrepatriated active earnings of U.S.-owned foreign insurance brokers may be subject to current taxation; indeed, even the funds which they temporarily hold as a fiduciary for others, such as premiums to be paid to insurance companies or benefits to be paid to policyholders, may be subject to tax as "passive" income.

Both Congress and Treasury repeatedly have affirmed the policy considerations which support not subjecting financial intermediaries to the PFIC rules and section 956A. Accordingly, the 1993 Act recognized that financial intermediaries generally should not be subject to the PFIC rules and section 956A, but it erred in failing to provide, as prior law had done, that insurance brokers be included among such financial intermediaries. Significantly, as detailed below, the legislative history of the 1993 Act strongly suggests that the omission was inadvertent.

The severe problems for insurance brokers which resulted from the 1993 Act quickly became evident, and a bipartisan effort commenced to provide that insurance brokers once again be treated like all other financial intermediaries. As noted, in 1994, Chairman Archer and Congressman Cardin introduced H.R. 4626, which, if enacted, effectively would have reaffirmed the exemption for insurance brokers from both the PFIC rules and section 956A.

A proposal identical to that proposed by Chairman Archer and Congressman Cardin in H.R. 4626 has been submitted to the Chairman by Congresswoman Dunn and Congressman Cardin for consideration for inclusion in a miscellaneous revenue bill

The Dunn/Cardin proposal, like the Archer/Cardin bill, would establish that any income derived from insurance brokerage activities would be treated as active income under both the PFIC rules and the deferred earnings provisions of new section 956A. Moreover, it would clarify that cash and cash equivalents representing premium payments held by insurance brokers for their customers on a temporary basis to be paid over to insurance companies (and return premiums and claims payments held to be paid over to their customers) are active assets for purposes of the PFIC provisions and new section 956A. This result correctly would recognize the active nature of these assets and the fact that they are not available for repatriation to the U.S. Moreover, this change once again would provide insurance brokers with treatment comparable to that provided for securities brokers or insurance companies. Moreover, this change would ensure that the practical effect of the tax rules comports with Congressional intent.

The Dunn/Cardin proposal likely would have only a modest revenue impact. No revenue estimate was prepared for H.R. 4626. However, the Joint Committee on Taxation ("JCT") estimated that a similar proposal presented by Chairman Archer in the course of the 1993 Budget debate would cost $10 million over 5 years. In addition, the fact that many insurance brokers may choose to avert the provisions of the 1993 Act through restructuring, even though such a course may be highly disruptive and expensive, likely also would tend to minimize the revenue impact to the federal government. Indeed, in its July 21, 1995 testimony to the Senate Finance Committee on foreign tax issues, the JCT noted "anecdotal evidence" that controlled foreign corporations have, in fact, taken such actions to avert section 956A.

II. DETAILED ANALYSIS.

A. Description of the Insurance Brokerage Business.

Insurance brokers act as intermediaries between clients seeking insurance coverage and insurance companies who underwrite insurance policies. Insurance brokers advise clients on their needs and find the proper "fit" between the client and an insurance company or companies, for which services brokers charge a commission. Insurance brokers also deliver claims adjustment services and provide risk management and insurance company management services. In short, insurance brokers are engaged in a financial services business. As a consequence, they typically do not maintain large investments in fixed tangible assets.

Insurance brokers provide many services that are similar to those provided by insurance companies and securities brokers and dealers. Indeed, insurance brokers are recognized as within the same "financial services" network as banks, insurance companies, and securities brokers.[1]

As a regular business practice, insurance brokers temporarily hold insurance premiums that are in transit from clients to the insurers. They also may hold claim payments and return premiums that are in transit from the insurance companies to the insured. These funds are held in a custodial capacity. Such "fiduciary funds" typically are subject to regulation, the nature of which depends upon the country in which the insurance broker is based. For example, in the United Kingdom, the Insurance Broker Registration Council rules govern the treatment of fiduciary funds, designating the manner in which such funds may be held and restricting the use

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[1] See, e.g., section 904(d)(2)(C) of the Tax Reform Act of 1986 and the regulations thereunder.

of such funds. These regulatory provisions, and the obvious practical limitation that the funds are held only on a short-term basis prior to being paid over, prevent any repatriation of such funds to a U.S. shareholder.

Additionally, insurance brokers often conduct directly, or indirectly through an affiliate, related services, including investment and financial advisory services, employee benefits services, securities brokerage and dealer services, and other financial-related services. These activities overlap extensively with the brokers' counterparts in the financial services industry, particularly with the activities of insurance companies and securities brokers. Moreover, these business activities (as is true for the brokerage business) do not require maintaining significant tangible fixed assets, although these businesses do require certain levels of working capital.

Insurance brokers are vital to the efficient operation of commercial enterprises and markets throughout the world, yet it remains a U.S.-dominated industry: of nearly 100,000 employees world-wide, a majority are in America.

B. Pre-1993 Act Law Regarding PFICs.

Any foreign corporation, including a controlled foreign corporation, was treated as a PFIC under pre-1993 Act law if it met either one of two tests which target foreign corporations used as passive investment vehicles. Thus, a foreign corporation was treated as a PFIC if either:

- seventy-five percent (75%) or more of its gross income was passive income (the "income test"); or

- its passive assets equalled or exceeded fifty percent (50%) of its total assets (the "asset test"). Section 1296(a).

For purposes of the PFIC asset test, an asset was "passive" if it produced (or was held for the production of) "passive income." The asset test generally was based upon asset fair market values.

If a foreign corporation met either of those tests, any U.S. person owning its stock was subject to rules that accelerated income recognition or charged a deferred interest "penalty". Unless the U.S. person owning PFIC stock elected to be taxed currently, the shareholder generally was subject to ordinary income treatment upon receiving distributions from the PFIC or upon disposition of the PFIC stock, and was subject to an interest charge based upon the value of the tax deferral. Section 1291.[2]

Congress recognized that active financial services businesses inadvertently may be drawn within the PFIC rules. Accordingly, Congress statutorily provided that corporations in the banking and insurance business generally were not subject to PFIC classification. This was effectively accomplished through the definition of "passive income": for purposes of the income test and the asset test, "passive income" did not include any income derived in the active conduct of a banking or insurance business. Section 1296(b)(2). In addition, U.S.-owned insurance brokerage companies that did business outside the United States also effectively were exempted because of the substantial goodwill and other active intangible assets taken into account at fair market value in the PFIC asset test. Accordingly, U.S.-owned foreign insurance brokers under pre-1993 Act generally were not treated as PFICs.

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[2] The Internal Revenue Service ("I.R.S.")provided limited guidance for the PFIC asset test in Notice 88-22, suggesting that assets were to be categorized as passive or nonpassive based upon the type of income generated. For example, trade receivables were passive or nonpassive based on the character of the income derived from the transaction that generated the receivables. Intangible assets were to be given similar treatment. Notably, goodwill and going-concern value could be taken into account in the asset test.

In addition, it had been generally assumed that funds held by insurance brokers to pay premiums, return premiums, and claim payments did not count as assets of the insurance broker for purposes of the PFIC asset test because they were being held for customers of the broker either to be paid over to the insurance companies or to be paid to the customer. While this is not an issue on which the I.R.S. provided guidance, its resolution generally was not viewed as determinative of PFIC status due to the ability to value goodwill and other active intangibles at fair market value.

C. Changes Under the 1993 Act.

The 1993 Act contained two specific proposals that adversely affected the tax treatment of U.S.-owned foreign corporations in the insurance brokerage business.

First, the 1993 Act provided that, in the case of a controlled foreign corporation (or any other foreign corporation if the corporation were to so elect), the PFIC asset test is based upon adjusted tax basis of the assets (as determined for purposes of computing earnings and profits); i.e., fair market value no longer may be used in the asset test. The use of adjusted tax basis of assets rather than fair market value substantially eliminates goodwill and other active intangible assets from the asset test and may convert active insurance brokers into PFICs.

Second, the 1993 Act included new section 956A. As noted, that provision requires a U.S. shareholder of a controlled foreign corporation to include in current income its share of the corporation's accumulated earnings invested in "excess passive assets," defined as the extent to which passive assets exceed twenty-five percent (25%) of total assets. The determination of whether an entity has excess passive assets is made by reference to the amended PFIC asset test, i.e., that which uses adjusted tax basis rather than fair market value. Again, that change may cause insurance brokers to be subject to section 956A notwithstanding their clearly active nature.

D. Securities Brokers' and Dealers' Activities are Specifically Treated as Active Under the 1993 Act.

As the Ways and Means Committee observed during its consideration of the 1993 Act, when the PFIC rules initially were enacted, Congress believed that foreign corporations conducting active businesses as dealers in stocks, securities, and derivative financial products would be excluded under both the asset and income PFIC tests. However, the Committee indicated it had become aware that foreign securities dealers did not always earn sufficient gross income in the form of commissions to avoid the income test and did not maintain sufficient levels of nonpassive assets for the PFIC asset test. Further, the Committee recognized the considerable overlap between activities conducted by foreign securities dealers and those conducted by banks.

Accordingly, the 1993 Act included a provision to treat foreign securities brokers and dealers under the PFIC rules in the same manner as banking and insurance companies by specifically providing that income earned in the active conduct of the securities business is not passive income. In this manner, securities brokers and dealers also are not subject to the new deferred earnings rules of section 956A.

The securities brokers and dealers provision is based on the policy that the PFIC rules and the deferred earnings rules of new section 956A are not intended to apply to corporations that actively engage in the business of providing services as a financial intermediary to unrelated parties. See Ways and Means Committee Print (May 19, 1993) at 266. In that regard, the Committee recognized the significant and broad activities of an active securities business, which include purchasing and selling inventory securities, servicing mortgages, investment banking, and providing financial and investment advisory services, investment management services, fiduciary services, trust services, and custodial services. Id. at n.71.

III. U.S.-Owned Foreign Brokerage Businesses Should be Treated in the Same Manner as Securities Brokers and Dealers and Other Financial Intermediaries.

Insurance brokerages are clearly "active" businesses in the literal sense of the word: they actively engage in a wide range of endeavors that are crucial to sustaining commercial activity. Because they are very much active, insurance brokerages should not be subject to either the PFIC rules or the excess passive asset provisions of section 956A. Congress has already recognized that comparable financial intermediaries also should not be subject to these provisions through rules applicable to banks, insurance companies, and securities brokers and dealers. A similar clarification should be provided for taxpayers engaged in the insurance brokerage business.

This clarification to the 1993 Act could be implemented by a statutory provision that provides as follows:

> "( ) TREATMENT OF CERTAIN INSURANCE AGENTS OR BROKERS.-
> "(A) IN GENERAL.--In the case of any foreign corporation (as defined in section 957(a)), the term 'passive income' does not include any income derived from insurance brokerage or agency services, to the extent provided in regulations. To the extent provided in regulations, income earned on fiduciary funds held by an insurance agent or broker shall not be passive income and such funds shall be treated as having a tax basis equal to their original purchase price."

This change, which was proposed in H.R. 4626, would provide insurance brokers with treatment comparable to that afforded other financial intermediaries, such as securities brokers or insurance companies, and would ensure that the practical effect of the tax rules comports with Congressional intent. It also would establish that any income derived from insurance brokerage activities[3] would be treated as active income under both the PFIC rules and the deferred earnings provisions of new section 956A. Finally, it would clarify that cash and cash equivalents amounts representing premium payments held by insurance brokers for their customer on a temporary basis to be paid over to insurance companies (and return premiums and claims payments held to be paid over to their customers) are active assets for purposes of the PFIC rules and section 956A. Such a provision would be consistent with the active nature of these assets and the fact that they are not available for repatriation to the U.S.

In the global marketplace, the activities of bankers, insurance companies, securities brokers, and insurance brokers comprise a single financial services network. Many times, the lines between these industries become blurred and, as a result, these businesses often compete directly with each other. By treating these businesses in comparable fashion, competitive advantages and disadvantages will be avoided.

In the case of insurance brokers, this need for equitable treatment takes on added importance. As noted, U.S. insurance brokers dominate international markets. By requiring those U.S. entities to be subject to the PFIC rules and section 956A, provisions which neither affect their principal U.K. competitors nor have any U.K. analogue, that U.S. dominance unnecessarily is put at risk.

In conclusion, Mr. Chairman, I once again thank you for this opportunity to testify and, in particular, for your efforts to remedy the anomalous treatment of insurance brokers under the PFIC rules and section 956A. On behalf of all the NAIB members, I pledge our strong support as you undertake that task.

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[3] As in the case of the 1993 Act's provision for securities brokers and dealers, it would be appropriate for the legislative history to elaborate on the various activities conducted by insurance brokers, including employee benefit consulting, risk management and insurance company management services, claims administration, financial investment advisory services, and holding of fiduciary funds and other properties.

(BY PERMISSION OF THE CHAIRMAN)

Canadian Embassy   Ambassade du Canada

501 Pennsylvania Ave., NW
Washington, D.C. 20001

July 5, 1995

The Honourable Bill Archer
Chairman
Ways and Means Committee
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman,

I am writing with respect to the application of U.S. passive foreign investment company rules as they affect Canadian corporations currently operating in the United States.

In recent years, our two governments have taken a number of significant steps aimed at encouraging and strengthening bilateral trade and investment flows, including the implementation of the NAFTA (North American Free Trade Agreement). Moreover, we have endeavoured to facilitate cross-border investment transfers through the development of multi-jurisdictional securities regulations, and the recent agreement to amend the Canada/U.S. Tax Convention.

Increasingly, however, as individual corporations in Canada have used direct investments to expand active business activities in the United States and developed new ways to co-operate with U.S. partners, they have been faced with regulatory obstacles in the United States which have discouraged the very investment flows our two governments are trying so hard to encourage.

In particular, I refer to the application of "PFIC rules", which I understand were developed primarily in response to the establishment of pooled offshore investment portfolios set up by U.S. residents as a means of deferring U.S. tax liabilities. In our view, the scope of PFIC rules as now interpreted with respect to foreign companies with active interests in the United States may be broader than necessary to achieve the objectives of the legislation. Indeed, PFIC rules have caught in their net a number of foreign companies, including Canadian corporations, who have undertaken legitimate investments in the United States. This has had a significant detrimental impact on the operations of such companies even though the

underlying business operations are active and are producing taxable U.S. income. Not surprisingly, this has affected their ability to raise equity capital in U.S. financial markets and has led to a distortion in cross-border investment decisions.

The problems which have arisen with respect to the application of PFIC rules have the potential to affect a number of major corporations in Canada. In part, this is due to the fact that it has become more common in recent years for Canadian corporations with business activities in the United States to undertake major "active" investments over which they may not exert conventional legal control as defined in the PFIC rules (i.e. a threshold of over 25 percent equity ownership), but in respect of which they nevertheless, in fact and contractually, have direct control and influence. It is in this regard that Canadian authorities would like to see U.S. tax rules clarified in a manner so that the PFIC rules do not impact negatively on active business operations by Canadian corporations in the U.S.

Representatives of several Canadian corporations affected by PFIC rules have previously been in contact with staff of your Committee in order to urge changes to the PFIC rules and will no doubt continue their efforts. The Embassy's Financial Counsellor, Brian A. Smith, (telephone: 682-1740 ext. 7437) has also spoken to staff on your Committee and at the JCT regarding this issue. He would be pleased to provide your staff with further information on any of the above points as required. I would urge you to take into account the above points concerning the impact of "PFIC rules" on Canadian and other foreign corporations doing business in the United States.

Thank you for your attention to this matter.

Yours sincerely,

Raymond Chrétien
Ambassador

July 21, 1995

STATEMENT OF
J. ROGER MENTZ & LINDA E. CARLISLE
WHITE & CASE
WASHINGTON, D.C.

ON BEHALF OF AMWAY CORPORATION

SUBMITTED TO THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

FOR HEARINGS ON
MISCELLANEOUS TAX REFORM PROPOSALS
JULY 11 & 12, 1995

REGARDING
VALUATION OF MARKETING INTANGIBLES
OWNED BY CONTROLLED FOREIGN CORPORATIONS UNDER THE
PASSIVE FOREIGN INVESTMENT COMPANY AND
EXCESS PASSIVE ASSET PROVISIONS

Mr. Chairman and Members of the Committee:

The Clinton Administration's 1993 tax law change (the "1993 Tax Act") affecting controlled foreign corporations ("CFCs") that sell goods in foreign countries favors corporations which export manufacturing jobs over those which export U.S.-manufactured goods. Amway Corporation ("Amway"), which manufactures its products in the United States and exports to over 60 countries in the world, is harmed by this change and seeks a legislative correction.

The 1993 Tax Act imposes very adverse tax consequences on CFCs whose "passive assets" exceed statutory percentages (25% and 50%) of the CFC's total assets. For purposes of these tests this law ascribes <u>no value</u> to the CFC's marketing intangible assets, such as customer lists, trademarks, and distribution systems. Intangible assets are recognized as having value for U.S. tax purposes and are routinely valued by the IRS. However, under this new statutory rule, intangible business assets of a CFC, such as trademarks and distributor networks, have zero value, while a CFC's tangible business assets (e.g., property, plant and equipment) have value equal to their adjusted tax basis (essentially depreciated cost).

This distinction provides <u>an incentive for U.S. corporations to move U.S. manufacturing activities abroad</u> into their CFCs, and provides a <u>disincentive to manufacture in the United States</u> and export products to foreign markets where foreign marketing intangibles are necessary. In other words, current law promotes "runaway plants". We urge that current law be changed to eliminate this perverse bias by allowing a CFC's marketing intangibles to be valued.

<u>"Excess" Passive Assets and Passive Foreign Investment Companies</u>

U.S. shareholders of a CFC owning 10 percent or more of its stock are subject to current taxation on a portion of the CFC's earnings if its "passive assets" exceed 25 percent of its total assets. If the CFC's passive assets equal or exceed 50 percent of its total assets, it is classified as a "passive foreign investment company" ("PFIC") and all of its earnings are either taxed currently to all of its U.S. shareholders, or taxed when distributed with an interest charge. These seemingly reasonable rules are profoundly unfair to CFCs that are not manufacturing abroad, such as Amway's foreign affiliates, because very valuable marketing intangibles that are essential to the active business performed by those CFCs in selling U.S. manufactured goods are valued at zero for purposes of these rules.

Essentially, the general rule under the 1993 Tax Act is that all assets held by a CFC must be valued at their adjusted tax basis. Since costs to develop and maintain both marketing and manufacturing intangibles are currently deductible, no tax basis in marketing or manufacturing assets is created. Thus, this general rule would be detrimental to both marketing and manufacturing intangibles.

This rule was modified by the Senate in 1993 in the case of manufacturing intangibles, however, so that a "hypothetical basis" is allowed equal to research and experimental expenditures incurred by the CFC during the last three years of operation. In addition, the "hypothetical basis" includes an amount equal to three times the license fees paid in the current year by the CFC to license intangible assets, including not only patents and manufacturing intangibles but also marketing intangibles such as trademarks or customer lists. In other words, if a CFC incurs R&E expenses, or if it licenses any intangible assets, it is allowed some relief in connection with the excess passive asset and PFIC rules through these "hypothetical basis" provisions. However, no relief was provided for the marketing company that does not license its marketing intangibles, but rather owns them. The application of the hypothetical basis rules to marketing and manufacturing intangibles is illustrated as follows:

Hypothetical Basis Rules

	Manufacturing Intangible	Marketing Intangible
Licensed	Basis = 3 x license fee	Basis = 3 x license fee
Owned	Basis = R&E expenditures over last 3 years.	Basis = 0

This flaw in the structure of the excess passive asset and PFIC rules was pointed out in the debate over the 1993 Tax Act and as a result the Treasury Department was directed to study the matter and prepare a report to Congress.

<u>The Treasury Report</u>

The Treasury Department issued its Report on November 22, 1994. Treasury notes at the introduction that prior law proved "difficult to administer" because it depended on a valuation of intangible assets. The Treasury Report then attempts to justify the two "hypothetical basis" exceptions to the general rule of the 1993 Tax Act added by the Senate and described above. Treasury explains the two exceptions as being "a narrow exception" assigning a "hypothetical basis" to "R&E assets." Treasury goes on to assert that this narrow exception should not be broadened to reflect marketing intangibles. This characterization by Treasury is misleading, because a hypothetical basis is allowed for <u>licensed</u> marketing intangibles, such as trademarks and distributor networks, but not for the same type of intangibles <u>owned</u> by the CFC.

As noted above, the three times royalty formula does not apply only to licenses of patents and other manufacturing intangibles, but includes a license for any intangible, including particularly a trademark, customer list, distribution system, or other consumer-based intangible. Thus, the hypothetical basis rule is not limited to "R&E assets" as Treasury asserts. Licensed marketing intangibles are included, but marketing intangibles owned by the CFC are not.

Conclusion

Current law disadvantages CFCs which market and sell products manufactured in the United States in foreign countries. No value is ascribed to marketing intangibles that are an essential element of such a company's active business, and as a result their U.S. shareholders are subjected to harsh tax treatment under the excess passive assets and PFIC provisions as they were amended in 1993. The law should be changed to avoid the likely removal of manufacturing jobs from the United States overseas that is encouraged by current law.

STATEMENT OF

DONALD V. MOOREHEAD

CONCERNING FOREIGN PERSONAL HOLDING COMPANIES (H.R. 3419)

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 27, 1995

I.

Introduction

This statement is submitted by Donald V. Moorehead (Patton Boggs, L.L.P.) on behalf of Charles Heilbronn and Alain Wertheimer for inclusion in the record of the hearings conducted by the Committee on Ways and Means on July 11 - 13, 1995 with respect to various tax legislative proposals. including the proposed simplification legislation (adopted by the House of Representatives in 1994 as H.R. 3419). H.R. 3419 provided for repeal the foreign personal holding company provisions of the Internal Revenue Code and modify the passive foreign investment company (PFIC) and subpart F provisions to make them the exclusive anti-deferral provisions of the Code. If the foreign personal holding company provisions ultimately are retained, they should be modified to apply the PFIC look-through rules (section 1296(c)) in determining whether a foreign corporation is a foreign personal holding company.

II.

Explanation of Proposal

The foreign personal holding company rules were enacted in 1937 to eliminate the opportunity for deferral of U.S. taxes with respect to foreign corporations that have substantial amounts of "passive" income and are controlled directly or indirectly by a small number of U.S. persons. The PFIC provisions were enacted in 1986 to close perceived gaps in the then existing anti-deferral regime, including the opportunity for deferral for investments in passive foreign corporations that are more than 50 percent owned by persons not subject to U.S. tax.

The PFIC and foreign personal holding company rules have much in common. They are both aimed at investment companies, they both take on "all or nothing" approach and neither is intended to apply to corporate parents of operating groups. The foreign personal holding company provisions were aimed at the "incorporated pocketbook" (H. Rep. No. 1546, 75th Cong., 1st Sess., p.20) and "[r]eal operating companies" were not intended to be included as p. 37, Aug. 5, 1937). Similarly, Congress did "not intend foreign corporations owning the stock of subsidiaries engaged in active businesses to be classified as PFICs". Pub. L. 99-514, 1986 U.S. Code of Admin. News 4728.

For purposes of the PFIC rules, this policy of excluding corporate groups engaged in active businesses is implemented by the subsidiary look-through rule of section 1296(c), which allows foreign corporation owning at least 25 percent of another foreign corporation to characterize the dividends, etc. it receives from such a subsidiary by reference to the character of the subsidiary's income. The absence of a comparable rule under the foreign personal holding company provisions produces results that are difficult to justify in terms of tax policy; namely, dividends received by a foreign parent from its operating subsidiaries will be treated as **operating income** of the foreign parent under the PFIC rules, but as **passive income** of the foreign parent under the foreign persona holding company rules if the operating subsidiary's country of incorporation is different from that of the parent.

The PFIC look-through principles should be substituted for the present related company dividend and interest provision contained in section 552(c) of the Code. The current provision is patterned after a comparable provision in subpart F is aimed at a different problem: selective tax avoidance by operating multinational corporations. As enacted in 1962 and strengthened thereafter, the subpart F rules are intended to eliminate the benefits of deferral for certain types of income (whether or not "passive" in the strict sense) that is shifted to tax havens through controlled foreign corporations. Given this purpose, subpart F is both specific and selective, with special rules for active leasing, branches, relative rates of tax, etc. This is marked contrast to the "all or nothing" approach of the PFIC and foreign personal holding company rules. In such "all or nothing" cases, the object should be to determine the overall economic nature of the group as either an investment enterprise or an operating enterprise.

H.R. 3419 rectifies this disparate treatment by folding the foreign personal holding company provisions into the PFIC rules. If Congress decides to retain the foreign personal holding company rules, those rules should be amended to incorporate the look-through principles of section 1296(c). This result would be consistent with the growing trend in the tax laws to focus on economic realities rather than legal structure. See sections 864(e), 904(d) and 7701(f) of the Code.

The PFIC look-through rules accomplish personal holding companies, as opposed to rules patterned on subpart F, would accomplish the same objective in a strikingly similar context. If the overall economic character of a corporate group is "investment", the PFIC and foreign personal holding company rules should apply. If that overall economic character is "operating", and the "passive" income is really dividends and interest from operating subsidiaries, nether the PFIC nor the foreign personal holding company rules should apply. The authors of H.R. 3419 properly reached this result and it should be embodied in the foreign personal holding company rules if those rules are retained as a separate anti-deferral regime in the Code.

STATEMENT OF

DONALD V. MOOREHEAD

CONCERNING "BANKS" UNDER THE PFIC RULES

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 27, 1995

I.

Introduction

This statement is submitted by Donald V. Moorehead (Patton Boggs. L L.P.) on behalf of Republic National Bank of New York for inclusion in the record of the hearings conducted by the Committee on Ways and Means on July 11 - 13, 1995 with respect to various tax legislative proposals, including proposals to modify the provisions of the Internal Revenue Code applicable to passive foreign investment companies (PFIC's). For the reasons set forth in this statement, Congress should clarify that the PFIC provisions were not intended to apply to bona fide banks which are regulated as such by appropriate foreign banking authorities.

II.

Explanation of Proposal

The PFIC rules (sections 1291-1297 of the Code) were enacted in 1986 in order to fill perceived gaps in the then existing limitations on the ability of U.S. taxpayers to use foreign corporations to defer U.S. taxes on passive foreign source income. For this purpose, a PFIC is defined as any foreign corporation if either 75 percent or more of its gross income is passive income or 50 percent or more of its assets produce or are held for the production of passive income.

Congress did not intend for banks to be classified as PFICs even though much of their income consists of interest or other receipts that ordinarily would be treated as "passive" income. To accomplish this objective, Congress created a statutory exemption (section 1296(b)(2)(A)) from the definition of passive income for ". . . any income derived from the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in the regulations, by any other corporation)". The legislative history of the Tax Reform Act of 1986 indicates that Congress intended this exemption to encompass "bona fide banks" engaged in the "active" conduct of the banking business.

Proposed regulations have recently been issued to implement the banking exemption, but (as explained below) they appear to exclude some foreign institutions that are regulated as "banks" either by the Federal Reserve (e.g., foreign bank affiliates of U.S. bank holding companies) or by the banking authorities of their home countries. This latter effect may be of increasing importance if the foreign banks continue to seek equity capital in the U.S. by selling stock (or ADRs) to U.S. citizens and institutions.

Specifically, the proposed regulations adopt a deposit test, a lending test and a licensing test, as well as a definintion of "banking income". Unfortunately, the "banking income" definition and various portions of these tests are based upon the concept of a "bank" that no longer comports with reality. For example, for purposes of the banking income definition and the proposed lending test, commercial paper and corporate debt instruments that are treated as securities for financial statement purposes do not qualify even though they are both well accepted alternatives to direct traditional loans of the type evidenced by loan agreements. Indeed, under

the proposed regulations, it may be virtually impossible for a foreign bank, which is regulated as "bank" and regularly accepts deposits and makes direct loans, to escape PFIC classification unless such direct loans constitute a dominant portion of its portfolio even though in numerous cases, holding such a high percentage of assets in the form of direct loans could well be imprudent. Moreover, that this approach is too narrow is evident from the fact that Republic itself -- the nation's 17th largest commercial bank -- would likely be treated as a PFIC if were a foreign corporation.

Congress should revisit this issue both to end nearly a decade of uncertainty and to assure that "bona fide banks" are in fact excluded from PFIC status. The proposed expansion of the PFIC rules as part of the pending tax simplification legislation (H.R. 3419) makes such a clarification all the more important. There are various legislative solutions that would be both administratively feasible and not open to abuse. For example, one could simply amend section 1296(b)(2)(A) to exclude from the definition of "passive" income any income that is derived by a corporation that would be described in section 581 if it were a domestic corporation (i.e., a substantial part of the corporation's business consists of receiving deposits and making loans and it is subject by law to supervision and examination by the banking authorities of the country in which its principle office is located). Alternatively, Congress could simply clarify that it intends for the Internal Revenue Service to retain and exercise the right to rule in individual cases where a bank, based on all relevant facts and circumstances, is a "bona fide bank" even if it fails to meet one or more of the standards of the proposed legislation. Finally, Congress could revise the definition of "passive" income to exclude deposit-based income (i.e., income earned from the investment of deposits).

STATEMENT OF VIOLET EFRON, EXECUTIVE SECRETARY
FEDERATION OF AMERICAN CONTROLLED SHIPPING (FACS)
BEFORE
HOUSE WAYS AND MEANS COMMITTEE
ON
MISCELLANEOUS TAX PROPOSALS SCHEDULED FOR
HEARING ON JULY 11-13, 1995

On behalf of the Federation of American Controlled Shipping (FACS) I am pleased to submit this statement for the record of your hearing.

The FACS membership comprises American based companies with an economic stake in owning, operating, managing, chartering, financing, or otherwise utilizing open registry vessels, and which share a common interest in preserving competitive open markets in international shipping.

FACS strongly supports the proposal that would "exempt service income of a nonresident alien earned on international ships or aircraft from U.S. tax."

U.S. taxation of the wages of nonresident, noncitizen crew members employed on foreign vessels temporarily in U.S. territorial waters is an issue that needs Congressional attention. The Internal Revenue Service has strictly construed the provisions of the Internal Revenue Code and determined that earnings of nonresident alien seafarers employed on foreign flag vessels are subject to U.S. tax if (1) individuals are present in U.S. territorial waters for 90 or more days each year (any part of a day is counted as a full day), or (2) individuals earn $3,000 or more per year attributable to such U.S. presence. If wages are subject to U.S. tax, they presumably are also subject to withholding by operators of foreign vessels, either on a computation of tax actually due or on a flat rate of 30% of wages attributable to U.S. sources.

We know of no other nation which taxes wages of nonresident alien seafarers and requires operators of foreign vessels to withhold tax from their crew members' wages. We have little doubt that if an American shipowning company were required by some foreign nation to withhold 30% of a portion of the wages earned by American seafarers on a U.S. flag ship temporarily in that nation's territorial waters, there would be an immediate protest and the threat of retaliatory measures.

That would not be surprising because reciprocity of treatment is the keystone of international shipping. If one nation acts unilaterally by imposing burdens on the vessels or citizens of other countries, threats of retaliation are understandable. Moreover, if various port states began to levy withholding taxes on foreign seafarers' wages, the cumulative decrease in take-home pay of seafarers would raise insurmountable problems.

The administrative burdens which the strict construction of the Internal Revenue Code imposes on both seafarers and their employers is a quintessential example of overregulation. Employers must keep detailed records of time spent in U.S. waters by each employee on each vessel. This can be a daunting undertaking because of variations in vessel trading patterns, changes in crew members' employment, absences because of vacations and sick leave, and unexpected vessel delays in U.S. waters (because of repairs, cargo operations, waiting for berths, bunkering, etc.). Furthermore, operators of vessels with crews of mixed nationalities presumably would be required to determine whether individual seafarers would or would not subject to withholding because of provisions in bilateral tax treaties.

Seafarers who are subject to withholding also have some daunting problems of their own. Virtually all foreign seafarers are unfamiliar with technical U.S. tax laws. Most are not able to obtain technical tax advice needed to file returns and seek refunds. Many do not even have a command of the English language that would enable them to understand the instructions for filing their own returns and seeking refunds.

The great majority of nonresident alien seafarers subject to withholding in a given year would, at best, owe trifling amounts of federal tax and probably would be entitled to at least partial refunds from the IRS of taxes withheld from U.S. source incomes. Even the process of receiving the refunds may be frustrating and problematic. Refund checks mailed to vessels may arrive long after the seafarers' terms of employment had ended. Refunds made to their homes abroad (which in many cases are in developing countries) many take many months before actually reaching the seafarers.

We believe that it is highly questionable whether the administrative costs to the IRS in processing such refunds would be offset by federal tax revenues actually owed by nonresident alien seafarers.

Finally, there is a question of fairness in seeking to tax wages of nonresident alien seafarers who in most cases do not leave their vessels while in U.S. waters, and thus benefit very little, if at all, from any federal services ashore.

For the above reasons we urge your support for the proposal to exempt from U.S. tax the service income of nonresident aliens earned on international ships and aircraft.

TESTIMONY OF CYNTHIA COLENDA
INTERNATIONAL COUNCIL OF CRUISE LINES

Mr. Chairman and members of the committee, thank you for the opportunity to submit testimony to you on the proposed legislation as contained in Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995 at 168-169, which would exempt the service income of nonresident aliens earned on international ships or aircraft from United States income tax. In addition, the presence of these nonresident aliens in the United States will be disregarded for residency determinations under the substantial presence test This proposal accurately responds to objections to current United States law voiced by other countries and represents a return to fairness in our taxation of the affected individuals. We support passage of this provision without modification.

Background

The International Council of Cruise Lines ("ICCL") is a non-profit trade association whose membership consists of American and foreign owned companies engaged in the over night oceangoing passenger cruise line industry. ICCL represents the interests of twenty-three passenger cruise lines which operate a total of eighty-six vessels on a worldwide basis. Our membership accounts for over 90 percent of the overnight, deep-sea passenger international cruise capacity worldwide. This capacity consists of over eighty-nine thousand lower berths and more than thirty-three million cruise days on a full year basis. As such, the owners and managers are vitally interested in the taxation of their nonresident alien employees working on board the vessels and its impact on cruise line operation. As withholding agent for the United States, the ICCL members are directly responsible for explaining the impact of United States tax laws to their nonresident alien employees and bear the burden of compliance with existing law.

Overview of Current Law

Following is a summary of current law, primarily as interpreted by the Internal Revenue Service and set forth in a position paper effective July 24, 1994, titled Shipping and Air Transportation Industries, Coordinated Issue, Federal Income Tax Withholding on Compensation Paid to Nonresident Alien Crew by a Foreign Transportation Entity (hereinafter, "IRS Position Paper"). For your reference, this document is attached as Exhibit C.

Section 871(b) of the Code imposes United States income tax at graduated rates upon the effectively connected income of each nonresident alien. Section 872(a)(2) provides that the gross income of a nonresident alien is that which is effectively connected with the conduct of a trade or business in the United States. Section 864(b) provides generally that the performance of personal services within the United States by a nonresident alien constitutes a trade or business within the United States.

Section 864(b)(1) excepts from effectively connected income the earnings of nonresident aliens who are not present in the United States more than 90 days and do not earn more than $3,000 from United States sources, as long as the wages are not paid by a United States corporation or the United States trade or business of a foreign corporation.[1]

Except for personal services on board vessels and aircraft employed in trade between the United States and its possessions (subject to the source rule of section 863(c)), the source of income earned by nonresident aliens is apportioned to United States sources under the general rule of section 861(a)(3). Apportionment under this section is based on the ratio of hours of service performed within the territorial limits of the United States to total hours of work. See, e.g. Rev. Rul. 77-167, 1977-1 C.B. 239. However, both the regulations and the IRS Position Paper indicate that apportionment on the basis of actual time is not the preferred method. Instead, one is to look to the number of days on which the individual spends a portion of his time in the United

[1]The stated position of the Internal Revenue Service is that a vessel entering the territorial waters of the United States is necessarily engaged in a United States trade or business, making the $3,000/90 day exception unavailable to the crew members under any circumstances. Query whether the business of the employer should have a bearing on the tax liability of the employee in any circumstances?

States.[2]

As with section 864(b)(1), section 861(a)(3) provides a 90 day/$3,000 threshold which must be exceeded before any wages earned by a nonresident alien are deemed to be United States source income. However, if the $3,000 exemption amount is exceeded, all earnings attributed to United States sources are included in gross income.

Section 3402(a) provides generally that each employer making payment of wages shall deduct and withhold the appropriate tax from an employee. Section 3401(a)(6) provides that payments to a nonresident alien which are to be considered as wages are to be defined by regulation. Treasury Reg. §31.3401(a)(6)-1(a) and (b) define wages with respect to income which is effectively connected with a United States trade or business and exclude from wages any payments for services which are performed outside the United States. Section 3402(e) provides that, if less than half of the remuneration paid by an employer to an employee during a payroll period which does not exceed 31 days is not "wages", none of the remuneration paid for the payroll period shall be deemed to be wages.

Section 1441 provides generally for the withholding of income tax from United States source fixed, determinable, annual or periodic income at a rate of 30 percent. Treasury Regulation §1.1441-4(b)(1)(i) excludes from withholding under section 1441 wages subject to withholding under section 3402.

Section 7701(b)(3) of the Code provides a mechanical test for residency determinations (the "substantial presence test"). Under this test, any presence by an alien (with certain exceptions not presently relevant) constitutes a full day towards resident status.[3]

Section 410 of the Code sets forth certain tests of participation and coverage which a pension plan must satisfy for the trust which holds the plan assets to constitute a qualified trust under section 401(a). Section 410(b)(1) provides specific rules concerning the employees which a plan must benefit to satisfy the minimum coverage requirements. As a general matter, these rules require that pension plan benefits be available to all employees on a non-discriminatory basis, permitting the exclusion of otherwise eligible employees only if the plan satisfies either objective numerical tests with respect to the number of employees benefitted or the benefit provided; or the separate line of business provisions.

Section 410(b)(3) provides that certain general groups or classes of employees may be excluded from consideration from the minimum coverage tests. Among the employees which may be excluded are nonresident aliens who receive no earned income from sources within the United States (as defined in section 861(a)(3)) pursuant to section 410(b)(3)(C).

Problems Presented by Current Law

Imposition of Income Tax on Nonresident Crew

The net effect of sections 861-864 and 872 is to impose United States income tax on the wages of many nonresident aliens for the time they work in the service of their vessel or aircraft within the territorial waters of the United States. Historically, this has not always been the law and appears to be an unintended consequence of the existing statutes.

The predecessor to sections 862 and 872 of the Code, section 213(c) of the Revenue Act of 1918

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[2]IRS Position Paper at 7; Treas. Reg. §1.863-4(c).

[3]Section 7701(b)(7)(C) provides an exception for presence within the United States by aliens actually present less than 24 hours and in transit from and to points outside the United States. However, Treas. Reg. 301.7701(b)-3(d) renders this unavailable to crew who perform services on board a ship or aircraft while in the United States.

provided:

> In the case of a nonresident alien individual, gross income includes only the gross income from sources within the United States....

As section 213 contained no specific rules by which the "source" of income could be determined, regulations were issued for this purpose. The Internal Revenue Service opted not to apply a strict geographical definition of source and, instead, determined that the wages of a seaman on board a vessel engaged in coastwise trade are considered to be United States source. Conversely, the Service decided that wages earned by a seaman on board a vessel engaged in foreign trade were to be considered foreign source.

In this regard, Article 92A of Regulation 45 stated:

> While resident alien seamen are taxable like citizens on their entire income from whatever sources derived, nonresident alien seamen are taxable only on income from sources within the United States. *Ordinarily, wages received for services rendered inside the territorial United States are to be regarded as from sources within the United States. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States, but wages earned by an alien seaman on a ship regularly engaged in foreign trade are not to be regarded as from sources within the United States, even though the ship flies the American flag, or although during a part of the time the ship touched at United States ports and remained there a reasonable time for the transaction of its business.* The presence of a seaman aboard a ship which enters a port for such a purpose of foreign trade is merely transitory and wages earned during that period by a nonresident alien seaman are not taxable.

emphasis added.

This regulation recognized a long standing principle of international law, the right of the country of registration to regulate matters affecting the operation of a ship. At least in part, this appears to have been one of the reasons behind the filing of diplomatic protests to the Department of State by the Republic of Liberia on September 27, 1994 and by the Republic of Panama on May 10, 1995. These demarches are attached as Exhibits A and B.

The imposition of taxes consistent with United States statutes could result in multiple tax burdens. Admittedly, residents of foreign countries may be permitted a foreign tax credit for taxes paid to the United States. However, the availability of a credit depends on the tax law of the seaman's home country since the individuals on whom this tax will be imposed are generally those residing in countries without income tax treaties with the United States.

To avoid duplicate withholding, a crew member would have to engage in sophisticated foreign tax credit planning to reduce his home country withholding. To do so, the crew member must have a reasonable estimate of the foreign taxes which will be imposed on him during the year. This is an impossible feat since the crew of most vessels and aircraft are not provided itineraries a year in advance and, even if they were, do not have the financial resources required for the counsel and analysis required.

From the standpoint of fundamental fairness, there is a lack of a *quid pro quo* for which the United States should be compensated. In theory, taxes are imposed so that government services can be provided to the taxed. In the case of seamen and flight crews engaged in international commerce, our immigration laws prohibit them from enjoying the benefit of presence in the United States. They are confined to the vessel on which they arrive and, unless in transit home under a "D" Visa, are, under no circumstances, permitted to leave the immediate area of the vessel.

In fact, the Immigration Act of 1990, Pub. L. No. 101-649 prohibits seamen from performing "longshore work" unless the vessel's nation of registry permits similar work by seamen on board United States vessels. Thus, through immigration law, the United States has limited the work that

can be performed by seamen and through tax law, as applied by the Internal Revenue Service, has sought to tax the seamen for the privilege of not being able to work.

Furthermore, this inability to enter the United States precludes the crew member from obtaining counsel to assist his or her compliance with some of the most complex provisions of United States tax law

Burden on Employers:

To determine the United States source income for each employee, the employer is required to maintain records for each employee which identify when the vessel or aircraft enters and exits United States territorial waters or airspace and which further identify those employees who were working during this time. In the case of cruise ships with many crew working different schedules and air carriers with numerous flights daily, the accurate maintenance of such detailed records is virtually impossible.

Once the wages attributable to United States sources have been determined, the employer then must compare the allocated wages to the $3,000 exclusion provided in sections 861(a)(3) and 864(b)(1). Since these limitations have not changed since the dates the provisions were originally enacted (1936 for section 861(a)(3) and 1966 for section 864(b)(1)),[4] it is not unreasonable to assume that many crew will have United States source earnings which exceed these thresholds and will, therefore, be liable for United States income tax, albeit only for de minimis amounts. Furthermore, most of those "trapped" due to the unchanged dollar amounts clearly were not intended by Congress to be tax payors when the statutes where originally enacted.[5]

Finally, a vessel, such as a cruise ship, may have crew from more than 60 countries, most of whom are unfamiliar with the United States tax system and do not speak English as the primary language. The burden of explaining the law and its impact on each individual in a language which they can understand, is placed on the employer.

Burden on the Internal Revenue Service:

Since no crew member performs services within the United States for the majority of any payroll period, withholding under section 1441 rather than section 3402 will apply, regardless of the tax, if any, actually due.[6] Given the relatively short time crew are present and working in the United States, most will not be liable for income taxes. Even those crew which are ultimately liable for tax (since their United States source income exceeds the personal exemption) will generally be taxed at rates substantially less than 30 percent. Thus, for the vast majority of the crew members, the employer is required to withhold income tax to avoid liability just so the Internal Revenue Service can, in most cases, refund the tax to the employee from which it was withheld.

As a result of these withholding rules, the Service will be required to process many returns merely to issue refunds. With respect to the remaining returns where a tax is due, it appears that the cost

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[4] Revenue Act of 1936, §119(a)(3), 49 Pt. 1 Stat. 1648, 1695 (1936) and the Foreign Investors Tax Act, Pub. L. No. 89-809, §102(d)(2), 80 Stat. 1539, 1544 reprinted in 1966-2 C.B. 656, 661 (1966).

[5] See also the current IRS position concerning the availability of these de minimis thresholds in any event discussed supra note 1

[6] Arguably, the holding of Inter-City Truck Lines, Ltd. v. United States, 187 Ct. Cl. 290, 408 F.2d 686 (Ct. Cl. 1969) (The exception to FICA tax liability under section 3121(c) applies only when an employee performs two types of service for the same employer.) supports withholding under section 3402 in the case of crew members. This is the position first advocated by the Internal Revenue in its position paper released July 24, 1995. However, within the paper, the Service indicates that the position is subject to question and, under certain circumstances, it does not apply. IRS Position Paper at 3-4

of processing most of these returns, particularly considering additional factors outlined below, will exceed the revenue raised.

It is well recognized that United States tax law, particularly the provisions which deal with international tax matters are among the most complex in the world. Since the crew are required to file complete and accurate returns without the benefit of counsel,[7] Service can expect a higher than normal error rate in the returns filed by these individuals.

The nature of service at sea involves substantial periods of time when the crew member is working on board the vessel. Correspondence, notices, and examination are all more time consuming as a result. Statutory time frames for responding to notices, filing protests and other matters may simply be inadequate for an employee to receive the notice or correspondence, without considering the time necessary for reply.

If the Service is to examine the return of a crew member not permitted entry into the United States by INS, the agent will be required to conduct the examination on board the vessel to which the employee is assigned. Since the vessel is an extension of the country where it is registered, the conduct of an examination within the jurisdiction of a foreign sovereign may present particular problems for the examining agent.

With the number of vessels (and aircraft) entering the United States daily, we believe uniform enforcement is impossible. Selective enforcement, either with respect to a class of aliens or employers, results in a tax which is discriminatory. Since, for the vast majority of alien seamen, educated compliance with United States tax laws is impossible and assistance is not available and the Service will be required to expend considerable resources which are not commensurate with the revenue raised.

Residency Issues:

Section 7701(b)(3) of the Code provides a mechanical test for residency determinations. Under this test, any presence by an alien (with certain exceptions not presently relevant) constitutes a full day towards resident status.[8]

Particularly in the case of flight crews employed on Caribbean airlines, they may actually be present in the United States each day of the week while the airplane to which they are assigned "turns around". As is the case for the crew of a vessel, they are not, for immigration purposes, admitted to the United States and do not benefit from the typical services provided by our government to citizens, residents and admitted aliens.

Qualified Retirement Plans for Shore or Ground Personnel:

The sourcing rules of section 861 which give rise to an income tax liability for the crewmembers also have an indirect negative effect on the United States shore and ground based employees of vessel and aircraft operators through the rules governing qualified retirement plans.

Section 410 of the Code sets forth certain tests of participation and coverage which a pension plan must satisfy for the trust which holds the plan assets to constitute a qualified trust under section 401(a). These rules require that pension benefits be available to the vast majority of a company's employees on a non-discriminatory basis before the plan will be deemed "qualified".

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[7]As mentioned briefly above, immigration laws as well as ship and flight schedules, prevent these individuals from obtaining advice concerning the preparation of their returns.

[8]Section 7701(b)(7)(C) provides an exception for presence within the United States by aliens actually present less than 24 hours and in transit from and to points outside the United States. However, Treas. Reg. 301.7701(b)-3(d) renders this unavailable to crew who perform services on board a ship or aircraft while in the United States.

An exception to these rules involve certain classes of employees which can be excluded from numerical testing. Among other excludable employees are nonresident aliens which receive no earned income from sources within the United States.

In the case of nonresident alien ship or aircraft crew, the preceding discussion indicates that there are few instances where these individuals will have no United States source income under section 861(a)(3). As a result, they are included in the minimum coverage testing required by section 410(b).

As a result of the inclusion of nonresident alien crew in the numerical tests for plan qualification, no qualified retirement plan can be offered to United States shoreside personnel unless it is also offered to all shipboard employees.[9] As a consequence, it is neither economically nor legally possible for a vessel operator to economically offer a qualified retirement plan to all of its United States employees.

The Proposed Legislation Solves These Problems

As reported by the Staff of the Joint Committee on Taxation, the description contained in the Miscellaneous Tax Proposals to remedy these problems is a comprehensive solution. By removing the source of the income of nonresident alien crew from the United States it is effectively exempted from tax. In addition, these individuals will have no United States source income which will require their inclusion in a qualified retirement plan designed for United States based employees.

The collateral amendment to the substantial presence test for residency completes the exemption, ensuring that an individual is not a tax resident merely through presence as a member of the crew of a vessel or aircraft.

The result will be that crew members are divided into two distinct classes of taxpayers - United States citizens/residents and nonresidents.[10] Citizens and residents will be subject to income tax withholding on all of their wages and subject to tax on their worldwide income. On the other hand, nonresidents will not be subject to United States tax on any income earned in connection with service on the vessel or aircraft. The United States taxation of other income earned by the nonresident is not changed.[11]

Conclusion

ICCL urges adoption of the proposal to exempt the service income of nonresident aliens earned in the service of international ships or aircraft from taxation. Mr. Chairman, this concludes my remarks.

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[9]The consequence that implementation of a qualified plan can be impeded due to the forced coverage of nonresident alien employees is contrary to general statement of Congressional intent upon the enactment of ERISA. As stated in the Senate Report, "It was believed that the United States tax laws should not impede appropriate pension plan benefits for United States citizens or persons with United States earned income, merely because comparable benefits were not afforded to nonresident aliens with no United States income from the employment in question. Also, the mere processing of such cases would take an inordinate amount of time because of the complexity of applying rules to integrate the appropriate foreign equivalent of Social Security with the benefits or contributions provided by employers under such plans." S. Rept. 93-393, 93rd Cong., 1st Sess. at 43 (1973). There is little difference between nonresident aliens with no United States income and those whose income from United States sources is nominal.

[10]The proposal would not effect the taxation of aliens which are considered residents under other provisions of section 7701. Thus, for example, a crew member possessing a green card would still be subject to tax on worldwide income and all of his or her wages would be subject to withholding.

[11]For example, non-portfolio interest or royalties would be subject to withholding under section 1441 and taxation at a 30 percent rate unless a lower rate of withholding and taxation applies pursuant to the terms of an income tax treaty between the United States and the alien's country of residence.

Exhibit A

LMTG/MFA/2241/2-5/'94

The Ministry of Foreign Affairs of the Republic of Liberia presents its compliments to the Embassy of the United States of America and has the honour to forward herewith the attached Note Verbale concerning the United States Internal Revenue Service regulations requiring operators of foreign flag vessels to withhold 30% of the wages earned by non-resident alien seamen for onward transmission to the Department of State of the United States of America.

The Ministry of Foreign Affairs of the Republic of Liberia avails itself of this opportunity to renew to the Embassy of the United States of America the assurances of its highest consideration and esteem.

The Embassy of the
United States of America
Monrovia, Liberia

September 27, 1994

Exhibit A

The Ministry of Foreign Affairs of the Republic of Liberia presents its compliments to the Department of State of the United States of America and has the honour to inform the latter of a communication received from the Bureau of Maritime Affairs apprising it that the Internal Revenue Service of the United States of America has adopted regulations requiring operators of foreign flag ships to withhold 30% of the wages earned by non-resident alien seamen (NRAS) while they are serving on board vessels in United States territorial waters.

The Ministry wishes to note that income earned in the United States is not subject to U.S. income tax if:

1. The alien is not in the U.S. for more than 90 days of the tax year; and

2. U.S. source income is not over $3,000.00

The Ministry has been informed that, as a matter of practice, the shipowners pay the withholding directly to the IRS, and do not file for refunds. Since the effective tax rate imposed on most, if not all, NRAS will be less than 30%, they have to file U.S. income tax returns in order to claim refunds.

The Ministry is of the opinion that the regulations are onerous for two obvious reasons. Firstly, U.S. immigration laws confine NRAS to the vessels when in U.S. Waters except when in transit for repatriation or home leave. This means that even if a vessel regularly trades in the U.S. the NRAS, who is subject to U.S. income tax cannot even enter the U.S. either to file his tax return or to receive same since he has no address in the United States. The NRAS who fails to file his tax return pays the highest tax. Furthermore, if such regulations were to begin to find international application chaos would result and seamen would find themselves paying the highest income taxes payable in every country where the vessel calls.

Exhibit A

Secondly, Liberia and the United States entered into a reciprocal tax agreement on 7 October 1987 (copy attached) which provides for the exemption from income tax of gross income derived from the international operation of ships and aircraft and applies to Liberian persons, including Liberian residents'. It is from its gross income that the ship pays its operating costs, including seamen wages, after which taxable income is derived. It would be most inconsistent and unfair to exempt the vessel's gross income from tax while taxing the derivative income of seamen, especially where the seamen is inextricably linked to the ship. Additionally, pursuant to Liberian Maritime Law, all seamen serving on Liberian flag Vessels are required to hold a Liberian license and a Liberian Seamen's Identification Book, which clearly establishes his ties to Liberia and makes him subject to the laws and regulations of Liberia. In view of this, for all matters pertaining to the seaman's relationship to the Vessel he is a Liberian "person".

The Ministry therefore wishes to appeal to the Department of State to request the IRS to reconsider its decision based upon the terms and conditions for the Reciprocal Tax Agreement entered into on 7 October 1987 between the U.S. and Liberia to exempt from income tax, the income of NRAS serving on board Liberian Flag Vessels. The Ministry believes that if its interpretation of the agreement is adhered to, it will further strengthen the long-standing spirit of friendship and mutual cooperation that have characterised relations between the two Governments over the years.

The Ministry of Foreign Affairs of the Republic of Liberia avails itself of this opportunity to renew to the Department of State of the United States of America the assurances of its highest consideration and esteem.

The Department of State
of the United States of America
Washington, D.C., U.S.A.

September 28, 1994

MINISTRY OF FOREIGN AFFAIRS
MONROVIA, L.

Exhibit B

NV-95- 034

EMBAJADA DE PANAMA
WASHINGTON, D. C. 20008

The Embassy of Panama presents its compliments to the Department of State, and has the honor of referring to the practice of the Internal Revenue Service of taxing the income earned by non-resident alien individuals employed on vessels and aircraft of foreign registry, while the vessel or aircraft is in the territorial limits of the United States.

The Government of Panama believes that the practice in reference infringes the right of a flag-state to regulate all aspects of an individual's service on board a vessel or aircraft. The practice of taxing these individuals is contrary to long-standing principles of international law recognized by the promulgation of Article 92A of Regulation 45 (T.D. 2869, June 20, 1919), which addresses the need in the international shipping and airline industries for the predictable legal framework governing crews provided by exclusive flag state regulation. Additionally, United States courts have recognized that Panamanian law governs all aspects of crew service on board a vessel registered in Panama. Henry v SS Bermuda Star, 1989 Am.Mar.Cas. 1392, 863 F2d 1225 (5th Cir. 1989). Similarly, the right of a flag state to tax its crew, regardless of nationality, is well established in US jurisprudence. Eg, Mostafa v SS Marathon, 1984 Am.Mar.Cas. 1117 (EDVa 1982). Imposing US income tax on crew already subject to Panamanian regulation and taxation impedes Panama's ability to exercise these recognized sovereign rights.

Panama recognizes that taxation is a social necessity. However, those taxed should receive services for taxes paid. The United States provides no service to non-resident alien individuals, employed aboard vessels which call on the United States' ports, for which taxation is appropriate, beyond the Coast Guard's enforcement of International Maritime Organization standards as they relate to seafarers. These enforcement services are provided by Panama and other nations, without charge or exaction from crew members aboard vessels which call within their territorial limits.

Exhibit B

Panama also believes that the imposition of United States income tax on crew already subject to foreign flag state regulation and taxation unfairly subjects the crew of the vessels to multiple and inconsistent systems of taxation. Non-resident alien individuals, pursuant to United States immigration law, are prevented from entering the United States. These individuals are, none the less, considered for tax purposes to be present in the United States for any day or fraction of a day that their vessel remains in the territorial limits of the United States. Preventing these individuals' entry into the United States also severely hinders their ability to seek, if they could afford it, qualified tax advice on United States international taxation provisions, recognizably one of the most complex in the world, and restricts their ability to file a complete and accurate tax return or refund request.

For all the reasons set forth above, Panama respectfully requests, pursuant to principles international law and practice, and under principles of international comity and fundamental notions of fairness, that the Internal Revenue Service stop its current practice of taxing income earned by non-resident alien individuals employed on vessels and aircraft of foreign registry, while the vessel or aircraft is in the territorial limits of the United States.

The Embassy of Panama respectfully requests the Department of State to communicate our views to the appropriate United States Departments and Agencies.

The Embassy of Panama avails itself of the opportunity to renew to the Department of State the assurances of its highest consideration and esteem.

Washington, DC
May 10, 1995.

United States Department of State
Washington, DC

Effective Date - - July 24, 1995 Exhibit C

SHIPPING AND AIR TRANSPORTATION INDUSTRIES
COORDINATED ISSUE
FEDERAL INCOME TAX WITHHOLDING ON COMPENSATION PAID TO NONRESIDENT ALIEN CREW BY A FOREIGN TRANSPORTATION ENTITY

ISSUE:

Whether compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the U.S. on trips between U.S. and foreign destinations should be subject to withholding tax under section 3402 or section 1441?

SUMMARY:

In cases involving international transportation other than transportation to a U.S. possession, the regulations under section 1441 are technically applicable. However, case law also supports withholding under section 3402 in lieu thereof. While employers may follow either approach, in order to avoid unnecessary refund claim procedures and minimize taxpayer burden, the Examination Division recommends that all employers paying wages in conjunction with such international transportation should uniformly withhold tax under section 3402 rather than section 1441.

FACTS:

The issue involves foreign corporations that are engaged in a trade or business in the United States through the operation of ships or aircraft. The ships or aircraft typically sail or fly around the world, transporting cargo and/or passengers. This paper considers the transportation that occurs between U.S. and foreign destinations.[1]

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[1] This paper is confined to transportation between U.S. and foreign destinations (described in section 863(c)(2)(A)), and does not consider transportation that begins and ends in the U.S. on so-called cruises to nowhere (described in section 863(c)(1))

Typically, these foreign corporations employ nonresident alien individuals as crew on their vessels or aircraft. Many of these crew employees do not have a U.S. social security number.

LAW:

Applicability of Section 3402:

Under section 3402(a)(1), every employer making payment of wages is required to withhold federal income taxes as provided in the regulations. Under section 3401(d), an employer generally means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. The question under section 3402 is whether the compensation paid to employees who are nonresident alien crew for their services performed while within the U.S. is wages.

Section 3401(a) generally defines wages as remuneration for services performed by an employee for his employer with certain exceptions. Under section 3401(a)(6), an exception from wages is provided for remuneration paid for such services performed by a nonresident alien individual as may be designated by regulations. Treas. Reg. § 31.3401(a)(6)-1(a) provides that all remuneration paid for services performed by a nonresident alien individual is subject to withholding under section 3402, if such remuneration otherwise constitutes wages and if such remuneration is effectively connected with the conduct of a trade or business within the U.S., unless excepted from wages under that section. Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the U.S. is excepted from wages and hence is not subject to withholding under section 3402. For these purposes, performance of services within U.S. territorial waters is considered within the U.S., and performance of services in international waters is considered

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or transportation to or from a U.S. possession (described in section 863(c)(2)(B)).

outside the U.S.[2] The crew's performance of services within the U.S. will necessarily constitute engaging in a U.S. trade or business, and the compensation will be U.S. source income effectively connected to that U.S. trade or business.[3] Thus, but for the application of section 3402(e) discussed below, compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the U.S. or U.S. territorial waters is wages subject to withholding under section 3402.

Section 3402(e) provides, in pertinent part, that if the remuneration paid by an employer to an employee for services performed during more than one-half of any payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed wages. As noted, Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the U.S. is excepted from wages and hence is not subject to withholding under section 3402. Typically, the greater portion of the pay period compensation of nonresident alien crew employed on trips between U.S. and foreign destinations will be attributable to the performance of services outside the United States. Technically, in such circumstances, none of the compensation paid the nonresident alien crew is wages subject to section 3402 withholding under the section 3402(e) all-or-nothing rule.

However, we believe that withholding under section 3402 may apply in these circumstances, notwithstanding section 3402(e). Such conclusion would be drawn by analogy to the conclusion under FICA reached in Inter-City Truck Lines, Ltd. v. United States, 408 F.2d 686 (Ct. Cl. 1969) and Rev. Rul. 79-318, 1979-2 C.B. 352. The Court of Claims construed a similar all-or-nothing rule in section

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[2] See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

[3] See I.R.C. §§ 864(b) and (c)(3); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the U.S., which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

3121(c) determining the existence of "employment" (since under section 3121(a) FICA wages must be "for employment"). Section 3121(c) provides, in pertinent part, that if the services performed during more than one-half of any payroll period do not constitute employment, then none of the services for such period shall be deemed employment. Under section 3121(b), services performed outside the U.S. do not constitute employment, unless performed by a U.S. citizen or resident for an American employer (or in connection with an American vessel or aircraft and meet other conditions). The employees in Inter-City Truck Lines were Canadian truck drivers employed by a Canadian carrier and who were stipulated in every pay period to perform less than one-half of their services in the United States. Although the Court acknowledged that a literal interpretation might lead to the conclusion that none of the Canadian truck drivers' services were taxable employment, it nevertheless concluded that FICA did apply on so much of their remuneration as was for services performed within the U.S., irrespective of what percentage of the employees' total service in this country and Canada was performed in the United States.

Section 3402(e) applies to payrolls of not more than 31 consecutive days. If the payroll period is more than 31 consecutive days the all-or-nothing rule would not apply and section 3402 withholding is required with respect to that portion of the remuneration which constitutes wages. Treas. Reg. section 31.3402(e)-1(e); see also Rev. Proc. 79-38, 1979-2 C.B. 501 (concerning "end-of-voyage" payroll procedures).

Applicability of Section 1441:

If section 3402 withholding does not apply to U.S. source compensation paid to nonresident crew, then section 1441 withholding applies.

Section 1441 provides, in pertinent part, that any person paying "wages, ... compensations, remunerations, ... or other fixed or determinable annual or periodical gains, profits, and income" constituting U.S. source gross income must deduct or withhold 30% thereof. As already noted, the nonresident crew's performance of services within the U.S. will necessarily constitute engaging in a

U.S. trade or business. Therefore, any part of their compensation that is U.S. source will be taxed as income effectively connected to that U.S. trade or business.[4] While section 1441(c)(1) provides an exception from withholding under section 1441 for certain income that is effectively connected with a U.S. trade or business, this exception does not apply to compensation for personal services performed by an individual.[5] Under section 1441(c)(4), regulations may exempt compensation for personal services from withholding under section 1441. However, the relevant regulations do not provide any exemption applicable in this case.

In pertinent part the regulations pursuant to section 1441(c)(4) provide for only two exemptions, neither of which is applicable. Under Treas. Reg. § 1.1441-4(b)(1)(i), withholding under section 1441 is not required if the personal services compensation of the nonresident individual is subject to withholding under section 3402. However, as discussed above, withholding under section 3402 technically may not apply to the compensation of nonresident alien crew by virtue of section 3402(e). Under section 1.1441-4T(b)(1)(ii), withholding under section 1441 is not required if the personal services compensation of the nonresident alien individual would be subject to withholding under section 3402 but for the provisions of section 3401(a), other than section 3401(a)(6). However, as discussed above, any inapplicability of section 3402 withholding to the compensation of nonresident alien crew is not

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[4] See I.R.C. §§ 864(b) and (c)(2); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the U.S., which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

Note that the exception for $3,000 or less earned during 90 days or less in the U.S. will not apply, since the foreign transportation entity will itself necessarily be engaged in a U.S. trade or business by virtue of performing services in the U.S. or U.S. territorial waters during trips between U.S. and foreign destinations. See I.R.C. §§ 861(a)(3)(C)(i), 864(b)(1)(A); Treas. Reg. §§ 1.861-4(a)(1)(iii)(a), 1.864-2(b)(1)(i).

[5] Accord, Treas. Reg. § 1.1441-4(a)(1).

the result of one of the exceptions under section 3401(a), but rather is the result of the operation of the section 3402(e) all-or-nothing rule.

Accordingly, if section 3402 does not apply, the U.S. source compensation of nonresident alien crew is subject to withholding under section 1441. However, employers that choose to rely on the section 3402(e) argument and so withhold tax under section 1441, rather than section 3402, for wages paid to nonresident alien crew employees in connection with international trransportation (other than to U.S. possessions) should be permitted to do so only provided the employer files forms 1042 and 1042S with respect to such payments. No refunds shall be granted unless the refund claim on form 1040NR bears a taxpayer identification number that matches the number stated on the corresponding Form 1042S.

Exceptions to Applicability of Section 1441:

Withholding is not required under section 1441 either for compensation for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the U.S. at frequent intervals, or for compensation which is, or will be, exempt from income tax by reason of a tax treaty to which the U.S. is a party.[6] The regulations set forth the Form 8233 procedure for obtaining the treaty exemption.[7]

Source of Personal Services Income:

Section 1441 only applies to items of income from U.S. sources. Section 863(c) generally sources income from transportation activities. However, wages paid in connection with international transportation between U.S. and foreign destinations are not sourced under section 863(c). Rather, they are sourced under

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[6] Treas. Reg. § 1.1441-4(b)(1)(iii)&(iv). The latter provision also would exempt from withholding under section 1441 compensation exempt from income tax under a provision of the Internal Revenue Code. Note, the exemption under section 872(b) for income from the international operation of ships and aircraft would not be available, since crew members are not the operators.

[7] Treas. Reg. § 1.1441-4(b)(2).

Exhibit C

sections 861(a)(3) and 862(a)(3). Under these rules, compensation for services performed in the U.S. is treated as U.S. source, and compensation for services performed outside the U.S. is treated as foreign source.

Since the compensation paid nonresident alien crew for services during trips between U.S. and foreign destinations is partly for services within the U.S. and partly for services outside the U.S., an allocation and apportionment must be made to determine the amount paid for services within the U.S. to which withholding tax under section 1441 applies. As noted, services within U.S. territorial waters are considered within the U.S. for these purposes.[8] The regulations provide for the division to be made on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.[9] In many cases the facts and circumstances will be such that an apportionment on the time basis will be acceptable, that is, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the U.S. bears to the total number of days of performance of labor or services for which the payment is made.[10] In some cases in which taxpayer's services are performed and an accurate record of all of the hours of service is available, an allocation of compensation for labor or personal services performed by the taxpayer between U.S. and foreign sources shall be made by comparing the hours of service performed in the U.S. and the total hours of service.[11]

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[8] See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

[9] Treas. Reg. § 1.861-4(b)(1)(i).

[10] Id. See also Treas. Reg. § 1.863-4(c) ("For example, ship wages ... shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage ....").

[11] Rev. Rul. 77-167, 1977-1 C.B. 239 (allocation of airline pilot's compensation by comparing hours of flight and required preflight services performed in the U.S. to the total

<u>Inapplicability of FICA and FUTA.</u>

Nonresident alien crew serving on a foreign-flag vessel or aircraft are <u>not</u> subject to FICA or FUTA to the extent that part of their employment is rendered while the vessel or aircraft is outside the United States.[12]

<u>Rules for Resident Aliens Not Addressed:</u>

This discussion is limited to <u>nonresident alien</u> crew members. Different rules apply for U.S. resident aliens or U.S. citizens. Section 7701(b) and the regulations thereunder define when resident alien status is acquired. Generally, there are two tests, one based on permanent immigrant status (green card test) and the other based on presence in the U.S. for a sufficient period of time measured by an objective formula (substantial presence test). In reviewing a time allocation of a purported nonresident alien's service between U.S. and foreign sources, the possibility should be kept in mind that time in the U.S. above a threshold could affect classification of the crew member as nonresident or resident alien.

<u>CONCLUSION:</u>

In cases involving international transportation other than transportation to a U.S. possession, the regulations under section 1441 are technically applicable. However, case law also supports withholding under section 3402 in lieu thereof. While employers may follow either approach, in order to avoid unnecessay refund claim procedures and minimize taxpayer burden, the Examination Divison recommends that all employers paying wages in connection with such international transportation should uniformly withhold tax under section 3402 rather than section 1441.

U.S. source compensation paid by a foreign corporation to nonresident alien crew for services performed in connection with international transportation is generally subject to withholding tax under section 3402, in accordance with the Department of

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hours of such services).

[12] I.R.C. §§ 3121(b)(4), 3306(c)(4).

Treasury, Internal Revenue Service "Circular E" Employer's Tax Guide.

However, employers that choose to rely on the section 3402(e) argument and so withhold tax under section 1441, rather than section 3402, for wages paid to nonresident alien crew employees in connection with international transportation (other than to U.S. possessions) should be permitted to do so only provided the employer files Forms 1042 and 1042S with respect to such payments. No refunds shall be granted unless the refund claim on Form 1040NR bears a taxpayer identification number that matches the number stated on the corresponding Form 1042S.

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July 21, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 205105

Re: Miscellaneous Tax Reform -- Carry Over of Excess Possession Tax Credit

Dear Mr. Moseley:

This statement, for the record, is for purposes of expressing our written support for the proposed amendment to section 936 that would provide a carryover of excess possession tax credits. We recommend that the proposal be adopted by the Committee effective for taxable years to which the Revenue Reconciliation Act of 1993 applies.

As you know, the 1993 Act added a provision which subjected section 936 to two alternative limitations. The first limitation, the economic activity limitation ("EAL"), is based on a possession corporation's compensation, depreciation deductions, and, in the case of income not subject to the profit split method, the possession income taxes paid. The second limitation, the percentage limitation, is based upon a percentage of the otherwise allowable possession tax credit for the year.

The proposed amendment is intended to minimize fluctuations with respect to the EAL which is more sensitive to year-by-year changes in a taxpayer's economic activity than the percentage limitation. Business income may fluctuate due to business and economic cycles. Moreover, economic activity in one year may generate income and possession tax credits in a second year. The fluctuations result in unfairness because a corporation's possession tax credit may be limited in one taxable year under the EAL even though in a second taxable year there is sufficient limitation to allow the use of additional credits.

The proposal would eliminate these distortions by permitting a taxpayer who uses the EAL to carry any excess possession tax credit to an excess limitation year. Such unused credits may be carried back two years and then carried forward for five years in a manner identical to the foreign tax credit carryback and carryover provisions.

We recommend that the effective date for the amendment be the effective date of the Revenue Reconciliation Act of 1993 which added the EAL limitation. The failure of the 1993 Act to provide for a carryback and carryover was a defect in that legislation which we believe should be rectified as of the date that the legislation was effective.

Sincerely,

Howard J. Silverstone

Howard J. Silverstone

WRITTEN TESTIMONY OF
DANIEL C. MACLEAN, VICE PRESIDENT AND GENERAL COUNSEL
THE DREYFUS CORPORATION

OR

A PROPOSAL FOR PASS-THROUGH TREATMENT FOR
INVESTMENTS IN U.S. MUTUAL FUNDS BY FOREIGNERS

BEFORE THE
HOUSE WAYS & MEANS COMMITTEE HEARINGS ON
MISCELLANEOUS TAX REFORMS

JULY 18, 1995

I am Daniel C. Maclean, Vice President and General Counsel of The Dreyfus Corporation. We urge the House Ways & Means Committee to act favorably on legislation permitting pass-through treatment of distributions paid by regulated investment companies to foreign investors. If enacted, this tax reform will allow U.S. mutual funds of U.S. securities, whose domestic market has expanded over the past decade, to market their products globally. If it is not enacted, U.S. mutual funds will continue to suffer a severe competitive disadvantage in the global marketplace, and investors from abroad will have a continued incentive to invest in U.S. securities through off-shore funds instead of through U.S. funds.

Dreyfus manages or administers more than 150 mutual funds, covering a full spectrum of investment strategies. The value of assets under management in 1994 was over $75,000,000. Funds consisting primarily of U.S. securities have been very popular with American investors. We believe these funds would be attractive to many international investors as well, were it not for the onerous 30% withholding tax they must pay on their earnings. (Some treaties lower this rate, but not sufficiently to attract potential investors.) Since these same investors can avoid this tax either by investing directly in U.S. securities, or by investing in U.S. securities through off-shore funds, we cannot effectively market these U.S. funds abroad.

The proposed legislation would correct this inequity by allowing the real character mutual fund earnings (i.e., capital gains, interest, dividends) to "pass-through" to the investor, and to be taxed accordingly. The tax would be the same, regardless of the vehicle though which the investor invested: directly; through a U.S. fund; or through an off-shore fund. Given a more level playing field, we are confident that U.S. mutual funds would be very attractive abroad, and that investments now being directed elsewhere would flow into this country. That would be good for the U.S. mutual fund industry, good for U.S. publicly held companies, good for the balance of trade, and good for the U.S. economy.

Thank you for considering this very sound proposal.

Daniel C. Maclean

Daniel C. Maclean
Vice President and General Counsel
The Dreyfus Corporation
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TESTIMONY OF JAMES M. McDONALD
FRANK RUSSELL COMPANY

I am James M. McDonald, Chief Financial Officer of Frank Russell Company, a leading global asset consultant and investment management firm headquartered in Tacoma, Washington. The purpose of this statement is to testify on behalf of a proposal to reform provisions of the Internal Revenue Code that substantially inhibit American mutual funds from exporting their products. This proposal would permit pass-through treatment of investment income from U.S. mutual funds. In our view, enactment of this legislation is critical for U.S. mutual funds to compete in the global investment products marketplace.

Russell is recognized as a premier global asset consultant and investment manager, providing investment strategy consulting on more than $500 billion in assets to over 200 institutional investors worldwide, including domestic clients such as the pension plans of General Motors, IBM, AT&T, and Boeing, as well as similar institutions overseas. Additionally, Russell and its affiliates serve as investment managers for over $14 billion of collective investment funds, including mutual funds and commingled employee benefit funds.

Russell has an international reputation as an innovative leader in the management of collective investment funds. Our unique "multi-style, multi-manager" portfolio management technology offers our clients an investment strategy designed to minimize risks while maximizing diversity and sustaining above-benchmark yields. This strategy has become increasingly attractive to overseas investors, particularly pension funds and insurance pools. Individual retirement plans overseas also are growing, as many foreign countries, following the lead of the United States, are turning to defined contribution plans to provide funded retirement security for their citizens.

Unfortunately, current federal tax law poses a significant barrier to American investment companies seeking to sell U.S. mutual funds in these international markets. As a result, only a tiny percentage of the huge American mutual fund market can be sold internationally. Instead, international investors generally invest in the U.S. market through off-shore investment funds that are not impeded by this unfavorable tax treatment.

This problem arises from the fact that the Internal Revenue Code characterizes distributions from U.S. mutual funds as "dividends," even though these distributions are made up of capital gains and interest, as well as dividends, on the various securities that comprise a mutual fund. Because of this treatment, distributions outside the U.S. are subject to U.S. withholding taxes at the rate of 30%, unless a treaty provides for a lower rate (typically 15%). If the character of a distribution's components (short-term capital gains, portfolio interest, etc.) were allowed to "pass through" to the underlying investor, the withholding tax on both short-term capital gains and interest in most cases would be reduced to zero.

"Pass-through" legislation would allow distributions from American mutual funds to retain their underlying character, for tax purposes, as capital gains, portfolio interest, or dividends. As a consequence, U.S. investment companies could sell their mutual funds outside the U.S. and the underlying investors would receive tax treatment comparable to investing through off-shore mutual funds and comparable to investing directly in U.S. securities. With the tax barrier removed, we believe the American mutual fund market would attract substantial investment capital now being invested in off-shore funds.

Institutional investors throughout the world have advised us that absent the withholding tax on capital gains and interest, U.S.-based mutual funds are otherwise high on their list of investment alternatives. The reasons are obvious to those of us who operate in that industry:

> The U.S. system of regulation for investment companies is unparalleled in its commitment to investor protection.
>
> The U.S. mutual fund industry uses the most advanced investment technology, as well as the best accounting, custodial and recordkeeping services, allowing funds to be operated and sold at greatly reduced expense to the investor.

The U.S. mutual fund industry has by far the best client servicing capabilities.

And yet, as several recent experiences at Russell illustrate, current tax law is pushing this business off-shore. In 1992 we entered into an arrangement to provide a series of investment funds to be marketed by a Canadian brokerage to the individual retirement account market in Canada. At first blush the existing Russell multi-style, multi-manager mutual funds appeared to be good candidates as investment vehicles for this new business opportunity. However, in large part because of the U.S. withholding tax and the impact of that tax on expected yields, Russell was forced to create a new family of Canada-based funds that are essentially "clones" of our existing U.S. based funds. Since they became operable in January 1993, these funds grew to over $100 million (CAN) the first six months, and 2-1/2 years later have grown to over $359 million (CAN).

Even though these funds are invested substantially in U.S. securities, they employ Canadian accounting, custodial, trustee and recordkeeping services, and pay investment management fees to selected Canadian investment managers. Moreover, Russell's Canadian affiliate pays Canadian corporate income tax on its earnings from managing these new funds.

Our country cannot afford to ignore that some foreign jurisdictions have actually enacted "magnet" legislation to attract the pooled investment business to their countries. A recent example of this trend is Ireland, which enacted legislation creating pure "pass through" treatment for funds located there and significantly lowering the income tax rate for investment management firms conducting fund operations in Dublin. This provides a double incentive to locate a funds business there. Other countries with attractive tax environments include Luxembourg, Bermuda, and the Cayman Islands.

In order to service its global clients, Russell created an off-shore investment fund in Dublin in 1993, and another fund in the Cayman Islands in 1994. Altogether, these off-shore funds comprise almost $1 billion in assets. We would much prefer to use U.S.-based funds for U.S. securities, but there is no real market for them under the current tax law.

The success and attractiveness of the U.S. mutual fund industry is recognized by investors throughout the world. Yet the current tax environment effectively prevents this industry from selling its product abroad. If flow-through legislation is adopted, it will help create a worldwide market for U.S. mutual funds, thus further encouraging the flow of international capital into U.S. investments. To the Frank Russell Company, this legislation makes sound business, policy and trade sense.

We appreciate the opportunity to present this testimony before you and look forward to any questions you may have.

James M. McDonald
Chief Financial Officer
Frank Russell Company
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P.O. Box 1616
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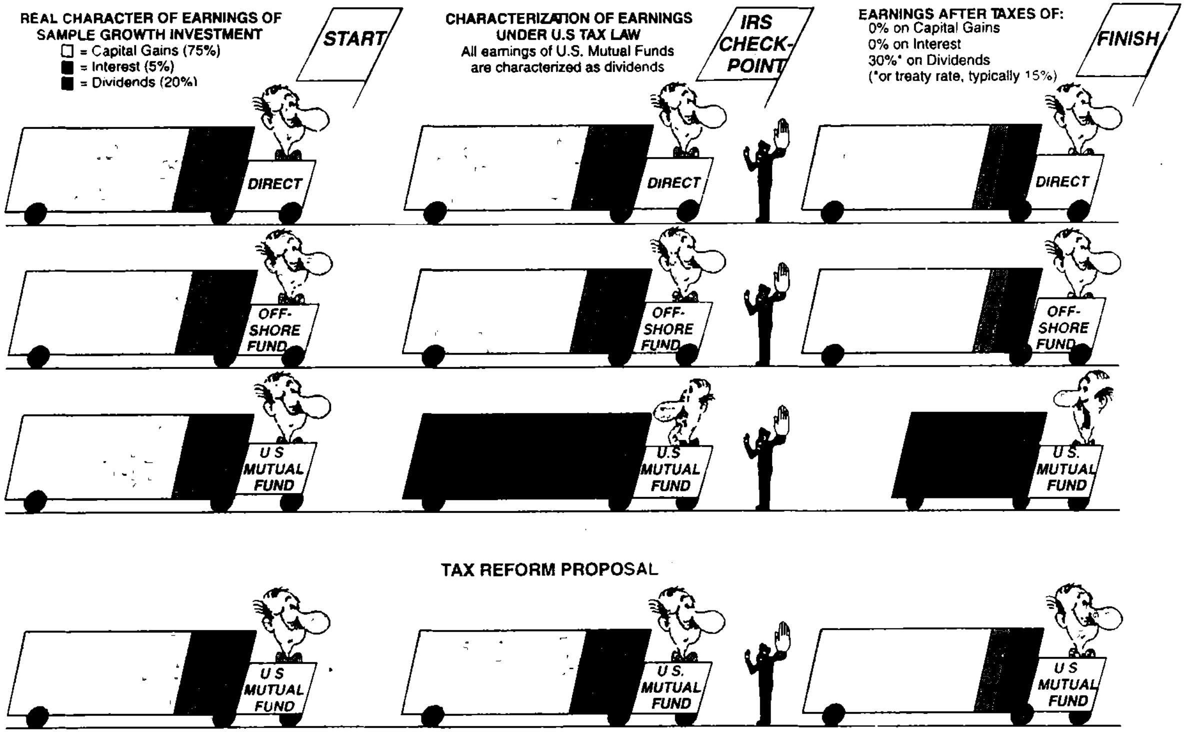
BEFORE- AND AFTER-TAX EARNINGS OF FOREIGN INVESTOR IN U.S. SECURITIES, BY INVESTMENT VEHICLE



Frank Russell Co. (7-95)

STATEMENT OF THE HONORABLE NITA M. LOWEY
IN SUPPORT OF H.R. 737

COMMITTEE ON WAYS AND MEANS
HEARING ON MISCELLANEOUS TAX REFORMS
JULY 11-13, 1995

I thank the Committee for this opportunity to testify on behalf of H.R. 737, legislation that would alleviate an inequitable tax situation which is affecting a number of my constituents.

As my colleagues on the Committee are aware, in a typical housing cooperative, the tenant stock-holders pool their assets to purchase both land and houses. When the cooperative takes out a loan to make a purchase, the interest on the mortgage can be deducted individually by the members against their personal income. Additionally, property taxes that are assessed to the cooperative can be deducted individually by its members.

However, a group of my constituents are treated differently. The residents of the Edgewater Park Cooperative own their own homes, while collectively the co-op owns the land on which the homes stand. Because their arrangement is unusual and does not fit with the IRS definition of a cooperative, they are not allowed to deduct their share of the mortgage interest and property taxes that the cooperative incurs from their personal income taxes.

These individuals are not covered by the IRS cooperative rules because of their unusual arrangement. It stands to reason that if one is a member of a cooperative and contributes to paying the cooperative's mortgage interest and property taxes, then that person should be allowed to deduct those costs when paying their taxes, regardless of whether the individual ownership rights to a home are retained.

H.R. 737 would address this inequity. It would allow individuals who belong to cooperatives to deduct mortgage interest and local taxes from their tax liability even if they own their homes. This legislation would only affect clearly defined groups of individuals; there is no opposition to the legislation that I am aware of, and Although the bill would have a relatively minor impact on the Federal Treasury, it would make a real difference to those taxpayers affected. In the end, it is a simple matter of equity.

I urge the Committee to approve H.R. 737.

STATEMENT OF
THE ALLIANCE OF AMERICAN INSURERS
THE AMERICAN INSURANCE ASSOCIATION
THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

On Miscellaneous Tax Reform Hearings
Tax Treatment of Salvage and Subrogation of Property and Casualty Insurance Companies

Mr. Chairman and Members of the Committee--we are submitting this written statement on behalf of a coalition of property and casualty insurance industry trade associations--the Alliance of American Insurers, the American Insurance Association, the National Association of Independent Insurers and the National Association of Mutual Insurance Companies (the Associations). Together the Associations represent a membership of approximately 2,000 property and casualty companies which write more than 80 percent of the premium volume on property and casualty insurance in the U.S.

The proposal before you provides a legislative correction to resolve a technical administrative interpretation of the transitional rules under the salvage provisions of the Revenue Reconciliation Act of 1990.

A. *Overview*

The salvage and subrogation problem arises in cases in which a property and casualty ("P&C") insurer subject to the statutory transitional rules on estimated salvage under the Revenue Reconciliation Act of 1990 (the "1990 Act") took estimated salvage into account in pre-1990 years. As described in more detail below, a P&C company could be in such a position as a result of reinsurance or a variety of pooling arrangements. Although we do not think the statutory language requires such result, Treasury regulations implementing the 1990 Act transitional rules currently prohibit taxpayers from claiming the benefit of both transitional rules. Treasury has taken the position that a technical correction is necessary in order for such taxpayers to claim full transitional relief of both the special deduction and the fresh start benefit. The technical correction would supplant those regulations.[1]

---

1 The legislative proposal also applies the overestimation, anti-abuse rule to the special deduction and denies transitional relief under the 1990 Act to life insurance companies. The Associations support these provisions as part of the overall legislative proposal and such provisions are not further addressed in these comments.

B. *Policy Considerations*

The reason for the fresh start rule in the 1990 Act is clear--Congress decided that taxpayers required to change their method of accounting to comply with the new statutory requirement relating to estimated salvage recoverable should not suffer the *full* impact of what otherwise would have been the resulting section 481 adjustment. Accordingly, Congress only required 13 percent of the section 481 adjustment to be included in income over four years.

Had Congress done nothing more, the fresh start rule would have been unfair to the extent that a taxpayer *did* take estimated salvage into account for pre-1990 periods. That taxpayer's deductions for losses incurred were reduced in pre-1990 years by estimated salvage, placing that taxpayer in a disadvantageous position as compared to a taxpayer that made no such an adjustment to losses incurred for those years. Further, the fresh start rule required the latter taxpayer to restore the tax benefit of prior deductions only in an amount equal to 13 percent of the estimated discounted salvage previously not taken into account.

In order to prevent this unfairness, the 1990 Act permitted a special deduction to taxpayers that had taken estimated salvage into account in prior periods, in an amount equal to 87 percent of the discounted amount of estimated salvage recoverable as of the close of its last pre-1990 taxable year. This deduction was spread over four years.

Except for P&C insurers that *fully* accounted for estimated salvage in pre-1990 periods, it is critical that the fresh start limitation (or equivalent relief) be available *in conjunction with* the special deduction. Otherwise, P&C insurers effectively would be penalized for having conformed at least in part, prior to the 1990 Act, with the accounting method mandated by the 1990 Act. The cost of obtaining fair treatment with respect to estimated salvage recoverable that was taken into account in pre-1990 periods (*i.e.*, the special deduction) would be a denial of the fresh start limitation with respect to estimated salvage recoverable that was not taken into account. Even if the estimated salvage recoverable that a taxpayer took into account was a relatively small portion of such taxpayer's total estimated salvage, the clear policy underlying the transitional rules is that (i) the special deduction is appropriate for such amount, and (ii) the fresh start limitation is appropriate for the estimated salvage *not* taken into account.

C. *Factual Contexts In Which the Salvage Issue Arises*

A particular company's method of accounting for estimated salvage may differ from one line of business to another. It may also differ within a single line of business by reason of reinsurance arrangements or pooling agreements to which the company is a party. For example, in such situations, a company may have both net and gross salvage reported within a single line of business. Because the policy considerations are the same, the technical correction should apply in all of these contexts.

Most insurance companies are required to participate in state-administered, high-risk insurance pools that allocate losses and underwriting expenses among the pool companies. For example, the Ohio Fair Plan pool for automobile insurance calculates reserves gross of salvage while the Oregon Fair Plan Association pool calculates reserves net of salvage. Thus, an insurance company that sold automobile insurance in both Ohio and Oregon and had reserves calculated on this basis in 1990 would have some reserves calculated on a gross basis and some reserves calculated on a net basis. Such a company reasonably should be entitled to a special deduction with respect to its share of salvage attributable to the Oregon pool, and should obtain the benefit of the fresh start limitation with respect to its share of salvage attributable to the Ohio pool. As another example, all workers' compensation reinsurance pools managed by the National Council on Compensation Insurance calculate their loss reserves net of salvage. Thus, any insurance company that wrote workers' compensation lines and calculated loss reserves on a gross basis also would have reserves calculated on a net basis if it participated in one of these pools.

In addition, many insurance companies (whether or not affiliated) voluntarily participate in similar reinsurance pooling agreements in order to spread risk and expenses among the participating companies. The pool accounting for salvage recoverable may well vary from each participating company's methods.

In summary, a single P&C company may have had (i) loss reserves on which estimated salvage recoverable was anticipated, (ii) loss reserves on which salvage was not anticipated, and (iii) loss reserves on which only *some* items of salvage were anticipated. For example, these variances may exist within the same line of business as a result of reinsurance or pooling arrangements.

D. *The Regulations*

Regulations implementing the 1990 Act transitional rules were published in 1992. Those regulations provide that a taxpayer cannot both (i) claim the special deduction permitted by section 11305(c)(3) of the 1990 Act (with respect to estimated salvage taken into account in pre-1990 taxable years) *and* (ii) benefit from the fresh start limitation on positive section 481 adjustments provided by section 11305(c)(2) (B) of the 1990 Act (with respect to estimated salvage *not taken* into account in pre-1990 years).

The current Treasury position on the salvage issue is reflected in TAM 9516001 (December 8, 1994). One of the issues addressed therein is whether a taxpayer that claimed the special deduction also was entitled to the fresh start benefit. In the TAM, the taxpayer took estimated salvage into account in determining its Schedule P loss reserves at December 31, 1989, but *not* in determining its Schedule O loss reserves at that date. In its returns, the taxpayer claimed the special deduction with respect to its Schedule P reserves and claimed the fresh start benefit with respect to its Schedule O reserves. In denying fresh start relief, the TAM states that "[a] taxpayer that claims both the special deduction and the section 481 [fresh start] adjustment is allowed the special deduction but not the section 481 adjustment."

E. *Current Ways and Means Proposal*

This issue is addressed in one of the miscellaneous tax proposals that were scheduled for hearings before the Ways and Means Committee on July 11-13, 1995. *See* Joint Committee on Taxation, 104th Cong., 1st Sess. 183 (Jt. Comm. Print 1995) (Item V of the Miscellaneous Proposals). Noting that the Treasury regulations do not permit taxpayers to claim both the special deduction and fresh start relief, the Joint Committee describes the legislative proposal as follows:

> The proposal would eliminate the Treasury regulations' rule of mutual exclusivity for the two types of transition relief under the salvage and subrogation provision of the 1990 Act. Thus, the proposal would provide that a property and casualty insurance company that took estimated salvage and subrogation into account with respect to some, but not with respect to other lines of business, could take the "fresh start" benefit with respect to those lines of business for which it did NOT take into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, and could take the special deduction with respect to those lines of business for which it DID take such estimated salvage and subrogation into account, provided that all the requirements for the "fresh start" benefit and the special deduction, respectively, are met.

Id.[2]

We strongly endorse the needed legislative correction, and we believe it should be expanded somewhat. The proposal operates by reference to lines of business, implicitly assuming that prior to 1990 an insurer necessarily treated a single line of business by either accounting for estimated salvage for the entire line of business, or not accounting for estimated salvage to any extent for that line of business. As discussed above, this does not meet issues such as participation in reinsurance and pooling arrangements with different methods of accounting for estimated salvage.

The following proposal takes all of these variations into account, permitting both fresh start and special deduction relief in all cases in which the taxpayer took estimated salvage into account only in part, whether in connection with different lines of business directly written by the taxpayer or business in which the taxpayer participated through reinsurance or pooling arrangements.

Under this proposal, a new paragraph (6) would be added to section 11305(c) of the 1990 Act, to read as follows:

---

[2] The Joint Committee explanation appears to track the language of the following technical correction:

> (7) TREATMENT OF COMPANIES DESCRIBED IN BOTH PARAGRAPHS 2 AND 3--
>
> In the case of any insurance company which for its last taxable year beginning before January 1, 1990--
>
> (i) was an insurance company described in paragraph (2) with respect to some, but not all, of its lines of business, and
>
> (ii) was an insurance company described in paragraph (3) with respect to some, but not all, of its lines of business,
>
> such insurance company shall apply paragraph (2) to the lines of business described therein, and shall apply paragraph (3) to the lines of business described therein.

(6) TREATMENT OF COMPANIES WHICH PARTIALLY ACCOUNTED FOR SALVAGE.–In the case of any insurance company taxable under section 831 which took into account a portion, but not all, of its salvage recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990 (including under a reinsurance or pooling arrangement), 87 percent of the discounted amount of such salvage recoverable as of the close of such last taxable year shall be allowed as a deduction ratably over its first 4 taxable years beginning after December 31, 1989, and the adjustments described in paragraph (2)(B) shall be applied with respect to the salvage recoverable that was not taken into account by such company in determining such losses incurred.

F. *Closing*

The Associations and their affected member insurers respectfully recommend that the Committee adopt the above-described legislative language.

GHI

Statement of
GROUP HEALTH INCORPORATED

Before the
COMMITTEE ON WAYS AND MEANS

Submitted for the Record for Hearings on
Miscellaneous Tax Reforms
July 11, 12 and 13, 1995
Washington, D.C.

Executive Summary

Group Health Incorporated ("GHI") is pleased to provide this written statement for the July 11-13, 1995 hearings of the Committee on Ways & Means on miscellaneous tax reforms. GHI is a New York not-for-profit health insurance service corporation which strongly supports enactment of the insurance tax reform proposal relating to health insurance organizations eligible for benefits of Section 833 of the Internal Revenue Code. This proposal is set forth as Item V. #2, of the Ways & Means Committee Release No. FC-8 dated June 30, 1995.

A similar proposal passed Congress on a number of previous occasions. Last year, the proposal was included in H.R. 3600 (the Health Security Act, 103rd Cong.), as passed by both the full House and the Ways & Means Committee, and in S. 2351 (the Health Security Act, 103rd Cong.), as reported by the Senate Finance Committee. A similar proposal was also included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed for unrelated reasons by President Bush. See, Joint Committee on Taxation Description (JCS-19-95) of Miscellaneous Tax Proposals.

The proposal is a minor, non-controversial tax reform which has wide bi-partisan support (including the support of the entire New York Congressional delegation) and has been scored by the Joint Committee on Taxation ("JCT") as having a "negligible" impact on revenues See, Attachments (New York delegation letter and JCT revenue estimate).

Background

GHI is a New York not-for-profit health service corporation which provides health benefit coverage for over 2 million people. GHI was incorporated in New York in 1937 as one of the first Blue Cross/Blue Shield-type organizations in the country. Although GHI is organized and operates as a not-for-profit health insurer in the State of New York, it does not use the words "Blue Cross or Blue Shield" in its name. GHI is organized under and is governed by Article 43 of the New York Insurance Laws, the exact same statutes which apply to the state's Blue Cross and Blue Shield plans ("the New York Blues").

Both GHI and the New York Blues are similarly restricted in the type of insurance products that can be offered and are subject to the same special statutory reserve requirements. Like the New York Blues, GHI provides coverage to high-risk individuals and small groups whose premiums are determined on a community-rated basis. Like the New York Blues, all GHI group policies provide for individual conversion which are written without the requirement of medical examination or questionnaire.

Other entities throughout the country may be similarly situated, in that they are legally the same as a Blue Cross or Blue Shield plan in all relevant respects, but do not use the identifiable terms in their name.

GHI, because of its special not-for-profit status under New York law, has been a pioneer in many areas of the health insurance field in which commercial insurers have been reluctant to participate until better defined risk evaluation statistics have become available. For example, GHI offered the first comprehensive dental plan in the country; and GHI was a pioneer in offering psychiatric coverage and paid-in-full coverage for low income subscribers. GHI's Board of Directors is comprised of prominent labor leaders, health professionals and members of the public.

<u>Legislative History to IRC Section 833</u>

Prior to enactment of the Tax Reform Act of 1986 ("the Act"), all Blue Cross/Blue Shield-type organizations, including GHI, were exempt from Federal income tax. Effective for taxable years beginning after December 31, 1986, section 1012 of the Act removed the tax exempt status for all Blue Cross/Blue Shield-type organizations, including GHI. However, the Act added a new Code section, Section 833, which provides a special deduction for "any existing Blue Cross or Blue Shield organization". The term "Blue Cross or Blue Shield organization" is not defined in the Code or relevant committee reports.

We believe that Congress intended that the term encompass a generic type of non-profit health insurer that is organized under, and governed by, special state insurance laws specifically applicable to so-called "Blues" type organizations. We do not believe that Congress intended to deny GHI or other similarly situated organizations the tax benefits available to all other Blues because of the way GHI or others spell their name or because they do not belong to a Blue Gross/Blue Shield voluntary national trade association. Yet, in the absence of clarifying language, the Internal Revenue Service or a court could determine that GHI or other similarly situated entities are not a Blue Cross or Blue Shield organization for these very reasons.

GHI is legally the same for all relevant purposes as organizations containing "Blue Cross or Blue Shield" in their name. The proposed amendment would clarify that for Federal tax purposes all such organizations would be treated the same. The proposed amendment would be effective from January 1, 1987, as if included in the originally enacted Internal Revenue Code Section 833.

Recommendation

As noted above, GHI and other similarly situated organizations are not explicitly identified in the statute as being eligible for the same tax treatment as the Blues, even though they are similar, if not identical, in all essential respects to a Blue Cross/Blue Shield organization. We believe Congress intended to treat all similarly situated, not-for-profit health insurers the same for tax purposes.

The proposed tax amendment to Section 833, would do just that by clarifying that organizations, like GHI, that are organized, operated and governed under state not-for-profit laws like Blue Cross/Blue Shield organizations, and have been since 1986, are to be treated the same as those organizations under the U.S. Tax Code. Thus, the amendment would ensure fair, reasonable and equitable treatment to similarly situated health insurance organizations.

Accordingly, we support the clarifying proposal on the basis of fairness, reasonableness and equity that all similarly situated organizations be treated the same for Federal income tax purposes.

Congress of the United States
House of Representatives
Washington, DC 20515

FEB 24 1995

February 23, 1995

Honorable Bill Archer
Chairman
House Ways & Means Committee
1102 House Longworth Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the New York delegation of the House of Representatives, we urge you to include a non-controversial technical tax amendment to IRC Section 833 in the pending "Contract with America" bill.

This measure has passed the Ways & Means Committee, the full House of Representatives and the full Senate on a number of prior occasions. Unfortunately, for a variety of reasons unrelated to the merits of the provision, it has not been enacted into law. This modification would ensure that similarly-situated Blue Cross/Blue Shield-type health organizations, including Group Health, Inc. in New York, are accorded the same treatment under Section 833 of the Internal Revenue Code as are Blue Cross/Blue Shield health organizations.

We look forward to working with you on this important matter.

Sincerely,

Ben Gilman
Honorable Benjamin A. Gilman

Charles B. Rangel
Honorable Charles B. Rangel

Susan Molinari
Honorable Susan Molinari

Amo Houghton
Honorable Amo Houghton

104TH CONGRESS, 1ST SESSION

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(LAW)
BERNARD A. SCHMITT
DEPUTY CHIEF OF STAFF
(REVENUE ANALYSIS)

MAR 13 1995

Honorable Amo Houghton
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Houghton:

This letter is in response to your request of March 7, 1995, regarding a modification to Internal Revenue Code section 833.

Specifically, the proposal provides that any health insurance company that was in existence on February 16, 1986, and was previously tax exempt under section 501(c)(4) would be taxed under the provisions of section 833 of the Code, even if it was not affiliated with Blue Cross/Blue Shield. Section 833 treatment would be available provided the organization otherwise meets the requirements of the section. We have assumed that an organization qualifies for this treatment only if (1) it is not a health maintenance organization and (2) it is organized under and governed by State laws which are specifically and exclusively applicable to not-for-profit health insurance or health service type organizations. This provision would be effective for taxable years beginning after December 31, 1991.

We have determined that this provision would cause a negligible revenue loss of Federal fiscal year revenue over the 1995-2000 budget window.

I hope this information is helpful to you. If we can provide further assistance, please let me know.

Sincerely,

Kenneth J. Kies

Testimony of Robert Lipp
Regarding Internal Revenue Code Section 818(b)

Mr. Chairman, thank you very much for the opportunity to testify before the Ways and Means Committee regarding the proposal now before the Committee to revise section 818(b) of the Internal Revenue Code to mitigate its adverse effect upon the life insurance industry.

My name is Robert Lipp, and I am Vice Chairman and Group Chief Executive Officer of the Travelers Group; in that capacity, I am responsible for certain major all insurance operations. I wish to emphasize, however, that I am testifying today in support of a position which has been endorsed by the American Council of Life Insurance, the principal trade association of life insurance companies.

At the outset of these hearings, Mr. Chairman, you identified three criteria which any of the miscellaneous tax proposals now under consideration by the Committee must meet in order to merit inclusion in any future legislation. First, the proposal must be sound policy. Second, it must not be a "rifle shot"; it must benefit a broad group of taxpayers and, preferably, have a positive effect upon the economy as a whole. Finally, the proposal must not have "significant" revenue costs.

As I hope to demonstrate in my testimony, this proposal to revise section 818(b) clearly meets each of these criteria. The proposal would promote productive, long term investment by making overdue changes to an anomalous, outdated Internal Revenue Code provision. By doing so, the entire economy would benefit. Finally the Joint Committee on Taxation scored a similar proposal presented in the 103rd Congress as a modest ***revenue raiser.***

Mr. Chairman, for your convenience and that of the Committee, this testimony is presented in two parts. First, I have included an executive summary of the problems presented life insurers by section 818(b) and the proposed solution now before the Committee. Second, I have presented a more detailed technical analysis of the issues relating to section 818(b) and the proposal.

Again, Mr. Chairman, thank you for the opportunity to testify before the Committee. I very much look forward to working with you and the other members of the Committee over the coming weeks to help enact much needed legislation to remedy the adverse effects of section 818(b) upon the life insurance industry.

I. EXECUTIVE SUMMARY OF SECTION 818(b) PROBLEM FOR LIFE INSURERS

Description of Current Law

All corporate taxpayers other than life insurance companies are entitled to ordinary loss treatment upon the disposition of foreclosed real estate used in a trade or business. Pursuant to Internal Revenue Code section 818(b), a vestige of the complicated three-phase system of the Life Insurance Company Income Tax Act of 1959, life insurance companies are required to treat such losses as capital losses. Virtually all other aspects of the 1959 Act were repealed in 1984. As part of the 1959 Act, the section 818(b) treatment actually provided a benefit to life insurance companies. Under current law, it produces severe negative effects.

The Problems With Current Law

The current law capital loss treatment of dispositions of foreclosed real estate used in a trade or business forces life insurance companies to produce capital gains from their investment portfolios to offset the section 818(b) capital losses. This often forces life insurance companies to alter what would otherwise be the most prudent management of their investment portfolios. A number of negative consequences arise from this forced behavior:

- It impedes the operation of free markets and causes life insurance companies to hold foreclosed properties longer than they otherwise might, thus delaying return of the properties to local control. In addition, it deters new investment by life insurance companies in real estate.

- It causes life insurance companies to incur unnecessary transaction costs to manage their investment portfolios to produce the needed capital gains to offset capital losses incurred upon sale of the foreclosed real estate.

- It penalizes operating income results by forcing life insurance companies to convert what otherwise would be level streams of interest income into capital gain income. Market analysts and others who rate life insurance companies treat capital gains less favorably than level streams of operating income. As a result, stock values suffer, capital costs increase, and other factors which affect life insurance companies are adversely affected.

- The forced disposition of portfolio assets results in a lower overall portfolio yield. Lower yields are reflected in higher premiums, thus penalizing consumers and placing certain companies at a competitive disadvantage.

- Life insurers may not be able to replace certain securities with equivalent investments, thus resulting in a continuing penalty to earnings. In turn, the returns affected life insurers can offer their policyholders are limited.

The Solution

Proponents of addressing the section 818(b) problem have developed, in close consultation with the Joint Committee on Taxation, an approach which substantially addresses the problems of current law while actually producing a slight revenue gain for the relevant estimating period. Under this proposal, life insurance companies would be entitled to ordinary loss treatment for 85% of their section 818(b) losses over a five-year period. Current law treatment would be retained for the remaining 15%.

II. DETAILED ANALYSIS OF INTERNAL REVENUE CODE SECTION 818(b)

A. Description of Current Law.

Internal Revenue Code section 818(b) requires life insurance companies to undertake extraordinary tax planning steps regarding the timing and structure of dispositions in order to receive a current tax benefit for the economic loss realized on foreclosed real estate. No taxpayers, other than life insurance companies, are affected by this provision. Other businesses are allowed the benefit of any loss they realize on the sale of their business property, without undertaking the additional, and non-economical, steps that life insurance companies are forced to take solely for tax purposes.

Essentially, section 818(b) provides that a life insurance company selling at a loss any depreciable property or real property used in any trade or business other than its life insurance business must treat that loss as a capital loss. Other taxpayers who dispose of identical kinds of properties at a loss are allowed an ordinary loss, as the following analysis shows.

Section 1221 of the Internal Revenue Code excludes certain property from the term "capital asset." Under section 1221(2), depreciable property used in a trade or business and real property used in a trade or business do not qualify as capital assets.

Under a special rule provided in section 1231, if gains from the sale or exchange of real or depreciable property used in a trade or business and held for more than one year exceed the losses from the sale or exchange of such property for the taxable year, the net gain is treated as capital gain. If losses from the sale or exchange of such property exceed the gains from the sale or exchange of such property for the taxable year, the net loss is deductible as an ordinary loss.

Section 818(b) modifies section 1221(2) and section 1231 of the Code, as those sections relate to life insurance companies. In the case of a life insurance company, section 818(b) provides that for purposes of applying section 1231(a), the term "property used in the trade or business" includes only depreciable or real property used in carrying on an insurance business. In the case of a life insurance company, section 818(b) provides that for purposes of applying section 1221(2), the reference to property used in a trade or business is treated as including only property used in carrying on an insurance business.

As a consequence of section 818(b), any non-insurance trade or business asset, which otherwise would not constitute a capital asset, that is sold by an insurance company at a loss results in a capital loss. As detailed below, there is no rationale for that anomalous treatment: life insurance companies should be afforded the same tax treatment as all other corporate taxpayers.

B. Section 818(b) is a Vestige of Prior Law and has no Present Rationale.

Section 818(b) is a vestige of the Life Insurance Company Income Tax Act of 1959, a tax scheme which is now widely recognized as irrational and unworkable. Former Code section 817(a), which was the predecessor of section 818(b), was enacted to avoid the complexity of including sales on non-insurance property in the three-phase tax system inaugurated by the Life Insurance Company Income Tax Act of 1959. The extremely complex three-phase system was eliminated by the Tax Reform Act of 1984. The overall objective of the 1984 Act was to tax life insurance companies in a manner comparable to that applicable to other corporations.

As a result of the 1984 repeal of the Life Insurance Company Income Tax Act of 1959, there is no longer any basis for preserving the special section 818(b) rule regarding the treatment of capital assets. Consistent with the objective of the 1984 Act, the character of a life insurance company's gain or loss on the sale of real estate or

depreciable property should be determined under the same general rules of section 1221 and 1231 that apply to other businesses.

Conceptually, the foreclosed real estate properties that a life insurance company actively manages as a trade or business are appropriately classified as non-capital assets under section 1221(2) of the Code. A sale or disposition of a non-capital asset at a loss is an ordinary loss, just as the rental income we report from the rentals of the properties are ordinary income. For tax purposes depreciable property and real property used in a trade or business are placed in a special category known as "section 1231 assets," which receive dual treatment under the Code. If a taxpayer has a net loss on the sale of section 1231 assets during a taxable year, the net loss is deductible as an ordinary loss. On the other hand, if there is a net gain on sales of section 1231 assets for the year, the net gain is treated as a capital gain and taxed at the capital gain rate.

Because the corporate tax rate on capital gains is now the same as the corporate tax rate on ordinary income, section 1231 today has little consequence to taxpayers. However, the section 818(b) rule, which denies life insurance companies ordinary loss treatment on the sale of what otherwise would qualify as section 1231 assets, has a real consequence. Unless the life insurance company actively takes special steps to ensure that it realizes sufficient capital gains, a section 818(b) capital loss may not be usable in the year it is realized.

D. Proposed Solution to Section 818(b) Problem for Life Insurers.

Because there is no contunued rationale for the anomalous treatment of life insurance companies under section 818(b), the most equitable, and sensible, resolution to the problem is repeal of the provision. However, we understand that the Joint Committee on Taxation has concluded in the past that total repeal would result in a loss of revenue to the federal government.

We recognize that, in the current budget climate, any tax legislation which loses revenues, however modest, faces dim prospects for passage. For that reason, representatives of the life insurance industry have developed, in close consultation with the Joint Committee on Taxation, an approach which substantially addresses the problems of current law while actually producing a slight revenue gain for the relevant estimating period. Under this proposal, life insurance companies would be entitled to ordinary loss treatment for 85% of their section 818(b) losses over a five-year period. Current law treatment would be retained for the remaining 15%. The proposed text of such legislation is attached for your reference.

Again, Mr. Chairman, thank you very much for the opportunity to testify before the Committee. I very much look forward to working with the Committee and you to resolve the section 818(b) problem for life insurers.

104TH CONGRESS

1ST SESSION H.R. ______________

To reform the tax treatment of business losses for life insurance companies.

IN THE HOUSE OF REPRESENTATIVES

___________, 1995

Mr. ________(for himself and ____________) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To reform the tax treatment of business losses for life insurance companies.

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

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE. - This Act may be cited as the "Life Insurance Losses Reform Act of 1995."

(b) AMENDMENT OF 1986 CODE. - Except as otherwise expressly provided, whenever in this Act an amendment or repeal is express in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

SECTION 2. REFORM OF TAX TREATMENT OF BUSINESS LOSSES FOR LIFE INSURANCE COMPANIES.

(a) GENERAL RULE. - Section 818(b) is amended by striking the provision and inserting the following:

(b) TREATMENT OF CAPITAL GAINS AND LOSSES, ETC. - In the case of a life insurance company -

"(1) In General. -

"(A) in applying section 1231(a), the term "property used in the trade or business" shall be treated as including only

"(i) property used in carrying on an insurance business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in carrying on an insurance business, held for more than 1 year, which is not described in section 1231(b)(1)(A), (B), or (C), and

"(ii) property described in section 1231(b)(2), and

"(B) in applying section 1221(2), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

"(2) Exception to Case of Section 818(b)(2) Election. -

"(A) If the taxpayer makes an election under this subsection in the manner prescribed by the Secretary, those losses which are treated as capital losses as a result of subsection (b)(1), to the extent they arise from the sale of foreclosure property, will be subject to the following treatment. -

"(i) 15% of such losses will be treated as capital losses,

"(ii) 17% of such losses will be treated as realized and recognized each year for 5 years commencing with the year following the year in which the sale or exchange causing the loss occurred and such losses when recognized shall be treated as losses from the sale or exchange or real property used in carrying on an insurance business, and

"(iii) to the extent that a taxpayer has net capital gain in any tax year, which capital gain would have been offset against a loss which would have been a capital loss but for the election under this subsection, such loss will be treated as a capital loss notwithstanding subsection (ii) hereof.

"(B) In applying this section (b)(2), the term "foreclosure property" means any real property (including interests in real property), and any personal property incident to such real property, acquired by a life insurance company as the result of such company having bid in such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or an indebtedness which such property secured.

"(C) Ordering Rule. -- In applying subsection (A)(iii) hereof, losses to which the rules of subsection (A)(iii) apply will be treated as coming first from the year which is the latest in time after the year of the net capital gain income.

"(D) Losses May Only be Deducted Once. - In applying the rules of this section, under no circumstances will any loss be deductible more than once.

SECTION 3. EFFECTIVE DATE.

(a) GENERAL RULE. -- Sections 2 and 3 shall apply to sales or exchanges of property occurring after December 31, 1994.

Statement for the
Committee on Ways and Means, U.S. House of Representatives

Prepared by: Pamela E. Davis
President/CEO
Nonprofits' Insurance Alliance of California (NIAC)

Introduction

The Nonprofits' Insurance Alliance of California (NIAC) is a liability risk pool exclusively for the benefit of charitable and other nonprofit organizations under California law which are exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. It provides general liability, miscellaneous professional liability, improper sexual contact liability, directors and officers liability, auto liability and physical damage and umbrella liability coverage to its members. It presently has over 1200 member-insureds and annual premium of over $9,000,000. All of NIAC's start-up costs and initial capital of $1,600,000 was provided by publicly supported charities and private foundations who are not members of NIAC.

As a part of the Tax Reform Act of 1986 Congress enacted Section 501(m) of the Internal Revenue Code in order to limit the commercial-type insurance activities of certain tax exempt organizations. However, in section 501(m)(3)(A) the Congress expressly recognized that an organization which provides insurance to a class of charitable recipients at substantially below cost should not be considered to be engaged in commercial-type insurance activities.

It is hard to conceive of an organization whose purposes and operations are more consistent with Congressional intent in enacting Section 501(m)(2)(A) than NIAC. However, the existing language has proven too vague to interpret and no organization has ever qualified for exemption inside the statute.

Large charitable organizations of sufficient size, such as Girls and Boys Scouts, the Salvation Army, and nonprofits hospitals can self-insure with tax exempt dollars. Consequently, these large, well-established organizations are able to set aside funds for future liability losses on a completely tax-exempt basis. When small community-based nonprofits, which are too small to self-insure, pool their resources with the assistance of foundations acting on behalf of them as a group, they are fully taxed on the dollars they set aside for future liability losses. We wonder what public purpose is being served by discriminating against the smallest, most financially fragile charities – those have the least market clout and sophistication – in this manner?

Applicability of H.R. 1299 to charities in other states

This testimony focuses on NIAC because NIAC it is the first to receive a substantial outside subsidy. As such it is a prototype of similar organizations which are likely to emerge in other states. Whether through available state legislation or through use of the Risk Retention Act, or other types of policyholder insurance mechanisms, nonprofits in other states across the country will benefit from NIAC's work to obtain clarifying language through H.R. 1299. NIAC is at the forefront of the effort to achieve this clear definition for the "below cost" test included in 501(m)(3)(A) because it is the only insurance organization created to date which received its initial capital from a consortium of non-beneficiary foundations. Consequently, NIAC is simply the first to be able to demonstrate that it is, in fact, providing subsidized insurance to nonprofits--a requirement of 501(m)(3)(A). The Treasury has clearly indicated that without this requirement of an outside subsidy by a non-beneficiary, insurance pools for nonprofits would be virtually identical to other mutual insurance companies and should not qualify for tax-exemption. It is the large subsidy which NIAC received that sets it apart at this time. However, there is nothing to preclude other charitable nonprofits in other states from establishing charitable risk pools similar to NIAC and seeking the $1 million subsidy which is required to meet the standards to achieve tax-exemption established by H.R. 1299.

The provision to make H.R. 1299 retroactive to December 31, 1991 is included in recognition of the fact that the language which presently exists in 501(m)(3)(A) as it applies to secular risk pools cannot be implemented. While many insurance companies affiliated with religious organizations have received tax exemption under the more clearly worded 501(m)(3)(C), no secular organization has or could qualify under the more vaguely worded 501(m)(3)(A). NIAC has led the effort to obtain a clarification of 501(m)(3)(A) since 1991 and it should not be penalized for falling under a portion of the code which has proven impossible to enact. The retroactivity provision does not give any special benefit to NIAC. It simply recognizes that if the language of 501(m)(3)(A) had been clear in the 1986 law, NIAC would have been granted tax-exemption in 1991.

Background

The following testimony is the story of California nonprofits' difficulties with liability insurance, but it could have easily been written by nonprofits in any other state. During the last hard insurance market, California nonprofits created NIAC out of desperation. Commercial insurance was simply not consistently available. Like electricity, insurance that is available only sporadically, is as good as none at all.

Charitable nonprofits in every state remain a poorly understood and undesirable market for commercial carriers. Even in soft insurance markets, when coverage for nearly all types of risks is amply available, many insurance carriers refuse to provide insurance for nonprofits at all. Nonprofits are a very small portion of the insurance market. Claims data for this sector is not readily available and the risks of insuring day care centers, centers for unwed mothers, programs for alcohol and drug addicts, AIDS hospices, and others are considered to be high and unpredictable. Of those that are willing to provide some coverage, many provide inadequate coverage which is ill-suited to the needs of charities. Only a few offer such key coverages as errors and omissions insurance for boards of directors or difficult but important coverages such as improper sexual conduct. During times when insurance capacity is low--whether resulting from natural disasters or pricing cycles--nonprofits, many of them already inadequately insured--are among the first to lose their insurance Today, this is California nonprofits' story. Tomorrow it could be the story of any state in the Union

Organizational structure and governance of Nonprofits' Insurance Alliance of California

Founded in 1988, NIAC was the result of a cooperative effort between community-based nonprofits and a consortium of foundations to help the charitable sector in California establish a source of affordable and stable liability insurance. NIAC is a California nonprofit public benefit corporation operating as a risk pool pursuant to unique authority for such nonprofit risk pools granted by Section 5005.1 of the California Corporations Code. Nonprofit organizations sponsored the enactment of Corporations Code Section 5005.1 for the purposes of reducing and stabilizing liability insurance costs and increasing the availability of insurance coverage for such organizations. This California statue codifies the inherently non-commercial nature of nonprofit risk pools operating thereunder and generally exempts these pools from state insurance regulation.

NIAC's formation costs and all of its initial capital ($1.6 million) were funded by 14 foundations, none of which benefits from NIAC's operation. NIAC is organized as a member-owned nonprofit charitable organizations incorporated in California; its members control the company and elect the Board of Directors annually; and all financial benefits of NIAC ultimately accrue to its tax exempt members. NIAC's assets are irrevocably dedicated to charitable purposes. Moreover, as a nonprofit public benefit corporation, NIAC is subject to special standards for the investment of its funds and extensive supervision by the California Attorney General.

Commercial insurance inadequate.

NIAC came into being only because ordinary commercial insurance companies were not adequately meeting charitable organizations' insurance needs. If commercial insurance had been adequate, consistently available, and reasonably priced, NIAC would never have ventured into the insurance arena. At some times, such as the present, insurers readily offer coverage to many, if not all, charitable organizations at reasonable premiums. At other times, when the capacity in the insurance industry is low, insurers desert small charitable organizations in favor of large business clients. Even when coverage is available and affordable, it is often not designed to meet the needs of charitable organizations. Many nonprofits have special needs for coverage for exposures related to extensive volunteer activity, and for unusual exposures such as those relating to improper sexual contact by employees, volunteers or clients.

In a study conducted by Peat Marwick and commissioned by the Independent Sector, 79 percent of the responding charitable organization administrators indicated that their organizations had been hurt because they could not obtain adequate insurance.[1] In another study conducted by the American Society of Association Executives, "The Liability Crisis and the Use of Volunteers by Nonprofit Associations," 14 percent of those charitable organizations polled indicated that they had eliminated programs because of liability insurance problems.[2] The implications of these findings are especially

[1]Study conducted by Peat Marwick, commissioned by Independent Sector, "D&O Liability: A Crisis in the Making." 1986.

[2]American Society of Association Executives, "The Liability Crisis and the Use of Volunteers by Nonprofit Associations," January 1988.

alarming because both surveys canvassed only large organizations. For the small, community-based human service providers that NIAC primarily services, the disruption is more severe. One study by the United Way of Los Angeles found that a loan program to help nonprofits absorb the annual increase in insurance costs would required funds in excess of $2 million for the Los Angeles agencies alone.[3] In 1986, an Issue Brief published by the United Way of California reported annual insurance premium price increases between 100 and 300 percent for human service agencies and 70 percent for youth serving agencies. A survey by the National Association for the Education of Young Children found that in 1985, 20 percent of child care programs had their insurance canceled or not renewed.[4]

The economics of commercial insurance all but guarantee that periods of low availability and high prices will periodically replace the conditions of adequate availability and more reasonable premiums that currently prevail. For several reasons, this cyclical pattern is much more disruptive for most charitable organizations than it is for for-profit businesses. First, inflexible funding rules limit many charitable organizations' abilities to meet sharp price increases. Unlike the money a business receives from sales, charitable organizations' grant funds typically are limited in how these funds can be allocated, and the organizations have few discretionary funds with which to cover unanticipated expenses. Second, charitable organizations usually cannot pass along the increased cost of premium increases to their clients. Finally, volunteers, upon whom many organizations depend, are reluctant to expose themselves to the possibility of personal liability. Because volunteers can quit without giving up a paycheck, they are more likely to desert a charitable organizations that loses its insurance than employees are to quit their jobs if their employer is uninsured.

In April 1988, the Ford Foundation funded the Nonprofit Sector Risk Management Project whose task force published recommendations regarding the provision of liability insurance for charitable nonprofits. A few excerpts from the report follow:

> "Over a dozen surveys from the 1984-1988 period, in addition to reams of original source materials, were analyzed. Taken together, the materials amply substantiated the assertions of nonprofit organization administrators and experts that existing legal liability and insurance arrangements are not satisfactory. Although the risk of lawsuits in the face of inadequate and sporadically unaffordable insurance has not brought the nonprofit sector to a standstill, it has adversely affected the delivery of human services."

> "Based on these multiple sources of input, a consensus emerged that nonprofits need to improve their risk management practices, support equitable rules to govern their legal liability, and gain greater control over whatever insurance they must have."

<u>NIAC serves many small community-based nonprofits</u>

NIAC presently has about 1200 nonprofit member-insureds. Nearly all of NIAC's members are small community-based nonprofits serving undeserved populations in their communities. All of NIAC's members hold current, unrevoked status as tax-exempt nonprofit organizations under Internal Revenue Code 501(c)(3). The median annual budget size of NIAC's members is $170,000. Typical members of this budget size or smaller include: Child Abuse Prevention Training Center of Northern California which brings training on this issue to children of Oakland's public schools; Defensa de Mujeres which provides assistance to abused and battered women, including counseling and shelter assistance, to the women of Watsonville, California; and Alliance for Mentally Ill which is a an all volunteer self-help organization of families of persons with serious mental illness such as schizophrenia, manic-depression and sever clinical depression.

In addition to pooling for insurance, NIAC provides free loss control and risk management services to its members. It provides extensive education and advisory services to its members to help them avert liability claims.

Large charitable organizations generally have the financial resources to provide for contingencies while small organizations do not. As 501(c)(3) nonprofits, NIAC's members would be able to individually set aside tax-free funds for future claims. However, 501(c)(3) organizations which are too small to self-insure and instead which have cooperated via the mechanism of NIAC to jointly fund claims must bear the burden of taxation on those pooled funds. We wonder what public purpose is being served by discriminating against the smallest, most financially fragile charities in this manner.

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[3]Report on workshops held by the Center for Nonprofit Management, May 1986.

[4]National Association for the Education of Young Children (January 20, 1986).

NIAC assists nonprofits serving distressed communities and populations at risk

In addition to serving many of the smallest charities, NIAC provides insurance coverage for nonprofits considered high risk by virtue of the distressed communities in which they are located and/or the various at-risk populations they serve. A few examples are provided below.

NIAC's largest member insured is The Watts Health Foundation (WHF). The predecessor organization to the Watts Health Foundation was formed in 1967 to provide health care services to residents of the community located in South Central Los Angeles, California. It provides various health care services including radiology, adult medicine, pediatrics, physical therapy, pharmacy, dental and prenatal care. In 1976, WHF formed a federally qualified health maintenance organization, United Health Plan (UHP), which provides outpatient services to more than 50,000 residents of South Central Los Angeles. WHF's other programs include House of Uhuru inpatient substance abuse programs, and counseling center for substance abuse problems. Its Geriatrics and Homebound Services provides transportation to and from its center where recreation, counseling and nutritional services are provided to seniors. NIAC provides general liability and auto liability coverage for WHF. NIAC does not provide medical malpractice coverages.

Victor Residential Center is also one of NIAC's larger members. Located in Chico, California, Victor is one of the largest residential and treatment centers for severely emotionally disturbed children and adolescents. In 20 locations around the state, Victor provides residential care for 170 children and teens with severe behavioral problems associated with drug and alcohol addictions, physical and sexual abuse and learning disabilities. These children are considered to be the most difficult and highest risk category funded by the state. Victor represents the community alternative to confining these children in a locked setting at state hospitals. Their focus on retaining community and family ties when possible increases the possibilities these children have of leading more normal and productive lives.

NIAC provides broad coverages at below commercial market cost

According to the most recent survey of NIAC members, they are paying, on average, 30 percent less for coverage with NIAC than they were paying for commercial insurance. At this rate, NIAC members will save about $2,000 each, for a total expected savings for NIAC members during 1995 of between $2 and $3 million. In addition to offering coverages a prices below commercial rates, NIAC offers coverages such as improper contact liability that are rarely available from commercial carriers.

NIAC serves a charitable purpose

Few, if any, organizations operating in the insurance or risk management sector can claim, as NIAC can, that they were conceived, organized and funded solely by the nonprofit community. By taking control of their insurance needs, nonprofit organizations in California realized that they could better manage their overall charitable operations. Although NIAC's members benefit from better risk management, reduced insurance costs and increased insurance availability, the true beneficiary of NIAC's charitable operations is the California public.

That NIAC operates exclusively for charitable purposes is further highlighted by its corporate form and the fact that its members must be charities. NIAC is a California nonprofit public benefit corporation which, by law, must exist for public or charitable purposes. Moreover, NIAC is controlled and managed by a volunteer Board of Directors elected annually by its members. NIAC's bylaws provide that the majority of the Board positions be filled by officers, directors or management-level employees of its nonprofit members.

The charitable community has already validated NIAC's value to the public by contributing 100 percent of NIAC's implementation costs and 100 percent of NIAC's initial capital, total funds of $1.6 million. Largely due to NIAC's undetermined tax status, its capital of $1.3 million was provided by foundations as loans on highly concessionary terms, with interest at the rate of 2% and generous subordinated repayment provisions. The six foundations that provided NIAC's capital are: The Ford Foundation, the David and Lucile Packard Foundation, the Wallace Alexander Gerbode Foundation, the Walter S. Johnson Foundation, the San Francisco Foundation and the Marin Community Foundation. The reason these very substantial charitable organizations support NIAC is because NIAC furthers the charitable programs of many of the operating charities which these organization support. Until NIAC receives its tax exempt status under 501(c)(3), private foundations will only make Program Related Investments to NIAC; support in the form of outright grants presents tax problems for the foundations. Tax exempt status under Section 501(c)(3) for NIAC would open the possibility of converting the loans to grants and would allow NIAC to leverage additional foundation funds to meet its increasing need for capital to serve its growing membership. Because all benefits of NIAC are reserved only for its

charitable nonprofit members, investment in NIAC is not attractive or possible for commercial sources of capital.

Attempting to apply a "substantially below cost test" on an annual basis is inappropriate for insurance-like mechanisms

Section 501(m)(3)(A) presently provides tax-exemption for insurance carriers which can demonstrate that they provide coverage "at substantially below cost to a class of charitable recipients." The policy objective is to assure that insurance mechanisms which are granted exemption under Section 501(c)(3) according to the provisions of Section 501(m)(3)(A) fulfill a true charitable purpose by providing continuity in availability and affordability of insurance not otherwise available to their charitable member organizations. However, it is practically impossible to determine whether this goal is being achieved by trying to apply a "substantially below cost" test to annual operating results of an insurance mechanism.

For many companies other than insurance companies, the actual cost of their operations may be easily analyzed. One can then compare the cost of their products or services with the price they charge for such products or services. In contrast, at the time that insurance is written an insurer's actual operational costs are not easily compared with its premium income. Certainly, an insurer incurs "home office" costs, e.g., rent, supplies, utilities, salaries, etc, like any other business. The most significant costs of transacting an insurance business, however, relate to an insurer's payment of claims and claim adjustment expenses, and the maintenance of sufficient capital and surplus to maintain solvency.

Insurance is a contract whereby one agrees to indemnify another against losses arising from a contingent or unknown event. California Insurance Code Section 22. In determining the price of its insurance policies, an insurer must necessary make certain assumptions. Specifically, an insurer must assume the amount of claims payments and claims adjustment expenses which it will incur on the business written. Further, an insurer must estimate the investment income that it will earn on policyholder premiums, surplus set aside to pay claims, and its owners' equity. An insurer's ultimate costs of operations are impossible to quantify at the time it collects policyholder premium payments. Because of the insurer's assumptions, until all potential insurance claims are settled and paid, there can be no absolute calculation of whether policyholder premium payments are "substantially below cost" within the meaning of Section 501(m)(3)(A) of the Code.

It is for this reason that a clarification to 501(m)(3)(A) is required. Because of the difficulties described in the preceding paragraph, some other criteria must be established to determine whether an insurance mechanism is carrying out a charitable purpose, hence the criteria established in HR 1299.

Other examples provide ample precedent for NIAC to receive tax exemption

There is ample precedent for enterprises serving only the purposes of charitable organizations to be exempt from tax. In the case of the Common Fund, the Congress intervened to prohibit the Internal Revenue Service from withdrawing tax-exempt status from a cooperative investment arrangement, controlled by and serving only charitable institutions. The history of this example is that initially nearly all of The Common Fund's costs were paid for by start-up grants from a private foundation and that eventually The Fund became more reliant upon payments from its member nonprofit institutions. The Internal Revenue Service sought to disqualify The Fund from exemption. At that time Congress made it clear that cooperative arrangements of this type--formed and controlled by the participating charitable organizations themselves--are entitled to tax-exemption. Congress made a distinction between organizations owned and controlled by charitable organizations and private organizations furnishing the same services--even where those services might be made available only to charitable or education organizations. The former may qualify for tax-exemption, the latter do not.

More recently, in 1992, the Tax Court overruled the IRS in the case of The Council for Bibliographic and Information Technologies v. Commission of Internal Revenue. In that case, a group of tax-exempt libraries formed an organization to provide research, computer programs, and computer equipment for library administration to its members, and the Court found that the organization's activities were deserving of tax exemption. The Internal Revenue Service had argued (as they did with NIAC) that the bibliographic service operated as a commercial enterprise; it provided commercial service and, because members' fees covered the expenses of the operation, it was not a charity. The Court disagreed.

In The Council for Bibliographic and Information Technologies v. Commissioner of Internal Revenue, the Tax Court's conclusion has merit. The analysis whether an entity is a charity and entitled to tax exemption must consider all facets of an organization's operating plan--its goals, its history, its funding and its performance. A formulaic test comparing income and expenses of the organization to determine whether a service or product is offered below cost must be flexibly applied and it can never provide the entire answer whether an organization is a charity.

There is a considerable variety of organizations exempt under 501(c)(3) whose purposes are to serve other charities. For example, the California Association of Nonprofits, the Center for Nonprofit Corporations in New Jersey, the Minnesota Council of Nonprofits, the Pennsylvania Association of Nonprofit Organizations, the Washington Council of Agencies, the Nonprofit Coordinating Committee of New York, and the Florida Association of Nonprofit Organizations are just a few of the scores of organizations which are exempt under 501(c)(3) and whose purposes are to provide managerial, financial, organizational, and technical assistance to nonprofits. In addition, The Support Centers across the country which provide management training, information referrals, and technical assistance exclusively to nonprofit organizations are tax-exempt under Section 501(c)(3) Likewise, the Nonprofit Risk Management Center, a 501(c)(3) organization in Washington, D.C., primarily trains other Section 501(c)(3) entities about how to lower their exposure to insurance claims. The Nonprofit Facilities Fund in New York is a 501(c)(3) entity which offers loans at below-market rates for capital improvements to other nonprofit facilities. Non Profit Services, Inc. in California, also tax-exempt under 501(c)(3) sells and distributes previously owned office furniture, acquires and distributes computer equipment and software and conducts management training seminars to members which pay an annual fee for access to these service. With all these financial and technical services provided by tax-exempt nonprofits to other tax-exempt nonprofits for a fee, it is not at all clear why the provision of another financial service, pooling for insurance claims, should not also be provided under certain specified conditions by tax-exempt entities serving only other charitable tax-exempt organizations.

Tax-exemption for non-commercial insurance contemplated by 501(m)

Although NIAC would be the first non-religious, secular nonprofit to qualify under Section 501(m)(3)(A), it would not be the first nonprofit pooling mechanism or insurance carrier to qualify under the provisions of Section 501(m)(3). Several religious insurance carriers have been granted tax-exempt status under Section 501(m)(3)(C), specifically: The Ordinary Mutual; The National Catholic Risk Retention Group; the Religious and Charitable Risk Pooling Trust of the Brothers of the Christian Schools and Affiliates. These religious pools are much easier to identify for tax exemption, but clearly NIAC is the prototype of the secular charitable pool that was contemplated by 501(m)(3)(A).

The Offshore Alternative

If it were denied exempt status, NIAC could reorganize its operations so as to substantially reduce or eliminate any U.S. income tax liability. One method by which this could be accomplished would be through the formation of a second insurance company outside the U.S. which would serve as the reinsurer for all of NIAC's U.S. risks. The effect of this arrangement would be that (i) NIAC itself would have minimal U.S. taxable income after deducting its reinsurance premiums, (ii) the offshore company would only be subject to a 1% gross premiums tax on the reinsurance premiums paid to it by NIAC, and (iii) none of the offshore company's residual profits would be subject to tax in the hands of its U.S. tax-exempt shareholders when paid, since any dividends paid by the offshore company would not be taxable as unrelated business taxable income in the hands of the tax-exempt shareholders. Finally, given NIAC's large membership the ownership of the offshore company would be sufficiently dispersed so as to avoid the application of the controlled foreign corporation rules.

Public Policy Implications

With dramatic funding cuts occurring at nearly every level of government, nonprofit social service organizations are being forced to do more with less. NIAC represents an innovative, intelligent and economically sound solution to a very difficult financial problem. Claiming through tax dollars more of the scarce resources available for direct services through these nonprofit organizations would defeat good public policy.

Possibly more than any other product or service required by the charitable nonprofit community, liability insurance coverage availability and affordability has the ability to limit the type and scope of social services that are available to the public. Many small, emerging nonprofits represent the cutting edge of social change in our country. Some of NIAC's smallest members are experimenting with ideas for such causes as providing better care for seniors, mentoring troubled inner-city youth, helping to incorporate the disabled into mainstream society, and stopping the cycle of drug addiction. Many of these programs are located in less than desirable neighborhoods, with clients who are far-removed in life experiences from commercial insurance underwriters. Commercial insurers are simply not the appropriate people to be deciding which of these social experiments can be undertaken and at what price. These types of decisions regarding the appropriateness and cost of undertaking the risk of new programs needs to be in the hands of nonprofits themselves, as it is with NIAC. To be able to safely pool the risks of these new and potentially higher risk groups, the nonprofit sector must be able to pool the risks of a broad spectrum of more established nonprofits. To receive available funds from private and community foundations to capitalize a pool of the size required to spread these risk broadly, NIAC must have 501(c)(3) tax-exemption.

The Nonprofits' Insurance Alliance of California (NIAC) is a prototype for other charitable risk pooling opportunities in other states. NIAC submits that it, and other pools that comply with the strict standards provided for by H.R. 1299, merit tax-exempt status under Internal Revenue Code 501(c)(3).

Summary

The Nonprofits' Insurance Alliance of California (NIAC) is a prototype for other charitable risk pooling opportunities in other states. NIAC submits that it, and other pools that comply with the strict standards provided for by H.R. 1299, merit tax-exempt status under Internal Revenue Code 501(c)(3). The facts and circumstances of NIAC's case are as follows:

- Liability insurance for charitable nonprofits is not consistently available and affordable from commercial insurance carriers;
- Large tax-exempt nonprofit organizations can reserve for contingencies with tax-exempt funds and that same benefit should be accorded to small nonprofits which jointly pool their resources;
- Foundations provided $1,630,000 to NIAC to enable its creation and prudent financial operation;
- None of the contributing foundations are beneficiaries of NIAC;
- NIAC's exclusive beneficiaries are tax-exempt 501(c)(3) organizations;
- NIAC is a nonprofit, public benefit corporation jointly owned by its 501(c)(3) member organizations;
- NIAC is member-controlled by annual election of the Board of Directors;
- NIAC's assets are irrevocably dedicated to charitable purposes;
- NIAC is the prototype of the secular insurance organization contemplated by 501(m)(A)(3) [religious insurance organizations are already exempt];
- The only sources of capital available to meet the needs of NIAC's growing membership are accessible only if NIAC achieves 501(c)(3) status;
- Since commercial insurance is not always available at affordable costs for tax-exempt nonprofit organizations, it is good public policy to assure that organizations like NIAC exist to serve the special needs of the charitable sector

WHAT OTHERS SAY ABOUT NIAC

"Not only have we saved money, but the service from NIAC staff is way beyond the call of duty."

- Carol Stone, **Volunteer Center of Greater Orange County**

"In every case your program (NIAC) has shown a high degree of professionalism and pride and a level of commitment rarely found in our industry. As we face another hard market, I feel very confident that you will continue to provide us with an excellent market for our nonprofit clients."

- Johnny D. Searcy, **Searcy Insurance Center, Inc.**

"Many other insurance companies turned down our organization because we deal with individuals with disabilities. NIAC was willing to work with us on a cost that was reasonable, and has remained reasonable each year. Special Needs Camp Projects, Inc. is also grateful for being able to obtain a corporate sponsor because of resources made available to us through NIAC."

- Joyce Gilden, Executive Director, **Special Needs Camp Projects, Inc.**

"Working through our local insurance broker, we were pleased to find an alternative like NIAC where we have a voice in the affairs of the company. In addition to helping us save over $9,000 in premiums, NIAC has assisted us by taking a personal, yet professional risk management approach to our business."

- Jack Bernstein, Executive Director, **Cri-Help**

"NIAC's approach and attitude makes us feel a part of their team; with all of us working toward providing nonprofit agencies with superior coverages, cost, and professional services. It is a privilege to work with such an outstanding group of professional underwriters, loss control specialists, and administrative staff who really care about nonprofit agencies."

- Tom South, **South Insurance Services**

"Your personal attention to our needs as a small nonprofit organization is extremely rare and wonderful to find. NIAC provides a desperately needed service as evidenced by the dramatic savings your insurance provides us. We are proud to be members of such a worthy organization."

- Dr. Mark Ruttle, Vice President, **Pacific Composers Forum**

"Building the organizational infrastructure of the nonprofit community is an important strategy of Marin Community Foundation's grantmaking. The difficulty that many nonprofits face in finding a reliable source of affordable, high quality insurance coverage has been an impediment to strengthening infrastructure.

The proposal to establish NIAC as an insurance cooperative for nonprofits was a carefully thought-out response to an important need. The exemplary manner in which NIAC has fulfilled its initial promise makes us proud to be one of the foundations that have enabled it to offer affordable insurance products and services to the nonprofit community."

- Barbara B. Lawson, Vice President, Administration and Finance, **Marin Community Foundation**

Associated Industries Insurance Services, Inc.

AIIS

MARKETING/UNDERWRITING/CLAIMS/BILLING: (800) 866-1234 OR (305) 772-2700
POST OFFICE BOX 619001, POMPANO BEACH, FLORIDA 33061 • FACSIMILE # (305) 772-7836
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July 24, 1995

Date of Hearing, July 11, 1995

House Committee on
Ways and Means

Dear Mr. Chairman and Members of the Committee:

Associated Industries Insurance Services, Inc. ("AIIS") is the managing and servicing agent for Associated Industries of Florida Property & Casualty Trust ("AIFPCT") and Associated Industries Insurance Company ("AIIC").

AIFPCT is a commercial self insurance fund currently licensed to write workers' compensation insurance in the state of Florida. Since it began operations in 1987 (after the Tax Reform Act of 1986), **AIFPCT has reported statutory income before taxes of approximately $8.7 million and has paid income taxes in excess of $11.4 million!!** AIFPCT currently has statutory assets of approximately $135 million and premium volume of $65 million.

AIIC currently has assets of approximately $2 million. AIIC was purchased by AIIS earlier this year for the purpose of providing an alternative workers' compensation market. **The projections for the first three years of AIIC's operations show $426,000 in income and $1.3 million in income taxes!!**

TAX REFORM ACT OF 1986

The reason for the excessive and inequitable income taxes being paid by these and other small insurance companies is the Tax Reform Act of 1986 (TRA 86). TRA 86 resulted in the following changes to the Internal Revenue Code which cause taxable income of small and start-up property and casualty insurance companies to be significantly in excess of statutory income and result in a gross inequity of taxes paid:

1. Twenty percent (20%) of the increase in unearned premium reserves at the year-end is to be added to statutory income in computing taxable income. Unearned premium reserves are premium revenues that are earned in a future year because insurance policies extend beyond a particular year-end. The rationale for taxing 20% of unearned premium results from statutory accounting for insurance companies requires policy acquisition costs to be recognized at the beginning of the policy. The 20% is to offset this early deduction (Internal Revenue Code Section 832(b)(4)(B)).

2. Loss reserves are to be discounted and the increase in the amount of discount added to statutory income when computing taxable income. The rationale for discounting loss reserves is to give recognition to the interest earnings on funds that loss reserves provide. (Internal Revenue Code section 832(b)(5)(A)(ii)).

These Internal Revenue Code sections result in confiscatory income taxes for start-up, small and rapidly-growing insurance companies. These insurers can have statutory losses before taxes and still pay substantial amounts of income taxes. If premiums are written toward the end of the year (resulting in proportionally large unearned premium at the end of the year), the effective tax rate can be a multiple of income before taxes. For companies desiring to strengthen their loss reserves, the additional taxes resulting from discounting the reserves can result in taxes in excess of income. The impact of TRA 86 on large insurers is minimal since any changes in unearned premium or unpaid losses are small in proportion to their totals.

RELIEF

Relief is needed from the confiscatory income taxes being paid by start-up, small and rapidly-growing insurance companies. **These taxes threaten the solvency of smaller insurers at a time when our whole financial system is being threatened!** Relief can come by the passage of H.R. 1515, the "Small Property and Casualty Company Equity Act". This act would improve the competitiveness of small property and casualty companies and make insurance available in locations and lines of coverage large companies will not or cannot provide.

Schedule A attached summarizes the actual statutory income (loss) before income taxes of AIFPCT as well as the effect of H.R. 1515. Even with H.R. 1515, income taxes will be excessive! This schedule also shows the projected operations for AIIC for 1995, 1996 and 1997 and the resultant income taxes with and without H.R. 1515. The difference is even more dramatic!

It is obvious that continuing at the current level of taxation could have resulted in putting AIFPCT out of business. Fortunately, because AIFPCT writes a long tail-line (one whose claims are paid out over an extended period of time), there is sufficient cash to pay these taxes. If AIFPCT were writing a property line that required a short term payout of claims, there would not be enough cash with which to pay claims <u>and</u> taxes. As it is, AIFPCT has lost the interest earnings on the taxes paid, earnings that would otherwise be used to pay claims. It is surely not the intent of the Congress to levy an income tax on a company sufficient to put it out of business!

The real issue here is one of **EQUITY**. Why should start-up or rapidly growing insurers pay confiscatory income taxes -- especially at a time when funds are needed the most to pay claims and other obligations -- while larger, more established insurers pay substantially less. This is clearly discriminatory to small, start-up insurers. It stifles competition and reduces liquidity at a time which competition and liquidity in the insurance industry are needed the most.

Both Associated Industries of Florida Property & Casualty Trust and Associated Industries Insurance Company have no objection to paying income taxes. Both would be most happy to pay the maximum rate of 34% instead of the rates actually or expected to be paid.

Your help is desperately needed to correct the inequities created by TRA 86.

Sincerely,

John L. Shebel
President & Chief Executive Officer

JLS:dpy
cc: L. A. "Skip" Bafalis, Alcalde & Fay

SCHEDULE OF INCOME (LOSS) AND INCOME TAXES

FILE TAXSUMM

SCHEDULE A

ASSOCIATED INDUSTRIES OF FLORIDA PROPERTY & CASUALTY TRUST

ACTUAL		1987	1988	1989	1990	1991	1992	1993	1994	Totals
Statutory income (loss)										
before income taxes		($264,309)	$596,626	($3,180,090)	($2,734,500)	($420,081)	$1,719,213	$8,482,861	$4,538,018	$8,737,738
Income taxes		$5,348	$643,516	$164,999	$1,305,749	$1,488,083	$2,085,444	$3,524,000	$2,221,261	$11,438,400
Effective Tax Rate		**	107.9%	**	**	**	121.3%	41.5%	48.9%	130.9%

** Taxes greater than income (loss)!!

EFFECT OF H R 1515

Actual taxable income		$35,650	$1,892,695	$485,291	$3,840,438	$4,376,715	$6,133,659	$10,364,[illegible]	$[illegible]533,121	$33,662,274
First paragraph deduction										
$3,000,000	60%	(21,390)	(1,135,617)	(291,175)	(1,800,000)	(1,800,000)	(1,800,000)	(1,800,000)	(1,800,000)	(10,448,182)
Subtotal		14,260	757,078	194,116	2,040,438	2,576,715	4,333,659	8,564,706	4,733,121	23,214,093
Second paragraph deduction:										
$15,000,000	15%	0	0	0	306,066	386,507	650,049	1,284,706	709,968	$3,337,296
Adjusted taxable income		$14,260	$757,078	$194,116	$2,346,504	$2,963,222	$4,983,708	$9,849,412	$5,443,089	$26,551,388
Income tax	34%									
Original		$5,348	$643,516	$164,999	$1,305,749	$1,488,083	$2,085,444	$3,524,000	$2,221,261	$9,217,139
Adjusted per legislation		4,848	257,407	66,000	797,811	1,007,495	1,694,461	3,348,800	1,850,650	$7,176,822
Income tax savings		$500	$386,109	$98,999	$507,938	$480,588	$390,983	$175,200	$370,611	$2,040,317
Effective tax rate		**	43.1%	**	**	**	98.5%	39.5%	40.8%	82.1%

** Taxes STILL greater than income (loss)!!

ASSOCIATED INDUSTRIES INSURANCE COMPANY

PROJECTED		1995	1996	1997	Totals
Statutory income (loss)					
before income taxes		($[illegible])	$735,000	$[illegible]	$[illegible]
Income taxes		$90,000	$48[illegible],000	$[illegible]76,000	$1,255,0[illegible]
Effective Tax Rate		**	66.5%	147.0%	294.6%

** Taxes greater than income (loss)!!

EFFECT OF H.R. 1515

Projected taxable income		$239,000	$1,301,000	$1,798,[illegible]	$3,338,[illegible]
First paragraph deduction:					
$3,000,000	60%	(143,400)	(780,600)	(1,078,800)	(2,002,800)
Subtotal		95,600	520,400	719,200	1,335,200
Second paragraph deduction:					
$15,000,000	15%	0	0	0	0
Adjusted taxable income		$95,600	$520,400	$719,200	$1,335,200
Income tax	34%				
Original		$90,000	$489,000	$676,000	$1,255,000
Adjusted per legislation		32,504	176,936	244,528	453,968
Income tax savings		$57,496	$312,064	$431,472	$801,032
Effective tax rate		**	24.1%	53.2%	106.6%

** Taxes STILL greater than income (loss)!!

TESTIMONY OF CHARLIE BANCROFT
COALITION OF INDEPENDENT CASUALTY COMPANIES OF AMERICA

TESTIMONY REGARDING

THE TAX TREATMENT OF SMALL PROPERTY AND CASUALTY INSURERS

JULY 11-12, 1995

PRESENTED AT

THE WAYS AND MEANS COMMITTEE HEARINGS ON MISCELLANEOUS REVENUE MEASURES

I. INTRODUCTION

Mr. Chairman, thank you very much for the opportunity to testify before the Ways and Means Committee in support of H.R. 1515, "The Small Property and Casualty Company Equity Act of 1995", introduced by Congressman Bill Thomas.

My name is Charlie Bancroft, and I am President of The Coalition of Independent Casualty Companies of America ("CICCA"), an association of small property and casualty insurance companies incorporated in the District of Columbia. Its members do business in all 50 states and the District of Columbia.

CICCA and its members are concerned with the adverse effects of the Tax Reform Act of 1986 on small property and casualty insurance companies, particularly as compared with the tax treatment afforded small life insurance companies. In particular, CICCA and its members are concerned that a failure to address these problems in the near future will make it difficult, if not impossible, for small property and casualty companies to assist, as they historically have, with the next property and casualty insurance availability crisis. Because small property and casualty companies tend to serve crucial market niches not adequately served by larger companies, markets could not adjust effectively to any impairment of small insurers' ability to raise and utilize capital. That market failure, in turn, could prove calamitous for the economy as a whole.

This testimony will contrast the tax treatment of small life insurance companies and small property and casualty insurance companies and present the context in which such differences arose. This testimony also will highlight the impact of these provisions on small, growing property and casualty companies, and demonstrate that current law produces dramatically high effective tax rates (frequently in excess of 100 percent) for such companies relative to the statutory income they must report to state regulators for solvency analysis and other purposes. Because there is no policy reason justifying the less favorable tax treatment of small property and casualty companies relative to small life insurance companies, and because of the macroeconomic risks created by the current tax treatment of small casualty companies, CICCA urges that such companies be allowed a small company deduction like that afforded small life insurance companies. This would be accomplished by enacting H.R. 1515, the "Small Property and Casualty Insurance Company Equity Act of 1995," introduced by Congressman Bill Thomas (R-CA).

II. CURRENT LAW

A. Tax Treatment of Property and Casualty Insurance Companies.

Property and casualty insurance companies pay income tax on their taxable income at the rates prescribed by section 11 of the Internal Revenue Code of 1986 (the "Code"). The taxable income of property and casualty insurance companies is computed under the rules provided in part II of subpart L of the Code, which partially take into account both the need for property and casualty insurance companies to maintain loss reserves and other special circumstances that affect property and casualty insurance companies.

Notwithstanding these provisions, it is very difficult for small property and casualty companies to grow, both because of surplus requirements restricting the amount of premiums which may be written and because of the inherently risky business in which they are engaged. In addition, an unusual loss occurrence, such as an earthquake, is more likely to financially cripple a small property and casualty company than larger companies, which have more flexibility in diversifying their risks. Small property and casualty companies, nevertheless, play a significant role in the property and casualty industry, providing competition for large companies and, in some cases, providing coverage which large companies are either unable or unwilling to provide. Their role can be particularly critical when coverage shortages arise, as in the middle 1980s.

A very limited class of small property and casualty companies are either exempted from tax by section 501 (c) (15) of the Code (those property and casualty companies, generally, whose yearly premiums do not exceed $350,000) or can elect under section 832(b) of the Code to be taxed only on their taxable investment income (those property and casualty companies, generally, whose yearly premium income is between $350,000 and $1,200,000). Even if the election under section 832(b) is utilized, electing companies are required to compute under the regular method for purposes of computing their alternative minimum tax liability.

Sections 501(c)(15) and 832(b) were inserted in the Code by the Tax Reform Act of 1986 to replace several provisions that previously applied to small mutual property and casualty companies. As discussed below, these limited provisions are not comparable to the small company provisions applicable to small life insurance companies, notwithstanding the fact that predicting losses for property and casualty insurance companies is far more difficult than for life insurance companies; the latter may rely upon actuarial certainties and are not subject to the unpredictable

risks associated with property and casualty coverage. Moreover, the Tax Reform Act of 1986 included a variety of other changes in the tax treatment of the property and casualty industry. These changes have resulted in a significant increase in the tax burden of small property and casualty insurance companies, making it especially difficult for them to attract and retain capital, particularly as compared with small life insurance companies.

B. CICCA Study Analyzing Effect Of Current Law on Small Companies.

In 1992, CICCA conducted a study to analyze the impact of the current property and casualty income tax provisions on small, growing property and casualty companies. The results of that study indicate that there is a direct relationship between the rate of growth of these companies and the magnitude of the effective Federal income tax rate relative to statutory income they must report to their state regulators for solvency analysis and other purposes. As a general rule, as the growth rate increased, the effective tax rate soared. Specifically, under current law, the effective tax rate frequently exceeds 100 percent and, except where there is no growth, almost always exceeds 50 percent. In those situations where the effective rate exceeds 100 percent, one of the obvious direct consequences is that the capital and surplus of the company declines notwithstanding the fact that the company has statutory income prior to the effects of Federal income tax. Set forth below is a summary of the study which shows the effective tax rates on statutory income for each of the growth scenarios examined by the study.

Summary of Effective Tax Rate on State Statutory Income as a Function of Rate of Premium Growth

Tax Year	1	2	3	4	5
			(Effective Tax Rate)		
Rate of Premium Growth					
0%	130%	86%	58%	45%	38%
10%.	130%	89%	64%	53%	47%
25%	130%	92%	70%	64%	56%
50%	130%	98%	80%	73%	70%
100%	130%	105%	Infinite	654%	Infinite
200%	130%	93%	374%	87%	104%

The results of the study clearly demonstrate that the effective rate of tax as compared with state statutory income increases as the rate of premium growth increases. Moreover, in companies with moderate to significant rates of growth, a category disproportionately comprised of small companies, the rate of tax as a percentage of statutory income regularly exceeds 100 percent. Significantly, these results are borne out by the actual situations which many CICCA member companies are facing.

III. IMPLICATIONS OF THE CURRENT TAX STRUCTURE FOR THE NEXT PROPERTY AND CASUALTY INSURANCE COMPANY CRISIS

The results of the CICCA study indicate that the current Federal income tax rules greatly impair the ability of small property and casualty insurance companies to rapidly increase their capacity when the next insurance availability crisis occurs.

The property and casualty insurance industry has always been cyclical in nature. During periods of losses, the total surplus of the industry contracts. Those contractions, in turn, lead to periods of availability shortages. In the past, small property and casualty insurance companies generally have responded to these availability shortages by increasing the amount of their capacity. That is typically done through either creating new small property and casualty insurance companies, or through addition of capital to existing companies.

If small companies fail to expand capacity in the next coverage crisis, the crisis could be far deeper than those in the past. As noted, the CICCA study indicates that the effective tax rate as compared with state statutory income increases as the rate of growth of a company rises. As a consequence, it will be extremely difficult in the next availability crisis to convince potential investors to contribute capital to new or existing small property and casualty insurance companies. The return on investment compared with other small potential uses of capital is unlikely to make investment in a property and casualty insurance company sufficiently attractive.

IV. PENDING LEGISLATION TO ADDRESS THE INEQUITABLE TREATMENT OF SMALL PROPERTY AND CASUALTY COMPANIES

Under current Federal income tax rules, small life insurance companies, defined as those with less than $500 million of assets, benefit from a provision which entitles them to a 60 percent exclusion from what would otherwise be taxable income up to $3 million of income. The exclusion phases out between $3 million of income and $15 million of income.

This small life insurance company tax provision, which was enacted as part of 1984 legislation which restructured the taxation of life insurance companies, is designed to permit small life insurance companies to overcome impediments to attracting and retaining capital which do not face larger companies, thus enabling small companies to grow and compete. Such policy considerations are even more compelling with respect to small casualty companies, whose capital needs are far less predictable than life insurers.

H.R. 1515, the "Small Property and Casualty Insurance Company Equity Act of 1995," would extend the small life insurance company provision to small property and casualty insurance companies. A variation of H.R. 1515 passed both the House and Senate in 1992 as part of H.R. 11, which was vetoed by President Bush Enactment of H.R. 1515 would significantly mitigate the problems currently faced by small, growing property and casualty insurance companies by offsetting, at least partially, the high effective tax rate on statutory income currently faced under existing tax rules. Enactment of this legislation also would serve to reduce significantly the negative incentives which impede investment in new or existing small property and casualty insurance companies. Finally, enactment of these H.R. 1515 would greatly enhance the ability of small property and casualty insurance companies to help the nation's economy overcome the next availability crisis.

Mr. Chairman, I am pleased to note that H.R. 1515 has earned bipartisan support from such distinguished Members of the Committee as Congressmen Matsui and Jacobs.

Mr. Chairman, thank you again for this opportunity to testify. The members of CICCA and I look forward to working with you and the entire Committee to secure the much needed passage of H.R. 1515.

TESTIMONY OF NATIONAL STRUCTURED SETTLEMENTS TRADE ASSOCIATION

The National Structured Settlements Trade Association (NSSTA) is an organization composed of more than 500 members which negotiate and implement structured settlements of tort cases involving persons with serious, long-term physical injuries.

Under a structured settlement, the injured person receives damages in the form of a stream of periodic payments tailored to his or her future medical and basic needs from a well-capitalized, financially-secure institution which must fund its periodic payment obligation from two of the safest assets available -- life insurance company annuities or U.S. Treasury securities. This method is chosen over compensation in the form of a lump sum because the lump sum in many cases is prematurely dissipated by the victim who often is ill-prepared for its management. Founded in 1986, the mission of NSSTA is to advance the use of structured settlements as a means of resolving personal injury claims.

NSSTA strongly supports H.R. 1037, introduced by Mr. Jacobs and currently co-sponsored by Reps. Houghton, Payne, and Brewster. H.R. 1037 would extend the I.R.C. § 130 qualified assignment of liability mechanism for structured settlements to include worker's compensation claims as well as tort claims, thereby providing to persons who have suffered serious, long-term injuries in the workplace the same financial protection that is currently available to tort victims.

NSSTA appreciates this opportunity to offer written testimony to the House Ways and Means Committee in support of H.R. 1037 NSSTA representatives had provided both oral and written testimony on identical legislation in the last Congress at hearings held before the Subcommittee on Select Revenue Measures on June 17, 1993. ("Miscellaneous Revenue Issues", Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 103rd Cong , 1st Sess. (June 17, 1993), Serial 103-63 (Part 1), at pp.174-179.) Having had this earlier opportunity to present testimony in person to the Committee and in light of the Committee's need to economize its hearing time this year, NSSTA is submitting a written statement for the current hearing. NSSTA remains committed in the strongest possible terms to pursuing the enactment this year of the provisions contained in H.R. 1037 and would be pleased to respond to any questions that Members or staff may have.

As described in detail below, H.R. 1037's extension of the I.R.C. § 130 qualified assignment mechanism to cover recoveries for physical injuries in the workplace will provide crucial financial protection for workers who suffer serious, permanent injuries. At the hearing on the identical legislation in the last Congress, Assistant Secretary of the Treasury for Tax Policy Samuels testified that the Administration does not oppose the proposal to extend section 130 to workplace injuries, reasoning that "[t]here appears to be no policy justification, apart from revenue considerations, for allowing less favorable tax treatment for work-related physical injury claims than other physical injury claims." (Written Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (June 22, 1993), Item C.2.).

Revenue considerations should not be a factor. H.R. 1037 has been estimated by the Joint Tax Committee staff to have a very minimal revenue impact. By letter dated February 23, 1995 to Mr. Jacobs, the Chief of Staff of the Joint Committee on Taxation transmitted the revenue estimate for H.R. 1037 of a total of $11 million over the fiscal 1996-2000 period.

I. Section 130 Adopted to Protect Seriously-Injured Tort Victims

Code section 130 was adopted as part of the Periodic Payment Settlement Act of 1982 (P.L. No. 97-473) to provide a mechanism under which badly-injured tort victims suffering harm well into the future could receive compensation in the form of a stream of payments from a financially-secure and experienced institution.

In adopting section 130, the clear focus of Congress was on providing maximum financial protection and security for a victim who has suffered serious, long-term physical injuries. Providing compensation to the victim in the form of a long-term stream of payments, such as the remainder of his or her life or 20 or 30 years, meets the injured person's medical and living needs over time and guards against premature dissipation of the recovery by the victim. However, the long-lived nature of the payment stream makes the financial health of the payor a vital concern to the injured person.

The section 130 qualified assignment mechanism reflects a Congressional recognition of the perils of leaving a badly-injured person exposed to the uncertain financial prospects of a self-insured tortfeasor or a financially-impaired property and casualty carrier over the next 20 or 30 years. The key feature of section 130 is that it permits the obligation to make the stream of payments to the injured person to be transferred from the tortfeasor (or its insurer) to a well-capitalized, financially-secure institution. Congress expressly mandated in section 130 that the assignee must fund its assigned payment obligation to the injured victim from two of the safest types of investments available -- U.S. Treasury obligations or annuities of state licensed and supervised life insurance companies.

To provide even greater financial security to the injured victim, Congress amended section 130 to permit the victim to be given secured creditor status with respect to these high grade funding assets being used by the assignee to make the periodic payments.

Section 130 includes a series of other requirements, protections, and restrictions regarding the assignment of the periodic payment obligation as well as the assets used to fund the payment obligation, in order to protect the injured victim as well as to ensure that no potential tax concern is raised.

II. Section 130 Rationale Applies Equally to Physical Injuries Suffered in the Workplace

A. Parallel Class of Injuries

In extending Code section 130 to cover physical injuries suffered in the workplace as well as physical injuries suffered from torts, H.R. 1037 is fully consistent with the original purpose of section 130 and merely adds a parallel class of physical injuries to those already covered by the statute.

All of the important policy reasons underlying the use of qualified assignments for physical injuries in the tort context apply with equal force to a person who has suffered physical injuries in the workplace -- as Treasury itself has recognized in its past testimony. The form of making the claim for such physical injuries -- whether in tort or worker's compensation -- should not be a basis for differentiation regarding the availability of the financial protections of section 130 for the seriously injured victim. Indeed, in many cases the worker's compensation statutes require injured workers to forego tort remedies against their employers.

B. Same Need for Financial Security for the Permanently Injured

A worker who has suffered a severe and permanent physical injury should have the same access to the financial security and stability offered by section 130 as tort victims are afforded -- that is, to have the compensation obligation assigned to a well-capitalized and experienced institution which can also provide the injured worker with secured creditor status. A seriously and permanently disabled worker who is to receive a stream of worker's compensation payments over the next 20 or 30 years has the same valid concerns as the tort victim over relying on the uncertain financial prospects of a self-insured industrial employer that may no longer be in business a decade from now or a compensation carrier that is weak and threatens to become more so in the future.

1. Risk to injured worker of self-insured employer who is financially impaired

Consider the case of a worker who has been permanently paralyzed from the waist down and will be receiving weekly worker's compensation benefits for a long period of time. His employer is a small construction business that is self insured and has been experiencing rising financial losses. The injured worker may well be motivated to seek a lump sum settlement of the remainder of his claim, fearing that he cannot rely on the future financial health of his employer to continue providing the payments that are necessary for his expensive, ongoing medical care and living needs.

In other instances, a financially-precarious employer may use the threat of insolvency to coerce a disabled worker to accept a settlement of his or her claim in the form of a reduced lump sum. A similar fear of the loss of future benefits can arise where the employer's compensation carrier becomes financially impaired.

In all of these cases, the specter of risk and uncertainty -- and the fear of having to battle the other creditors of the employer or of the compensation carrier -- can cause the permanently disabled worker to "take the cash" as a lump sum settlement of the remainder of the claim, even though the amount is likely to represent considerably less than he or she would have received in statutory worker's compensation benefits over time.

In the case of threatened insolvency, the state worker's compensation referee who hears all worker's compensation claims and must approve the terms of their resolution would have only two options under current law. The state referee could deny the injured worker's request for a lump sum resolution of the remainder of his claim, exposing the worker to the risk of worsening financial health of the employer or compensation carrier. Alternatively, the state referee could permit a lump sum resolution of the remainder of the injured worker's claim as the best of two poor choices, knowing that continued periodic payments would have been in the best interests of the disabled worker and his or her family who often are ill-equipped to manage a lump sum to provide for medical and basic needs that will extend well into the future.

The concerns over the insolvency of a self-insured employer are very real. Up until the past few years, there were no guarantee funds available to protect the injured workers of self-insured employers. For example, a few years ago a large self-insured supermarket chain in the Southwest failed, leaving approximately 75 workers without any benefits at all. Since the time of the bankruptcy of this employer, these workers have received no payments and are presently pursuing their claims for benefits through the bankruptcy court.

Even in the approximately 25 states that have guarantee funds for self-insured employers, the capacity of these funds to respond to a major insolvency is untested.

Thus, a state facing the insolvency of a self-insured employer in many cases has few options with which to address these serious long-term disability cases other than to shoulder the burden of worker's compensation claims running 20 or 30 years out or offer these permanently disabled workers lump sum settlements which the workers and their families often are ill-equipped to manage.

2. Risk to injured worker of financially-weakened worker's compensation insurer

Similar concerns exist over the threatened or actual insolvency of casualty insurers. Since 1969, over 200 casualty insurers have failed. Some of the larger insolvencies include the following companies:

Name	State of Domicile
Mission Insurance Co.	California
Transit Casualty	Missouri
Ideal Mutual Insurance Co.	New York
American Mutual Liability	Massachusetts
Midland Insurance Co.	New York
Champion Insurance Co.	Louisiana

Four of these companies -- Mission Insurance Co., American Mutual Insurance Co., Ideal Mutual Insurance Co., and Midland Mutual Insurance Co. -- had written a significant volume of worker's compensation coverage. While it is fortunate that in these particular instances the casualty guarantee associations ultimately were able to provide the injured workers with their full benefits, we understand that in many cases there were delays and interruptions in payments. These seriously-injured workers often face significant ongoing medical and living expenses, and hence even delays or interruptions in benefits can create serious problems for these disabled workers.

Even the failure of a small carrier can affect many injured workers. For example, Westmoreland Casualty had less than one percent of the overall worker's compensation market in Pennsylvania at the time it was taken over by state regulators in 1987, yet the liabilities associated with worker's compensation claims exceeded $30 million to disabled workers.

III. H.R. 1037 Would Provide Crucial Protection for an Injured Worker Facing a Financially Impaired Employer or Compensation Carrier

If H.R. 1037 were enacted, the most likely section 130 assignment-of-liability transaction in the worker's compensation context would involve these situations where concern exists about the continued financial ability of a self-insured employer or compensation carrier to provide future benefits to permanently disabled workers.

A. Review by State Worker's Compensation Authority

Under the applicable state or federal worker's compensation statute, each resolution of a worker's claim and any assignment of liability for that claim are subject to review by the state worker's compensation referee on an individual case basis under its particular facts. The injured worker must assent to the arrangement, and the state referee must determine that the

resolution of the claim and any assignment of liability are consistent with the worker's compensation statute and are in the best interests of the injured worker. State worker's compensation referees historically have demonstrated a strong inclination to have financially healthy employers or compensation carriers retain liability for worker's compensation claims. As a result, assignments of liability by a self-insured employer or by a compensation carrier are likely to be permitted by the state referee in most cases only where there is some demonstrated concern as to the future financial health of the employer or carrier.

B. Maximum Financial Security for the Badly-Injured Worker

If H.R. 1037 were enacted, the availability of the section 130 qualified assignment mechanism would provide maximum financial security to this permanently disabled worker by permitting assignment of the responsibility for the 20- or 30-year stream of payments for medical and living expenses to a well-capitalized, financially-experienced institution. The assignee would fund its obligation to the injured worker out of the very high grade assets mandated by Congress in section 130 -- U.S. Treasury obligations or annuities of state licensed and regulated life insurance companies. Section 130 would enable the assignee to provide the injured worker with secured creditor status in respect of these high quality assets, thereby giving the worker the maximum financial protection that his or her future medical and other needs will be met.

State worker's compensation referees would welcome this additional option for addressing the situation of the financially troubled employer or compensation carrier.

Conclusion

The National Structured Settlements Trade Association strongly supports the adoption by the Ways and Means Committee of H.R. 1037. This measure would enable workers suffering from serious, long-term physical injuries to receive the same high level of financial protection now provided to tort victims, by extending section 130 to worker's compensation claims.

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TESTIMONY OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Executive Summary

"Small" property and casualty insurance companies may make an irrevocable election to base their tax liability solely on taxable investment income. Companies that make this election are also subject to the alternative minimum tax (AMT). It is the Internal Revenue Service's (the Service) position that underwriting income be used in calculating the adjusted current earnings (ACE) adjustment in the calculation of AMT in 1990 and subsequent years.

The Service's position defeats the Congressional intent to alleviate the Internal Revenue Code's (the Code) complexity for small property/casualty companies. Since AMT and regular tax (RT) are parallel calculations, the Congressional intent must have been for the comparison to be between similar items, i.e. investment income. To do otherwise would make a mockery of the small company election. The election was intended to relieve small companies of the need to comply with the complex provisions introduced by the Tax Reform Act of 1986 (TRA of '86) that apply to underwriting income. The small company election was also intended to insulate underwriting from tax to maintain surplus levels and afford protection to policyholders. If the AMT adjustments were to include underwriting income, these benefits would be completely offset.

Reference should be made to the examples in the brief which demonstrate the harshness of an AMT calculation which would include underwriting income for purposes of the ACE adjustment.

Suggested Legislative Relief

The following amendment to the Internal Revenue Code is necessary in order to make certain that the integrity and purpose of the small property/casualty company election is maintained.

The following should be added to the Internal Revenue Code at 56(g)(4)(B)(iv) and should be made effective for years ending after December 31, 1989.

> *Property and casualty companies making the election under Section 831(b) of the Code shall exclude underwriting income and expense in calculating alternate minimum taxable income.*

In addition, as the ACE adjustment evolved from the TRA of '86 book income adjustment which existed from December 31, 1986 through December 31, 1989, this ACT should provide retroactive relief for companies who included underwriting income in their AMT calculation during those years.

On behalf of its member companies, the National Association of Mutual Insurance Companies (NAMIC) submits this statement regarding Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), V- 8, Treatment Of Certain Small Property And Casualty Insurance Companies Under The Alternative Minimum Tax. This proposal was originally included in H.R. 11 (102nd Cong.), as passed by the House and Senate and vetoed by President Bush.

NAMIC

NAMIC is the largest property/casualty insurance trade association in the world with more than 1,200 member companies and celebrates its 100th anniversary this year. Our membership ranges in size from small county and farm mutuals to industry giants and consists of several types of companies including mutuals, stocks, reciprocals, reinsurers, and surplus line carriers. Our membership represents nearly 30% of the direct written premiums in the industry. The smaller companies comprise the majority of its membership; they were the genesis and continue to be the backbone of the organization.

The Small Company Election And The AMT

Introduction

NAMIC believes that underwriting income and expense should be excluded from the corporate alternative minimum tax ("AMT") for small property/casualty insurance companies that elect under section 831(b) of the Internal Revenue Code to be taxed on taxable investment income only. This amendment would be effective for taxable years beginning after December 31, 1986 and would negate any unintended harm that might have occurred because of the existing ambiguity, giving these companies the simple fair tax system that Congress intended.

Small Companies and the Election

Small companies (those companies with net written premiums or, if greater, direct written premiums, in excess of $350,000 but not in excess of $1,200,000 for the taxable year) may irrevocably elect to base their Federal tax liability solely on their taxable investment income[1]. The purpose of the election was simplification and not a reduction in tax liability. [2]

To increase the tax cost by including underwriting income in the AMT calculation nullifies the original purpose by either making the election costly or raising additional calculation complexities which were to be avoided. The complexities could run the gamut of trying to forecast the future and/or calculating the complex underwriting tax adjustments required under the tax law changes of the TRA of '86.

In consonance with the simplification purpose behind the TRA of '86, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) provides that the phase-in of the changes in calculating underwriting income such as discounting and the unearned premium adjustment are to be delayed for small companies until such time as they are no longer eligible for the election.

Electing Companies and the ACE Adjustment

The ACE adjustment increases alternative minimum taxable income (AMTI) by 75 percent of the difference between ACE and AMTI for tax years beginning after December 31, 1989[3]. The Conference Committee Report on the TRA of '86 provides that ACE is to be

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[1] IRC Sec. 381(b)

[2] The House Committee Report to the Technical and Miscellaneous Revenue Act of 1988 Pub. L. No. 100-647 (1988) provides that changes to the small company provision were made to reflect "Congress' intent that the election not be used as a means of eliminating tax liability...but rather as a simplification for small companies."

[3] For years prior 1987-1989 the adjustment for AMT was predicated on a concept called the book income adjustment.

computed without taking into account the small company election afforded property and casualty insurance companies nor the small company deduction automatically granted "small" life insurance companies [4]

The Conference Report must be interpreted to be a reference to the small life company exclusion, which is automatic, but not to the small company election which is voluntary and binding. This interpretation should be in consonance with the long-standing interpretation of earnings and profits.

If, as the Service believes, underwriting income is to be included in calculating the AMT, the intent of Congress is defeated for several reasons. These companies, which have no access to actuarial expertise, are burdened with the complexities of the property/casualty provisions necessary to properly calculate the ACE adjustment and have not, therefore, had their Federal tax responsibilities simplified as was Congress' intent. Moreover, as the election cannot be revoked without the Service's permission, electing companies would pay tax in all years, even those years in which underwriting losses would otherwise have affected taxable investment income. This would be eminently inappropriate since a company would always pay regular tax when it is unprofitable and pay AMT when it is profitable. Congress intended that, in return for avoiding the complexities and difficulties of computing tax on their entire income, these companies would always pay some tax even when they lose money on a bottom line basis. Including underwriting in the AMT calculation breaches this understanding.

Examples

The most dramatic way to view the inequity that would result if an electing small company were compelled to include underwriting income is to review examples based on actual company profiles (See examples I & II at end).

Example I shows the harshness of an interpretation that would include underwriting income in the calculation of AMT. RTI is based on taxable investment income of $39,000. ACE of $250,000 is the sum of investment and underwriting income. The amount of underwriting income which is included in AMTI in this example is $105,000 ($140,000 @ 75%). The inclusion of underwriting income offsets the intended benefit of the small company election. An electing small company's economic income is its investment income and the only principal adjustments needed to arrive at AMTI are those for excludable dividends and municipal bond interest. Example II shows the effect where ACE equals investment income using the facts of Example I.

In Example II, the ACE adjustment includes economic income not includible in RTI - municipal bond interest and excludable dividends. It demonstrates the parallel nature of the AMT and RT and correctly effects the intent behind the small company election to subject only investment income to taxation. This must be the correct interpretation of the ACE adjustment or else the small company election loses its vitality.

Treasury regulations[5] allow a foreign taxpayer to base its ACE adjustment on an ACE amount which is tied to the corporation's regular taxable income base thereby, avoiding a comparison of dissimilar items. To include income that is not effectively connected in the ACE adjustment would be to compare dissimilar items as requiring the ACE of an electing small property and casualty company to include underwriting income does. Thus, a portion of a foreign corporation's ACE has been removed from consideration for purposes of the ACE adjustment. Similarly, a small company's ACE which relates to underwriting income should be removed for purposes of the ACE adjustment. This approach is analogous to the approach permitted by the regulations applicable to foreign corporation in that it bases the ACE adjustment on the same type of income used in calculating RTI.

In calculating AMT for an electing small property/casualty company, underwriting income must be excluded. To do otherwise would result in the election provisions being inoperative. However, the statute is not specific and the Conference Committee Reports with regard to ACE casts a shadow on the correct interpretation.

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[4] H. Rep. No. 99-841, 99th Cong. 2d Sess. (1986).

[5] Treas. Reg. Sec. 1.56-1(b)(6)(ii).

Retroactive Application:

The book income adjustment was the ACE equivalent for tax years 1987 through 1989. The most significant difference in the calculation of the book income adjustment and the ACE adjustment is that the ACE adjustment subjects 75% of underwriting income to tax and the book income adjustment subjected only 50% of underwriting income to tax. By subjecting a larger portion of underwriting income to tax, the ACE adjustment further offsets the intended benefits of the small property/casualty election.

The statute of limitations (SOL) for the last tax year in which the book income adjustment applied, 1989, would normally close in 1993. Many taxpayers who made this irrevocable election under the belief that AMT would only apply to investment income, have been burdened for reasons unknown to them at the time they made the choice. Fairness warrants retroactive relief to these companies. Consequently, any company that either voluntarily or involuntarily included underwriting income in the AMT base for any statute barred year should be permitted to file a claim for refund within six (6) months after this provision become slaw.

Conclusion

Consequently, and for all the reasons mentioned above, we urge the Congress to exclude underwriting income and loss from the corporate AMT calculation for small insurers electing to be on taxable investment income, effective for taxable years beginning after December 31, 1986.

EXAMPLE I

Underwriting Income Used In Calculating AMT.

Regular taxable income (RTI)		$39,000	
Regular tax (RT) (15%)			$ 5,850
Tentative AMTI		$39,000	
ACE 1/	$250,000		
Less tentative AMTI	(39,000)		
ACE/tax difference	$211,000		
	x .75		
ACE adjustment		$158,250	
Subtotal		197,250	
Exemption		(40,000)	
AMTI		$157,250	
AMT Rate		x .20	
Tentative AMT			$31,450
Tax liability (AMT)			$ 31,450
1/ ACE:			
Investment income	110,000		
Underwriting Income	140,000		
	$250,000		

EXAMPLE II

Investment Income Only Used In Calculating AMT.

Regular taxable income (RTI)		$39,000	
Regular tax (RT) (15%)			$ 5,850
Tentative AMTI		$39,000	
ACE 1/	$110,000		
Less tentative AMTI	(39,000)		
ACE/tax difference	$71,000		
	x .75		
ACE adjustment		$53,250	
Subtotal		92,250	
Exemption		(40,000)	
AMTI		$52,250	
AMT Rate		x .20	
Tentative AMT			$10,450
Tax liability (AMT)			$ 10,450
1/ ACE:			
Investment income	110,000		
Underwriting Income	140,000		
	$250,000		

TESTIMONY OF ROBERT K. SHERIDAN
PRESIDENT, SAVINGS BANK LIFE INSURANCE COMPANY
OF MASSACHUSETTS
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
JULY 13, 1995

The Savings Bank Life Insurance Company of Massachusetts (SBLI) provides low-cost life insurance consistent with absolute safety to the citizens of Massachusetts. Legislative language is being sought which would clarify the tax consequences of the consolidation of the SBLI into a stock life insurance company pursuant to state legislation. The issue comes down to whether or not an additional policyholder dividend that is to be paid over a twelve year period is treated the same as any other policyholder dividend as was the intention of the state legislation.

The sole reason there is any question is because of the unique nature of SBLI. In truth, it is unlike any other company in the country. Massachusetts SBLI was created by an act of the Massachusetts Legislature in 1907 as the brainchild of Justice Louis D. Brandeis. The enabling legislation represented one of the earliest efforts at progressive, consumer reform. Justice Brandeis felt that there was much waste in the prevailing system of selling life insurance. In response, he devised a plan whereby life insurance could be purchased at a cost much lower than that generally available. The vision for SBLI was a system of over the counter sales with reduced costs by eliminating sales commissions and other ancillary expenses. Justice Brandeis' selection of mutual savings banks can be traced to history as at that time savings banks were the banking institutions of low income and immigrant consumers. Experience has shown that the Brandeis experiment has even exceeded the greatest of expectations. Consumer's Report made a study of insurance company costs in the United States and concluded that before any Massachusetts citizen purchases life insurance, they consider SBLI, noting that" "Massachusetts Savings Bank Life Insurance in particular is a model for what all life insurance ought be". Consumer's Report, in a three-part series on life insurance, consistently rated SBLI in the top tier of low cost, high quality life insurance companies, including number one in whole life coverage, and other categories. Many other consumer-oriented publications have similarly endorsed SBLI.

Presently, SBLI has over 500,000 policies and $12 billion in in-force insurance. While we have the full range of life insurance products our yearly renewal term insurance has grown in popularity and does represent about 80% of current issues. An example of our rates for a 30 years old non-smoker should show why the product is so popular – $99 for $100,000; $180 for $250,000; and $315 for $500,000. This policy, as virtually all of our policies is participating, meaning that dividends can be expected at some point in time.

The deregulation of the banking industry posed a significant challenge to the prior SBLI system. During the 1980's, many savings banks converted to stock ownership which produced a natural conflict between a stock bank and a non-stock life insurance department. Moreover, as a stock entity, such banks were subject to acquisition and if a non-savings bank were involved, SBLI outlets would have diminished. Desirous of preserving and protecting SBLI for future generations of Massachusetts consumers and wanting to make available low-cost life insurance through a banking network, legislative and consumer leaders overhauled the SBLI governing statute in 1990.

The plan consolidated the fifty separate life insurance departments into a closely held stock company. All conceivable so-called home office functions, including the underwriting and servicing of policies and the investment of premiums, were transferred to the consolidated entity. Almost immediately, the efficiencies of consolidation manifested themselves as after the first year of operation in 1992, the restructured SBLI realized a 34.1% reduction in general insurance expenses. Further aspects of the plan included the

repeal of artificially capped policy size limits and the creation of a public watchdog group whose mandate was to see that SBLI remained faithful to safe, low-cost life insurance.

In effecting consolidation, the SBLI banks received stock in the new company roughly in proportion to the size of the surplus in the life insurance department. The size of the stock distribution sought to equitably recognize the degree of subsidy and support that was provided by any host savings bank. To buttress the provision of low-cost insurance, an additional dividend was prescribed to be paid out to policyholders over a twelve-year period. This dividend roughly equated to the present value of 60% of the total combined surplus and constituted mounts made excess by operating one consolidated entity as opposed to fifty small life insurance departments.

The issue was raised as to whether such dividend is the same as the payout of surplus to policyholders for their ownership interest in a conventional demutualization. In a typical demutualization, policyholders receive a payment for their legal ownership interest as it is considered a redemption.

Unfortunately, given the sui generis nature of SBLI, conversion models cannot be followed. If ownership is the controlling factor, then the normal attributes of ownership were not held by a SBLI policyholder: 1) there was no right to vote; 2) the right to participate to earnings was qualified; and 3) there was no right to participate in the distribution of assets.

The prior regulatory body, the Division of Savings Bank Life Insurance, and the Massachusetts Legislature carefully analyzed the status of policyholders and concluded that SBLI policyholders did not have an equity interest in the surplus of their life insurance department. They further determined, even to the extent of receiving judicial clearance, that the conversion / consolidation could be effected without any vote of policyholders, that there was no requirement to distribute surplus, and that policyholders were not entitled to any stock.

For the reasons cited above, the payment of the additional annual dividend based on the combined surplus should not be construed as payment for the redemption of any ownership interest, but rather represents a dividend payment as it would be reflective of earnings, mortality and expenses like any other dividend. Moreover, the legislation made clear that a policyholder must keep his policy in force so in the case of a lapse or surrender such individual would cease to be eligible for the dividend.

While it is crystal clear in our opinion that the additional dividend is the same as any other dividend pursuant to SBLI operations, our unique fact pattern did not permit Internal Revenue Service guidance through a private letter ruling. Among developments considered was the pending regular demutualization of the Equitable Life Assurance Society in New York so the IRS was disinclined to create any exceptions to standard practice, however meritorious the facts or arguments.

Legislative clarification was decided upon as the best route to give meaning to the intent of Massachusetts law.

The Joint Tax Committee has estimated a revenue loss of $25 million over five years if the additional dividend was legally found to be a non-deductible redemption of a propriety interest as opposed to a deductible repayment of a creditor interest. This estimate must be placed in perspective. In 1992, the federal government realized more than $5 million more in federal income taxes from SBLI since the small business deduction ended due to corporate reorganization. Ongoing, SBLI will pay more in federal income taxes as one large taxpayer in contrast to multiple smaller ones. This permanent revenue windfall to the federal government should more than mitigate the impact of clarifying the additional dividend. We understand that the Joint Tax Committee's methodology prevents taking into account any revenue enhancements. For purposes of revenue estimates, we do, however, understand that a revenue offset has been identified.

In summation, we believe that the amendment merely clarifies the state of the law and effectuates the intended meaning of the Massachusetts legislation. In so doing, the legitimate interests of SBLI policyholders and stockholders are acknowledged. It is crucial that this matter be resolved soon so we can continue to provide consumers with the most cost-efficient life insurance coverage. If the tax clarification is not made SBLI will be subject to a tax inequity which would regrettably be passed on to the consumer. Accordingly, we urge approval of this important amendment.

We appreciate your consideration and attention.

STATEMENT OF

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

On behalf of the Association of Financial Guaranty Insurers ("AFGI"), I am pleased to express the Association's support of a proposal to amend section 832(e) of the Internal Revenue Code of 1986, as amended (the "Code"), so as to extend the provisions thereof to certain non-tax-exempt debt securities.

The Association of Financial Guaranty Insurers (AFGI) consists of nine triple-A rated U.S. based companies that insure or reinsure the payment of debt service on municipal, asset-backed and mortgage-backed bonds. AFGI member companies operate solely in the area of financial guaranty insurance. Financial guaranty insurance, commonly called "bond insurance", is an insurance contract that guarantees timely payment of principal and interest when due on both tax exempt and non-tax exempt bonds. The bond insurance contract generally provides that, in the event of a default by an insured issuer, principal and interest will be paid to the bondholder as originally scheduled. The list of AFGI members is attached.

Section 832(e) presently applies to underwriters of mortgage guaranty insurance, lease guaranty insurance, and state and local tax-exempt bond insurance. The proposed amendment expands the scope of section 832(e) to include general financial guaranty insurance. This reflects the fact that the type of insurance which the financial guaranty industry underwrites has expanded from the mortgage insurance offered at the time section 832(e) was first enacted to include other forms of financial obligations. Further, as discussed below, insurance of these other types of financial obligations is subject to the same regulatory and economic restraints which prompted the original enactment of section 832(e). *Thus, the proposed amendment constitutes a sensible modification of the Code to reflect new forms of bond insurance, and does so in a way which Congress and Treasury have previously found both to be acceptable, and, even more importantly, to be effectively revenue neutral. As Assistant Secretary Samuels wrote in his statement to the Ways and Means Subcommittee on Select Revenue Measures during the last Congress regarding this proposal, it "does not raise a significant federal tax issue, but instead relates primarily to [state] regulatory matters."*

Under section 832(e), a company writing mortgage guaranty insurance, lease guaranty insurance and tax-exempt bond insurance may deduct for federal income tax purposes amounts required by state law to be set aside in a reserve for losses resulting from adverse economic cycles. The deduction cannot exceed the lesser of (i) the company's taxable income or (ii) 50% of the premiums earned on such guaranty contracts during the taxable year. Further, the deduction is available only to the extent that the taxpayer purchases non-interest-bearing "tax and loss bonds" equal to the tax savings attributable to the deduction. The taxpayer insurance company may redeem such bonds only as and when it restores to income the reserves associated with the deduction. Reserves are restored to income as and when they are applied, according to state regulations, to cover losses, or to the extent that the company has a net operating loss in some subsequent year. Further, the reserve deduction taken in any particular year must be fully restored to income by the end of the 10th subsequent year. For the tax-exempt bond insurance, this period is increased to 20 years.

Code section 832(e) was originally enacted in January, 1968 (P.L. 90-240), effective January 1, 1967. At that time it applied only to mortgage guaranty insurance. It was enacted in response to high reserve requirements imposed by state regulatory authorities with respect to such insurance. These reserve

requirements ranged up to as much as 50% of earned premiums, and amounts were often required to remain in reserve for as long as 15 years. Imposition of a current federal income tax on the reserved amounts, when combined with the effect of operating expenses and a loss experience of approximately 30% of non-reserved premiums, imposed a serious burden on the insurance company's working capital. In such circumstances, the company's federal income tax obligation could easily exceed the cash remaining from available, i.e., unreserved, funds after payment of expenses and losses.

Prior to the enactment of section 832(e), the mortgage insurance industry had relied upon a series of private letter rulings allowing it to treat these contingency reserves as if they were unearned premium reserves, for which a deduction was already permitted. When the Internal Revenue Service revoked these rulings, Congress responded by passing section 832(e), thereby allowing such insurers to take a deduction for such reserves. However, because the reserve requirements imposed by the state regulatory authorities were substantially in excess of that suggested by experience, the legislative history indicates that Congress was concerned that a deferral of tax on such reserves could ultimately result in an unwarranted windfall for the companies. Accordingly, in section 832(e) it required companies to invest the tax savings associated with the deduction in so-called "tax and loss bonds," which are non-interest-bearing obligations issued by the U.S. government. This had the effect of denying the companies the benefit of the earnings on the "float" associated with the tax deferral while at the same time, because the non-interest-bearing bonds were expected to qualify as assets for state financial regulatory purposes, providing relief from the cash flow problems which the insurers would experience if the deduction had not been allowed.

In the years after enactment of section 832(e), the state regulatory authorities applied to lease guaranty insurance and state and local tax-exempt bond insurance the same contingency reserve requirements which they had applied initially to mortgage guaranty insurance. As a result, Congress amended section 832(e) in 1974 (P.L. 93-483) so that it also applied to insurance of those financial obligations as well. The 1974 change was added by means of a floor amendment to P.L. 93-483 offered by Senator Wallace Bennett. Senator Bennett's statement in support of his amendment included a letter from the Treasury Department, in which it said it did not object to the proposal. Significantly, in discussing the provision, Treasury observed that:

> "[f]rom the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the non-interest-bearing bonds give the Treasury at all times the unrestricted use of the deferred tax dollars as if there were no deduction and as if taxes were in fact paid." (Emphasis added.)

In short, as Treasury recognized in 1974, assuming tax rates do not change in the period between the issuance of the bonds and their redemption, and because the tax and loss bonds do not bear interest, Treasury's economic position is the same as if no deduction were allowed.

Since 1974, the type of instruments which the financial guaranty industry insures has expanded to include other financial obligations. In response, state regulatory authorities have applied the same contingency reserve requirements, which had previously been applied only to mortgage, lease guaranty and tax-exempt bond insurance, to general financial guaranty insurance. Accordingly, since these new forms of financial guaranty insurance are now treated the same as mortgage guaranty, lease guaranty and tax-exempt bond insurance for regulatory purposes, they should

also be treated the same for federal income tax purposes and section 832(e) amended accordingly. The same policy concerns which prompted the original enactment of section 832(e) in 1967, and the subsequent expansion of its scope in 1974, are equally applicable here.

For the convenience of Members and staff, suggested wording of the proposed amendment is enclosed. A slightly abridged copy of the letter from the Department of the Treasury expressing its position on the expansion of section 832(e) in 1974 is also attached.

Respectfully submitted,

Association of Financial Guaranty Insurers

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Letter from the Department of the Treasury regarding the 1974 Amendment to Code section 832(e)
(Retyped and abridged from version printed in the Congressional Record, August 13, 1974, p. S 14854)

Department of the Treasury,
Washington, D.C.
March 25, 1974
Hon. Wilbur D. Mills, Chairman
Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Chairman:

. . . This bill would allow those insurance companies which are writing lease guarantee insurance and insurance guaranteeing the debt service of municipal bond issues (i.e., obligations the interest on which is excludable from gross income under Section 103 of the Code) to deduct additions to contingency reserves in accordance with the current treatment of such additions for mortgage guaranty insurance under Section 832(e).

Mortgage guaranty insurance companies guarantee the holder of a real estate mortgage against loss on a mortgage loan. State insurance commissions regulate these insurers by requiring the establishment of a contingency loss reserve of up to 50 percent of earned premiums in order to protect against extraordinary losses resulting from adverse economic cycles. These reserve additions are not related to loss experience and remain in the reserve for 15 years, in the absence of authorization from the State commission for prior restoration of income. Normal losses are charged to income currently, rather than to the reserve. Prior to enactment of Section 832(e), the deductibility of additions to a contingency loss reserve was in dispute. Where state law requires 50 percent of earned premiums to be placed in a reserve for extraordinary losses, it would be extremely difficult, if no deduction were allowed for such reserve additions, for a company to operate without continuing additions to working capital, since current losses and other expenses amount to more than 50 percent of their earned premiums.

Section 832(e) was intended to deal with these unusual State law requirements and to afford uniform treatment to all companies engaged in writing mortgage guaranty insurance. . . .

The net tax effect to a mortgage guarantee insurance company under Section 832(e) is the ability to carry back for as much as 10 years extraordinary losses from such insurance against taxable income. The deduction for additions to the special contingency reserve gives no immediate tax benefit, since that "benefit" must be invested in tax-and-loss bonds. A non-tax benefit is gained, however, since the bonds are recognized by both accountants and state insurance commissions as assets for financial statement purposes and may thus be used for the special contingency reserve.

Similarly, from the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the noninterest bearing bonds give the Treasury at all times the unrestricted use of the deferred tax dollars as if there were no deduction and as if taxes were in fact paid currently. Although the insurance companies obtain a deduction for additions to the special reserves over the approximate average life of the mortgages guaranteed (10 years), at the same time the companies are denied the earnings on the portion of such reserves representing deferred taxes during the time that portion is held for special contingencies.

Proposed Amendment to Section 832(e)
(New language is in italics)

Paragraph (6) of Section 832(e) is amended as follows:

(a) In the title of such paragraph (6), add before the period:

; FINANCIAL GUARANTY INSURANCE

(b) In the first sentence of such paragraph (6), add before the period:

or a company which writes financial guaranty insurance

(c) In the second sentence of such paragraph (6), delete the word "and" after the words "lease guaranty insurance," insert a comma in place thereof, and add before the semicolon:

, and to financial guaranty insurance

(d) In the second sentence of such paragraph (6), after the words "in the case of" add the following:

financial guaranty insurance and

(e) In the second sentence of such paragraph (6), after the words "revenues related to" add the following:

such financial guaranty or

After such amendment, Paragraph (6) of Section 832(e) would read as follows:

> (6) LEASE GUARANTY INSURANCE; INSURANCE OF STATE AND LOCAL OBLIGATIONS; *FINANCIAL GUARANTY INSURANCE*. --In the case of any taxable year beginning after December 31, 1970, the provisions of this subsection shall also apply in all respects to a company which writes lease guaranty insurance or insurance on obligations the interest on which is excludable from gross income under section 103 *or a company which writes financial guaranty insurance*. In applying this subsection to such a company, any reference to mortgage guaranty insurance contained in this subsection shall be deemed to be a reference also to lease guaranty insurance, to insurance on obligations the interest on which is excludable from gross income under section 103, *and to financial guaranty insurance;* and in the case of *financial guaranty insurance and* insurance on obligations the interest on which is excludable from gross income under section 103, the references in paragraph (1) to "losses resulting from adverse economic cycles" include losses from declining revenues related *to such financial guaranty or* to such obligations (as well as losses resulting from adverse economic cycles), and the time specified in subparagraph (A) of paragraph (5) shall be the twentieth preceding taxable year.

Lease guarantee insurance and insurance on tax-exempt obligations have generally been subject to the same contingency reserve requirements as mortgage guarantee insurance. Accordingly, the reasons for enactment of Section 832(e) for mortgage guarantee insurance companies are equally applicable to those companies writing lease guarantee insurance and/or insurance on tax-exempt obligations.

The Treasury Department does not object to the enactment of H.R. 4520, but calls the Committee's attention to the fact that the legislation would be generally effective with respect to all taxable years beginning after December 31, 1970. In addition, because of the provisions of Section 832(e)(1)(B), a deduction would be allowed in the current taxable year for additions to a contingency reserve for taxable years beginning after January 1, 1967, but before January 1, 1971. While the Treasury Department normally opposes retroactive legislation, it recognizes that there are unusual circumstances in this case which the committee may wish to consider.

. . .

It is not possible to quantify the revenue effect of this bill, but its effect is thought to be negligible.

The Office of Management and Budget has indicated that it has no objection from the standpoint of the Administration's program to the submission of this report.

Sincerely yours,

Frederic W. Hickman
Assistant Secretary.

Association of Financial Guaranty Insurers

List of Members

AMBAC Indemnity Corporation

Capital Guaranty Insurance Company

Capital Markets Assurance Corporation

Capital Reinsurance Company

Connie Lee Insurance Company

Enhance Reinsurance Company

Financial Guaranty Insurance Company

Financial Security Assurance, Inc.

Municipal Bond Investors Assurance Corporation

TESTIMONY OF RICHARD S. BELAS
DAVIS & HARMAN

Mr. Chairman and members of the Committee, my name is Richard Belas. I am a partner in the law firm of Davis & Harman and am submitting this statement on behalf of thirty-four companies who support adjustment of the dollar limits on burial like insurance contracts to reflect inflation. A list of these companies accompanies my statement. We appreciate that this issue has been included for consideration as part of these hearings and urge enactment of this proposal to help individuals provide for the cost of their burial and related expenses in an efficient way without burdening their surviving family and loved ones.

Historical Background

In 1984, Congress enacted Internal Revenue Code section 7702, which contains the statutory definition of a "life insurance contract" for Federal tax purposes. In order for a life insurance contact under applicable (*e.g.*, state) law to qualify under section 7702[1] as a life insurance contract for Federal tax purposes, it must satisfy the requirements of one of the two alternative tests set forth in that section: (1) the requirements of the "cash value accumulation test" under section 7702(a)(1) and (b), or (2) both the "guideline premium requirements" under section 7702(a)(2)(A) and (c), and the "cash value corridor" requirements under section 7702(a)(2)(B) and (d).

Furthermore, subsection (e) of section 7702 sets forth several computational rules for purposes of making determinations under that section. In particular, section 7702(e)(1)(A) provides a general computational rule that the death benefit (and any qualified additional benefit) shall be deemed not to increase for purposes of section 7702.

As part of the Tax Reform Act of 1986, Congress enacted section 7702(e)(2)(C), providing an exception to the general computational rule and permitting limited increases in death benefits for certain small life insurance contracts purchased to cover the payment of burial expenses or in connection with prearranged funeral expenses ("prearranged funeral contracts").

Prearranged funeral contracts are designed simply to assure that certain agreed upon funeral and burial arrangements will be provided, even if the actual cost of the arrangements exceeds the death proceeds paid under the contract. Such a contract has an initial face amount equal to the cost of the selected arrangements as of the date of contract application. The contract face amount increases each year in an amount not less than the prior year's increase in the CPI. Thus, the death benefit keeps up with inflation and, hopefully, the price of the chosen funeral and burial arrangements.

However, if, on the date of death, the cost of the selected arrangements has grown to an amount greater than the current face amount of the contract, the agreed upon services nevertheless will be provide in exchange for the policy proceeds. On the other hand, if the death benefits have grown to an amount in excess of the price of the funeral and burial expenses at the time of death, any excess funds are paid to the surviving beneficiary designated under the contract.

Under this small contract exception enacted in 1986, certain death benefit increases (*i.e.*, fixed annual increases not exceeding 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year) may be taken into account under a small prearranged funeral contract for purposes of the cash value accumulation test. In order to qualify

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

for this exception, a prearranged funeral contract must have an initial death benefit of $5,000 or less and a maximum death benefit of $25,000 or less. (For this purpose, the initial death benefit is determined by treated all contracts issued to the same contract owner as one contract.) Section 7702(e)(2)(C) was made effective generally for contracts entered into after October 22, 1986.

The Problem

The $5,000 initial death benefit limit and the $25,000 maximum death benefit limits in the section 7702(e)(2)(C) small contract exception for prearranged funeral contracts were adequate in 1986 to cover the cost of an average funeral and burial. However, these limits were not adjusted for inflation, and have not been updated to reflect inflation since that exception became effective in 1986.

Consequently, inflation has eroded the value of the small contract exception for prearranged funeral contracts to an extent that reasonable funeral expenses and associated costs can no longer be adequately funded by these contracts.

For instance, the average cost of a funeral – including cemetery costs, flowers, a concrete vault, and head stone -- has increased substantially since 1986 and is approximately equal to between $7,000 and $8,000 today, depending on the area in the U.S in which the funeral is held. Thus, the $5,000 initial death benefit limit in section 7702(e)(2)(C) is too low to allow individuals to provide for their own funeral expenses by purchasing prearranged funeral contracts today.

The Dollar Limits in Section 7702(e)(2)(C) Should Be Adjusted for Inflation Since the Enactment of That Section

The Code currently provides for inflationary adjustments to many provisions.[2] These adjustments are typically based on increases in the Consumer Price Index for all-urban consumers published by the Department of Labor (the "CPI").

Similar inflationary adjustments should be made to the dollar limits in the section 7702(e)(2)(C) small contract exception for prearranged funeral contracts. Since 1986, the CPI has risen by approximately 37 percent. A precise adjustment to the initial death benefit and maximum death benefit limits under section 7702(e)(2)(C) to reflect inflation from enactment of that section through 1994 would result in a $6,840 initial death benefit limit and a $34,199 maximum death benefit limit.

Thus, it is clear that inflation since the small contract exception for prearranged funeral contracts became effective already has seriously eroded the value of contracts which may be purchased to fund funeral costs. This contravenes Congress's recognition of the need for special treatment of small prearranged funeral contracts and, if not remedied, will become more pronounced in future years as the CPI continues to rise.

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[2] Inflation adjustment provisions in the Code include those for the tax tables (section 1(f)); credit for producing fuel from nonconventional sources (section 29(b)); earned income credit (section 32(i)); basic standard deduction and additional amounts for the aged and the blind (section 63(c)(4)); limits on excludable income from U.S. savings bonds used to pay higher education tuition and fees (section 135(b)); allowance of deductions for personal exemptions (section 151(d)(4)); limitation on the amount of investment tax credit and depreciation for luxury automobiles (section 280F(d)(7)(A)); limits on annual compensation under certain deferred-payment plans (section 404(l)); limits on benefits under defined benefit plans (section 415(d)); lower discount rates in the case of certain qualified debt instruments (section 1274A(d)(2)); and below market rate loans provision limit (section 7872). These inflation adjustments extend as well to the lower and upper limits of any applicable phase-out range. *See* sections 29(b) and 32(i).

In order to provide adequate benefits under prearranged funeral contracts, the dollar limits in section 7702(e)(2)(C) should be adjusted to reflect the effects of inflation since that exception's October 22, 1986, effective date. If legislation is enacted to apply to contracts entered into after December 31, 1995, it would be appropriate to adjust the dollar limits to reflect inflation during 1995.

Accordingly, it would be reasonable for the $5,000 initial death benefit limit and the $25,000 maximum death benefit limit in section 7702(e)(2)(C) to be (1) increased to $7,500 and $35,000, respectively, for contracts entered into after December 31, 1995, and (2) amended to provide that they will be adjusted annually thereafter for inflation, measured as the increase in the CPI. Unless these dollar limits are so adjusted, inflation will result in the denial of the small contract exception for prearranged funeral contracts providing death benefits which do not exceed that exception's limits other than by inflation.

Adjusting for Inflation is Good Tax and Social Policy and Does Not Present "Targeted Tax Relief"

The tax definition of life insurance contracts was designed to assure that life insurance was used primarily as insurance, not just as a savings plan with tax benefits.[3] The small contract exception for prearranged funeral contracts recognized that such contracts are not being sold as savings plans. The purpose of such contracts is to provide an inexpensive way for individuals to make certain prior to their death that there will be adequate funds to pay for their own funeral and burial expenses, rather than to leave these expenses to their surviving family and loved ones. Stated differently, prearranged funeral contracts provide a socially beneficial and cost efficient way for people to provide for a dignified burial.

Prearranged funeral contracts are sold primarily by modestly-sized life insurance companies, not by very large life insurers throughout the country. The benefits provided under such contracts are very modest and will remain modest if the dollar limits are adjust to reflect the effects of inflation since 1986. They will never be able to be sold as an "investment" in anything but peace of mind. Thus, the enactment of legislation adjusting the dollar limits in the small contract exception for prearranged funeral contracts to reflect the impact of inflation is good tax and social policy. Furthermore, since such contracts are available to all individuals, it is clear that such legislation can, in no way, be considered "targeted tax relief."

* * *

In conclusion, in order to provide adequate benefits under prearranged funeral contracts, the $5,000 initial death benefit limit and the $25,000 maximum death benefit limit under section 7702(e)(2)(C) should be adjusted to reflect inflation since that section was enacted in 1986 through 1995 by increasing these amounts to $7,500 and $35,000, respectively, for contracts entered into after December 31, 1995. In addition, that section should be amended to provide that the initial and maximum death benefit limits thereafter be adjusted annually for inflation, measured as the increase in the CPI.

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[3] *See* H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1443 (1984); S. Rep. No. 169, Vol. I, 98th Cong., 2d Sess. 572 (1984); H.R. Rep. No. 861, 98th Cong., 2d Sess. 1076 (1984); Staff of Jt. Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 646 (Jt. Comm. Print 1984).

Supporters of Tax Proposal:

American Home Life Insurance Company, KS
Assured Security Life Insurance Company, AL
Baltimore Life Insurance Company, MD
Boston Mutual Life Insurance Company, MA
Capital Holding, KY
Employees Life Company (Mutual), IL
Farmers & Traders Life Insurance Company, NY
Federal Life Insurance, IL
Franklin American Life Insurance Company, TN
Franklin Life Insurance Company, IL
Home Mutual Life Insurance Company, MD
Homesteaders Life Company, IA
Investors Heritage Life Insurance Company, KY
Lafayette Life Insurance Company, IN
Lincoln Mutual Life and Casualty Insurance Company, ND
Lincoln Mutual Life Insurance Company, NE
Midland Mutual Life Insurance Company, OH
Milestone, Inc., KS
Ministers Life Insurance Company, MN
Mission Life Insurance Company, TX
Monumental Life Insurance Company, MD
National Farm Life Insurance Company, TX
National Travelers Life Company, IA
National Western Life Insurance Company, TX
Pioneer Mutual Life Insurance Company, ND
Prairie States Life Insurance Company, SD
Protected Home Mutual Life Insurance Company, PA
Security Life Insurance Company of America, MN
Security Mutual Life Insurance Company, NE
Shenandoah Life Insurance Company, VA
State Life Insurance Company, IN
State Mutual Insurance Company, GA
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STATEMENT OF THE CLHIA SUBCOMMITTEE ON U.S. TAXATION[1] IN SUPPORT OF HR 1178: PROPOSED CORRECTIONS TO SECTION 842(b)

HEARING BEFORE THE HOUSE WAYS AND MEANS COMMITTEE: JUNE 11 & 12, 1995

This statement is in support of enactment of **HR 1178**, which is a bill to modify and correct the tax treatment of foreign insurance companies operating in the United States. [Item #12 of the June 30, 1995 List of Miscellaneous Tax Reforms, Insurance Items]

SUMMARY

Prior to enactment of section 842(b), the U.S. operations of a foreign insurance company were taxed under section 842 of Subchapter L in generally the same manner as a domestic insurance company. In 1987, pursuant to the Omnibus Budget Reconciliation Act (the 1987 Tax Act), section 842(b) was added to the Internal Revenue Code (the Code). Section 842(b) taxes foreign insurance companies based on a formulary minimum amount of net investment income and surplus. Domestic insurance companies are not subject to any similar formulary minimum investment income or surplus requirement. Domestic insurance companies pay tax each year based upon their actual net investment income and surplus.

*Currently, under section 842(b), in each taxable year, a foreign insurance company with U.S. insurance operations is taxable on the greater of (a) its actual effectively connected net investment income (**Actual Investment Income**), or (b) a formulary minimum effectively connected net investment income (**Formulary Minimum**), calculated using a formula that takes into account the foreign insurance company's U.S. insurance liabilities, the average asset/liability ratio of U.S. insurance companies and the average net investment yield earned by U.S. insurance companies. At the present time, the computation of the U.S. company averages is calculated by Treasury based on **2 year old** domestic insurance company financial statement data.*

Section 842(b) mandates taxation each year based upon the "greater of" Actual Investment Income or the Formulary Minimum. Thus, the company is always taxed on the higher amount without regard to whether the company earned that amount or will ever earn that income.

Treasury has taken a consistent position that U.S. tax treaties prohibit the use of formulary methods of taxation. Under that position, section 842(b) would be in conflict with the U.S.-Canada Income Tax Treaty (the Treaty).

HR 1178 would make section 842(b) operate in a fairer way by eliminating:

(a) the distortion caused by comparing a foreign insurance company's current year actual investment results with results calculated using domestic insurance company data from 2 years prior to the current year,

[1] This statement is submitted on behalf of the Canadian Life and Health Insurance Association (CLHIA) Subcommittee on U.S. Federal Income Taxation (the Subcommittee). The members of the Subcommittee represent Canadian life insurance companies each of which operates a life insurance trade or business in the United States in branch form. This statement has been issued by Raymond L. Britt, Jr., Esq. and Mary V. Harcar, Esq. Both Raymond L. Britt, Jr. and Mary V. Harcar have registered as an agent of The Manufacturers Life Insurance Company, 200 Bloor Street East, Toronto, Ontario, Canada M4W 1E5, under the Foreign Agents Registration Act. Mary V. Harcar has registered as an agent of the CLHIA. Registration materials are available for inspection at the Department of Justice, Washington, D.C. Such registration does not indicate approval by the U.S. Government of the contents of this statement.

(b) *the distortion caused by comparing a foreign insurance company's actual investment results calculated on a tax basis with the investment results of domestic companies, calculated on a financial statement basis, and*

(c) *the distortion caused by the lack of an appropriate carryover account to adjust for year-to-year fluctuations in investment yields and differences in trading practices.*

* * *

I. CURRENT LAW UNDER SECTION 842(b)

Pursuant to section 842(b), if a foreign insurance company's Actual Investment Income for the year is less than the Formulary Minimum, the excess of the Formulary Minimum over Actual Investment Income is added to the foreign company's income for purposes of determining its Life Insurance Company Taxable Income (LICTI) for the year.[2]

In any year, the Formulary Minimum is calculated as the product of "U.S. Required Assets" and the "Domestic Investment Yield", where:

a) **U.S. Required Assets** is the product of the foreign company's total mean insurance liabilities and the Domestic Asset/Liability Percentage;

b) **Domestic Asset/Liability Percentage** is calculated as the domestic companies' total mean assets divided by the domestic companies' total mean insurance liabilities; and

c) **Domestic Investment Yield** is calculated as the domestic companies' total net investment income divided by the domestic companies' total mean assets.

Both the Domestic Asset/Liability Percentage and the Domestic Investment Yield are calculated by the Treasury Department (Treasury) using "representative data" for domestic insurance companies. Since Treasury estimated that it would take approximately 2-years to gather the data needed to calculate these averages, section 842(c)(4) specifies the use of representative data from the "second preceding taxable year". A significant amount of the distortion inherent in section 842(b) is precipitated by this "2-year lag".

In addition, under current law, distortion is also caused by the fact that the average Domestic Asset/Liability percentage and Domestic Investment Yield are calculated using financial statement data rather than tax return data.

Lastly, section 842(b) is further distorted by the absence of an appropriate carryover account to adjust for year-to-year differences in an individual insurance company's investment performance compared to the average. These differences occur because of variations in the mix of assets held by, and the trading practices of, the individual insurance company compared to the average U.S. company rather than because of a plan to minimize investment income.

These distortions are discussed in more detail below:

(a) Distortion Caused by the 2-year Lag

The chart below shows the Domestic Asset/Liability and Investment Yield Percentages announced by Treasury in the indicated notices. These percentages are used by a foreign life insurance company for the taxable years beginning after December 31, 1987.

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[2]In addition, if the foreign company is a mutual life insurance company, and its "U.S. Required Assets" exceed its actual U.S. assets, the excess will be added to the company's equity base for purposes of calculating its section 809 Equity Adjustment for the year.

Treasury-Announced Life Insurance Company Percentages

Percentages for use in Taxable Year	**Domestic Asset/Liability Percentage (Surplus %)**	**Domestic Investment Yield**	**Date of IRS Notice**	**Percentages Based on Data From:**
1988	120.5%[3]	10.0%	IRS Notice 89-96 (8-89-89)	1986
1989	117.2%	8.7%	IRS Notice 90-13 (1-17-90)	1987
1990	116.5%	8.8%	IRS Notice 90-67 (11-13-90)	1988
1991	115.1%	9.0%	Rev. Proc. 92-27 (3-23-92)	1989
1992	113.6%	8.3%	Rev Proc. 92-95 (11-24-92)	1990
1993	112.9%	8.6%	Rev. Proc. 94-14 (1-18-94)	1991
1994	114.1%	8.5%	Rev. Proc. 95-26 (5-30-95)[4]	1992

Evidence of the distortion inherent in the current law is obvious by reference to the Asset/Liability Percentage and Yield chart above. The effect of the 2-year lag on the Minimum Yield Percentages dramatically illustrates the need for correction. For example, in 1988, the required Minimum Domestic Investment Yield announced by Treasury was 10.0%. This was calculated by Treasury by reference to the *1986* NAIC Annual Statements[5] of domestic insurance companies. However, the actual 1988 average yield for domestic life insurance companies, calculated by reference to 1988 NAIC Annual Statements, was 8.8%. As a result, for the 1988 year, section 842(b) taxes foreign insurance companies based on a 10% yield even though domestic companies only earned 8.8%.

This 120 basis point difference is particularly onerous in view of the amount of assets held by life insurance companies. For example, consider the case of a foreign insurance company which held $7 billion in assets, satisfied the Required Asset/Liability Percentage, and earned an 8.8% net investment yield on its assets for 1988. Under current law, because of this 120 basis point distortion caused by the 2-year lag in investment yields, $84

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[3]Treasury has admitted that this percentage should be 117.5% but Treasury has refused to correct the number stating that the original surplus percentage was "...determined using the best information available to Treasury at that time." See IRS Notice 90-13.

[4]The percentages for 1994 were based on tax return data (from 1992) rather than NAIC statement data.

[5]The NAIC Annual Statement is the annual statement form approved by the National Association of Insurance Commissioners.

MILLION of taxable income would be imputed to the company for the 1988 tax year.[6] This attribution of $84 million of taxable investment income would occur despite the fact that the company's investment performance and surplus ratio were consistent with the industry average for the same year.

The impact of the 2-year lag is made even worse because section 842(b) taxes a company in each year on the greater of the Actual Investment Income of the company or the Formulary Minimum.[7] In years when the Formulary Minimum is greater than the company earned, the company is taxed on the Formulary Minimum. In years when the Formulary Minimum is less than the company earned, the company is taxed on its Actual Investment Income. Since investment rates fluctuate over time, the combination of the 2-year lag and the "greater of" rule produces an extremely unfair result. In years when interest rates are dropping (reducing Actual Investment Income), the company will be subject to tax based upon the Formulary Minimum. However, in years when interest rates are rising, section 842(b) will tax the higher Actual Investment Income. This is a perfect example of the taxpayer being whipsawed by the Code.

(b) Distortion Caused by the Use of Financial Statement Data

Currently, section 842(c)(4) states that Treasury should calculate the Domestic Asset/Liability Percentage and the Domestic Investment Yield based upon "representative data" with respect to domestic insurance companies. In the Treasury Notices referenced above, Treasury stated that it utilized NAIC Annual Statement data to determine both the Domestic Asset/Liability Percentage and the Domestic Investment Yield. Tax return net investment income can vary significantly from NAIC Annual Statement net investment income.[8] Using NAIC Annual Statement data for section 842(b) purposes has the effect of taxing foreign life insurance companies based upon the financial statement net investment income of domestic life insurance companies even though there is no assurance that the domestic life insurance companies have been or will be actually subject to tax on that amount of net investment income.

The most significant difference between NAIC Annual Statement data and tax return data is in the calculation of net capital gains and losses. For NAIC Annual Statement purposes, gains and losses are calculated using NAIC asset values, not actual costs. NAIC asset values are subject to write-downs and write-ups, with conservative guidelines mandated for use in the preparation of the NAIC Annual Statement dictating more write-downs than write-ups. This results in a book value which is generally less than tax cost and therefore NAIC Annual Statement capital gains greater than capital gains on a tax basis. Such overstatements inflate the Domestic Investment Yield. This inflation of the Domestic Investment Yield is inappropriate since U.S. insurance companies are not being taxed on the gains calculated in this manner.

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[6]Note that the income imputed by section 842(b) would in fact exceed this $84 million since this example ignores the distortive impact of the 2-year lag in the minimum surplus requirement in section 842(b). In 1988, the required surplus percentage was 120.5% (as calculated by reference to 1986 domestic insurance company financial statement data). However, when calculated by reference to 1988 financial statements, the surplus percentage was 116.5%. As in the case of the domestic yield requirement, if the company had a surplus percentage for 1988 equal to the domestic average for the same year [i.e., 116.5%], section 842(b) would tax the company based on a surplus ratio of 120.5%. This would result in imputed surplus which would be subject to the minimum yield requirements of section 842(b), thus, further exacerbating the distortive impact of section 842(b). In contrast, domestic companies are not subject to any similar requirements to hold minimum surplus or to earn a minimum yield.

[7]Under section 842(b), a company cannot "recover" from the distortive impact of the 2-year lag. A "recovery" might be theoretically possible if section 842(b) consistently and exclusively applied a formulary minimum amount of net investment income. Then, at least a taxpayer would ultimately get the benefit of falling interest rates. However, since section 842(b) applies a "greater of" rule to each year independently, taxable investment income under section 842(b) never correctly reflects lower actual investment yields.

[8]Congress recognized this in section 56(f)(1) which provides that, for taxable years 1987, 1988, and 1989, a corporation must increase its alternative minimum taxable income by 50 percent of the difference between financial statement income, as adjusted, and alternative minimum taxable income computed without regard to section 56(f)(1).

(c) Distortion Caused by the Lack of a Carryover Account

As noted above, section 842(b) creates a whipsaw effect due to the year-by-year comparison of the required Formulary Minimum and the company's Actual Investment Income. Under current law, in any taxable year, a foreign insurance company is subject to tax on *the greater of* Actual Investment Income and Formulary Minimum, with the Formulary Minimum being calculated using domestic company financial statement data from 2-years previous to the current year. This "greater of" approach will result in the foreign insurance company being subject to tax on net investment income greater than either it or a representative domestic insurance company earns over any measured period of time.

For example, if foreign company investment yields over time are identical to domestic company investment yields during the same period but differ on a year-by-year basis, the foreign company will be subject to tax on a greater cumulative yield over the period than either it or the representative domestic companies earned during that period.[9] This results from the "greater of" approach of section 842(b) exacerbated by the 2-year lag and data collection problems. Small differences in required surplus and investment yield can create large distortions in the calculated Formulary Minimum under section 842(b). This distortive impact can create a U.S. tax liability for a foreign insurance company that exceeds its actual U.S. net effectively connected income.

Current section 842(d)(2) provides that Treasury shall issue regulations on this issue. If an appropriate carryover account were provided for in these regulations, the magnitude of the distortion inherent in section 842(b) would be at least somewhat reduced.[10]

II. PROPOSED CHANGES TO SECTION 842(b)

The correction of section 842(b) by HR 1178 would not change the fundamental goal of section 842(b), but would correct some of the technical problems, distortions and inequities in the current law. HR 1178:

(1) requires that the Domestic Asset/Liability Percentage and the Domestic Net Investment Yield be calculated using <u>same year</u> data, with such data being tax return data to the extent possible, and

(2) establishes an appropriate carryover account to ensure the payment of tax on the greater of cumulative Formulary Minimum or cumulative Actual Investment Income as opposed to the greater of Formulary Minimum or Actual Investment Income on a year-by-year basis.

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[9]A simple example shows the "heads I win, tails you lose" approach of section 842(b):

	Actual Yield of Foreign Company	Average Domestic Investment Yield	Yield Under "Greater of" Approach
Y_1	4	6	6
Y_2	6	4	6
	10	10	12

In this example (which ignores the 2-year lag), the foreign insurance company will be taxed on $6 in both year 1 and year 2 despite the fact that the company's actual income over the Y_1 - Y_2 period is the same as the total domestic average over the period.

Thus, because of the "greater of" aspect of section 842(b), the foreign insurance company will be taxed on $12 of taxable income over the Y_1 - Y_2 period when it actually earned $10 which is exactly the same as the domestic insurance company average yield for the same period. This is another example of the discrimination inherent in the operation of section 842(b). Needless to say, the discrimination resulting from the "greater of" approach is further exacerbated by the 2-year lag.

[10]No regulations have been issued by the IRS under section 842(b). Some guidance was provided by the IRS in Notice 89-96 but the Notice provided no guidance with respect to "relief mechanisms" in section 842(d).

HR 1178 clarifies that the foreign company will be subject to tax over the cumulative period on the greater of what it actually earns over that period and what the average domestic company earns over that same period. The carryover account would keep track, on a yearly basis, of the cumulative difference between Actual Investment Income and Formulary Minimum Investment Income.

Mechanically, under HR 1178, a company would pay U.S. tax in the current year based upon Actual Investment Income. Subsequently, after Treasury has calculated the domestic averages for that prior taxable year, then the foreign insurance company would compute and compare the cumulative Formulary Minimum to cumulative Actual Investment Income. If the cumulative Formulary Minimum exceeds cumulative Actual Investment Income, then the company would pay tax on the amount of any shortfall. Interest would also be charged on any underpayment resulting from the adjustment.

A carryover account is needed even though the amending legislation eliminates the use of 2-year old data. The carryover account is needed to account for year-to-year differences in trading practices, investment performance, portfolio mix, and differences in the timing of realization of capital gains and losses among insurance companies. These variations can result in significant year-to-year differences between the domestic company averages and the individual foreign company yields, even where the yields are identical on a cumulative basis over time.

It should be noted that even after enactment of the proposed changes to section 842(b) in HR 1178, the U.S. operations of foreign insurance companies will remain subject to a formulary minimum tax. The benchmark for imposing that tax will simply be made fairer, and less distorted.

III. SECTION 842(b) AND U.S. INCOME TAX TREATIES

The Conference Report to the 1987 Tax Act specifies that if section 842(b) is found to be in conflict with any existing U.S. Income Tax Treaty, section 842(b) is **NOT** intended to override the treaty. H.R. Rep. No. 100-495, 100th Cong., 1st Sess., 983 (1987) (the 1987 Conference Report). The 1987 Conference Report states that "...the Treasury Department believes that the provision does not violate any treaty now in effect".[11] This position was reiterated in the testimony of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, June 22, 1993 (the 1993 Treasury Testimony).[12]

However, it is clear that in fact section 842(b) **DOES VIOLATE** U.S. income tax treaties in the following ways:

1. Most U.S. Income Tax Treaties include a non-discrimination article. The test for discrimination generally examines whether similarly situated domestic companies are subject to the same or a similar provision. No similar formulary minimum tax is imposed on domestic insurance companies. Domestic insurance companies pay tax only on their Actual Investment Income despite

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[11]The 1987 Conference Report states (in part): "The conferees understand, however, that the Treasury Department believes that the provision does not violate any treaty now in effect. In particular, the Treasury Department believes that the provision does not violate treaty requirements that foreign corporations be taxed only on profits derived from the assets or activities of a corporation's U.S. permanent establishment, that permanent establishments of foreign corporations be taxed only on profits the permanent establishments might be expected to make were they separate enterprises dealing independently with the foreign corporations of which they are a part, or that permanent establishments of foreign corporations be taxed in a manner no more burdensome than the manner in which domestic corporations in the same circumstances are taxed. The conferees similarly believe that this provision does not violate any treaty now in effect". See the 1987 Conference Report, 983. The issue of whether section 842(b) violates the Treaty is the subject of litigation before the U.S. Tax Court. See Northwest Life Assurance Company v. Commissioner, Docket No. 4694-94, U.S. Tax Court.

[12]This 1993 Treasury Testimony was provided at a June 22, 1993 hearing before the Select Revenue Measures Subcommittee of the House Ways & Means Committee. The 1993 Treasury Testimony states (in part) that "[w]hile the provisions of current law do not violate our treaty obligations, **we believe the proposed amendments [referring to HR 1178] could improve the operation of the statute.**" See 1993 Treasury Testimony, p. 8. [Emphasis added.]

the fact that, by the nature of averaging, most domestic insurance companies do not meet the section 842(b) minimums in every year.

2. Under most U.S. Income Tax Treaties, a foreign company pays tax based upon actual business profits. The section 842(b) formula fails to relate in any way to the actual profits of the foreign insurance company.

3. Even if a formula to impute income to a foreign insurance company were acceptable under U.S. income tax treaties, the distortions in current section 842(b) which were discussed previously produce clear evidence of the discrimination inherent in the current section.

It is also clear from recent statements by Assistant Secretary Samuels and Joseph Guttentag, International Tax Counsel, Treasury, that U.S. tax treaties prohibit the use of formulary methods.[13]

If domestic companies were subject to section 842(b), their tax burden would be **SIGNIFICANTLY** increased. For example, if section 842(b) had applied to Prudential Insurance Company of America ("Prudential") in 1988, the Subcommittee estimates that Prudential's 1988 Formulary Minimum would have exceeded its 1988 NAIC Annual Statement net investment income[14] by **$1.5 BILLION**. As a result, Prudential's 1988 taxable income would have been increased by $1.5 billion, which is an enormous amount given that its pre-tax net income as reported in its NAIC Annual Statement was only $1.4 billion! Similarly, for the fourteen (14) largest U.S. life insurance companies, their aggregate 1988 Formulary Minimum would have exceeded their NAIC Annual Statement net investment income by over **$8 BILLION**, compared to their aggregate reported pre-tax net income of $5.8 billion. This provides conclusive evidence of the discrimination inherent in section 842(b).

Thus, contrary to the Treasury view outlined in the 1987 Conference Report and the 1993 Treasury Testimony, section 842(b) imposes a distorted and plainly more costly and burdensome tax on the U.S. operations of foreign life insurance companies than is imposed on domestic insurance companies.[15] The section 842(b) minimum tax is imposed without regard to the actual surplus and investment income of the permanent establishment. Accordingly, section 842(b) would easily be found to violate the Business Profits and Non-Discrimination articles of U.S. Income Tax Treaties.

IV. WORLDWIDE YIELD ELECTION DOES NOT ELIMINATE TREATY VIOLATION

The provision in section 842(b)(4) which allows a company to elect to use its "worldwide net investment yield" in lieu of the Domestic Investment Yield in the calculation of the Formulary Minimum does not eliminate these treaty violations. The Subcommittee notes that if a company elects under section 842(b)(4) to use its own worldwide yield, the company must still calculate its minimum surplus using the 2-year old domestic asset/liability percentages. No domestic insurance company is required to calculate and pay tax on investment income based upon the 2-year old average surplus of other taxpayers.

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[13] For examples of the speeches by Samuels and Guttentag, see the remarks by Leslie B. Samuels at the 7th Annual International Tax Institute, George Washington University, December 16, 1994 (Samuels Remarks) and the remarks by Joseph H. Guttentag at the European-American Chamber of Commerce, Hotel Washington, January 10, 1995 (Guttentag Remarks). See also the reports of Samuels and Guttentag speeches: for example, *Tax Notes International*, January 23, 1995, pp. 297-98: *Daily Tax Report*, December 22, 1994, p. G-4.

[14] This calculation is based on the assumption that Prudential's NAIC Annual Statement net investment income is equal to its Actual Investment Income. This assumption is consistent with Treasury's calculation of the Domestic Investment Yield which is also based on NAIC investment income as opposed to tax return data.

[15] While domestic insurance companies are taxed on their worldwide income, they are eligible to deduct worldwide expenses and are eligible for foreign tax credits (which foreign companies are not). Domestic insurance companies are not subject to any U.S. formulary minimum taxes.

The underlying concept of section 842(b)(4) (i.e., that you can split the investment income and underwriting income of a life insurance company) is valid only if a company is operating in a single currency and in a single economy. Even then, the concept operates only theoretically and only based upon the use of an agreed-upon formula for calculating net investment income. Such an agreed-upon formula does not exist.

Such a theoretical splitting of investment income and underwriting income ignores the actuarial assumptions upon which life insurance is based. By failing to take into account the fact that investment income subsidizes underwriting income, any formula which utilizes the worldwide yield of a foreign insurance company to impute investment income to its U.S. operations will produce inflated results where the non-U.S. operations of the foreign insurance company have higher investment yields than the U.S. Because of the highly competitive nature of the financial services industry, higher investment yields dictate higher policyholder benefits. Higher yields earned on Canadian investments fund policies sold in Canada: similarly, U.S. yields fund U.S. policies. As a result, higher investment yields do not result in higher net profits for the insurance company. Consequently, it is unreasonable to expect that foreign insurance companies with operations in higher interest rate countries should have their worldwide investment yield applied to their U.S. operations without some adjustment for higher levels of policyholder payments. However, if deductions are taken for payments to worldwide policyholders, the result will no longer be worldwide "investment" income. Consequently, the required minimum investment income (calculated based on this adjusted "worldwide yield") will no longer be validly comparable with Actual U.S. Investment Income.

The Subcommittee has concluded that when an insurance company functions in multiple currencies and multiple economies, it is erroneous to assume you can apply a "worldwide current investment yield" to determine U.S. investment income. A numerical example may be helpful in illustrating this point.

Suppose Company C does business only in Canada and Company US does business only in the U.S. Both are of equal size and offer a single product, a deferred annuity contract with interest rates set annually during the deferral period and having sufficient mortality guarantees that the reserves under the contract would be life insurance reserves as defined by the Code. Both companies invest in government T-Bills. Assume Canadian Government 1 Year T-Bills were selling to produce a yield of 5.74%; on the same day, U.S. 1 Year T-Bills were selling to produce a yield of 3.4%.[16] [Note that these interest rates are the actual Canadian and U.S. T-Bill rates published in the Globe and Mail of Toronto, Ontario on June 6, 1993.] Based on these interest rates, and consistent with standard actuarial methodology, contracts would typically be "priced" as follows:

	Company C	Company US
Gross Interest Rate	5.74	3.40
Margin for Investment Expenses	0.20	0.20
Net Investment Yield	5.54	3.20
Administrative Expenses & Contingencies	1.00	1.00
Profit	0.25	0.25
Increase in Benefits Payable to Policyholders	4.29	1.95

The above pricing formula reflects the fact that both companies must be competitive in their own markets with domestic life insurance companies and with other financial

[16]Historically, spreads between Canadian yields and U.S. yields have been consistently similar to this rate differential. There is an economic correlation between investment yield and the stability of a nation's economy and the economic strength of its currency. Higher investment yields are required in those countries where the currency is regarded as weaker than the U.S. dollar and where the economy is regarded as less economically stable.

institutions. Since Canadian investment yields generally exceed U.S. investment yields,[17] to be competitive in Canada, Canadian multi-national insurers must offer Canadian policyholders market yields which are higher than yields offered to U.S. policyholders. [Note that yields paid to U.S. policyholders must also be market-competitive with yields paid by U.S. banks and insurance companies.] The fact that higher Canadian yields result in higher benefits to policyholders is reflected in the above example: the 2.34% differential in yields (5.74% - 3.40%) results in a 2.34% differential in benefits paid to policyholders (4.29% - 1.95%). Note that, because the competitive nature of the industry requires that competitive yields be paid to policyholders, both companies earn the same profit (0.25) despite the higher Canadian investment yields.

If each Company has $100,000,000 of assets and insurance liabilities, based on the pricing formulae above, their income statements would be as follows:

	Company C	Company US
Gross Investment Income	5,740,000	3,400,000
Benefits and Reserve Increase	4,290,000	1,950,000
Expenses - Investment	200,000	200,000
- Other	1,000,000	1,000,000
Profit	250,000	250,000

If Company C were to acquire Company US and merge the two, the "worldwide net investment yield", calculated under Notice 89-96, would be as follows:

$$\frac{5,740,000 + 3,400,000 - 200,000 - 200,000}{100,000,000 + 100,000,000} = 4.37\%$$

Assuming the section 842(b)(4) election was made to use worldwide yield, the U.S. taxable income of the U.S. branch of the merged company (ignoring currency differentials) would be as follows:[18]

Formulary Minimum Investment Income	4,370,000
Non-Investment Expense	1,000,000
Benefits & Reserve Increase	1,950,000
Taxable Income	1,420,000

In the above calculation, taxable income would be approximately **SIX TIMES** the real economic income of the U.S. branch, i.e., $250,000. In addition, U.S. taxable income would be almost **THREE TIMES THE TOTAL WORLDWIDE PROFITS** of the company, i.e., $500,000. This clearly demonstrates that the worldwide yield election does **NOT** eliminate the treaty problem. Instead, making the worldwide yield election distorts U.S. income since the higher Canadian yields are required to be paid over to Canadian policyholders in order to remain competitive in the Canadian insurance market. The use of the higher worldwide yield using Canadian yields which are properly attributed to policies sold in Canada and properly payable to Canadian policyholders causes the foreign based taxpayer to be taxed less favorably than the U.S. taxes a domestic insurance company.

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[17]Generally, Canadian investment yields closely parallel and almost always exceed U.S. investment yields. See Homer, S. and Sylla, R., A History of Interest Rates, 1991 and 1977, 495; see also Schwartzman, J.B., Forecasting Interest Rates. 1992, 123.

[18]This simplified calculation ignores the minimum surplus ratio requirements. Accordingly, minimum investment income has been calculated as follows:

$100 Million Branch Insurance Liabilities x 4.37% "Worldwide Yield"

As previously alluded to, the fact that the election to use worldwide yield under section 842(b) is not helpful (or even administrable[19]) relates to the role of interest in actuarial calculations and in the actuarial blending process basic to the underwriting operations of a life insurance company. Premium income is invested in income-producing assets and the earnings on these assets permit life insurance companies to "discount" premiums in advance in anticipation of such earnings. Premiums are invested while in the company's possession, and it is proper that the resultant interest earnings be regarded as one source of the funds available to pay claims. See Huebner & Black, Life Insurance, 1982, 318. Investment income, in effect, subsidizes underwriting income and is used to pay out underwriting expenses when policyholder claims are made. As noted above, Canadian policyholder benefits are higher because of higher Canadian yields and the requirement to produce such yields to be competitive in the Canadian market.

Given that Canadian yields consistently exceed U.S. yields, if a Canadian company elects to use worldwide yield, its non-U.S. policyholders will be forced to pay U.S. taxes by virtue of diminished payments to policyholders. Additionally, the insurance company will not be able to price its non-U.S. products competitively because a portion of the non-U.S. investment return will be inappropriately deemed by section 842(b) to be subject to U.S. taxation.

Thus, "worldwide current investment yield" as described in section 842(b)(4) and in Notice 89-96, is not consistent with the actuarial underpinnings of life insurance. To attempt to calculate a net yield, the calculation must adjust in some way for payments to policyholders which are effectively made out of gross investment income. Failure to do so will inflate "investment" yield. But doing so will mean that the result is no longer an "investment yield".

The Subcommittee submits that it is inappropriate to separate investment and underwriting income. An arbitrary separation can be achieved as long as the operations of the company are in a single economic system. But a multinational company must back its policies with investments which match the liabilities in each local currency and market.[20] Under these circumstances, it is extremely unreasonable to require a multinational operation to apply its own worldwide investment yield to determine its U.S. investment income. Accordingly, the election to use worldwide investment yield does **NOT** eliminate the existing treaty violation problem inherent in section 842(b).

V. CONCLUSION

Section 842(b) is plainly discriminatory. Taxation under section 842(b) as currently drafted represents bad tax policy which should be rectified on a retroactive basis. Retroactive correction is particularly important because of the magnitude of the impact of the 2-year lag in 1988. Since it is unlikely that the drafters intended section 842(b) to tax in such an unfair and discriminatory manner, the correction of section 842(b) should be viewed as a technical correction and should be made retroactive to the date section 842(b) became effective.

July 27, 1995

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[19]Since worldwide assets of foreign insurance companies are not maintained on a U.S. basis, worldwide assets would have to be valued on a U.S. tax basis. In addition, worldwide investment income would also have to be computed on a U.S. tax basis.

[20]Because of the currency exchange fluctuation risk, a well-managed insurance company needs to back its U.S. dollar liabilities with U.S. dollar assets. It would not back its U.S. dollar liabilities with non-U.S. dollar assets without hedging the currency exchange risk. The actuarial matching process requires the matching of assets and liabilities, both with respect to duration and currency.

STATEMENT OF THE AFFORDABLE HOUSING TAX CREDIT COALITION

CONCERNING LOW-INCOME HOUSING TAX CREDIT PROPOSALS

HEARINGS BEFORE

THE COMMITTEE ON WAYS AND MEANS

MISCELLANEOUS TAX PROPOSALS

JULY 11-13, 1995

Mr. Chairman and Members of the Committee, this statement is submitted for the record by the Affordable Housing Tax Credit Coalition concerning certain proposals with respect to the low-income housing tax credit (the "Credit") described in Section I.W.2. of the Joint Committee on Taxation Staff Description (JCS-19-95). We appreciate this opportunity to present this statement in conjunction with the Committee's hearings on miscellaneous tax proposals.

By way of background, the Coalition, a non-profit corporation founded in 1988 (under the name, "The Coalition to Preserve the Low Income Housing Tax Credit") is comprised of syndicators, lenders, investors, for-profit and non-profit developers and others concerned with the Credit. Its members are responsible for raising a substantial majority of the equity capital which is invested in affordable housing properties. The Coalition worked closely with this Committee and others to achieve permanent extension of the Credit in 1993. Since that time, the Coalition has continued to educate Members of Congress and the public at large on the successful use of the Credit in providing much needed housing to hundreds of thousands of Americans across the country. In addition to working closely with state housing credit agencies (including the National Council of State Housing Agencies) and the Internal Revenue Service on matters involving the administration of the program, the Coalition has drafted Standards of Professional Responsibility, which are ethical standards governing business dealings in Credit related transactions to which its members subscribe as a condition of membership.

The Coalition believes that the Credit program is working very successfully under current Code provisions. The Credit has provided the critical financing which since 1987 has made possible over 700,000 units of affordable housing. It has done so with virtually no federal bureaucracy in a cooperative partnership with state housing agencies, which oversee the award of Credits and the compliance monitoring responsibilities. Virtually all affordable rental housing and more than one-third of all apartment construction is financed with the Credit. In addition to the housing it provides, the Credit helps produce jobs in the construction, building products, appliance, real estate and other private sector industries.

Although the program is working well at present, certain of the pending proposals would make useful additions to Section 42 of the Internal Revenue Code of 1986. Our specific comments follow:

1) <u>Allow HOME funds to be used with the 91 percent Credit.</u>

In 1993, the Congress wisely allowed the use of the 70 percent Credit in conjunction with below market loans funded under the Department of Housing and Urban Development's HOME

program, provided that more stringent income targeting tests were met by the project owner. Unfortunately however, the legislation also prohibited the use of this provision for properties benefiting from the increase in eligible basis allowable in qualified census tracts and difficult development areas. The Coalition believes that this prohibition is unwise and should be repealed, as proposed.

Properties located in qualified census tracts and difficult development areas ("QCTs and DDAs") are, as the statutory designation denotes, the most difficult properties to develop from a financing perspective. Given the extremely low incomes encountered in such areas, rents must be kept low. However, operating expenses are often higher than other properties. In order to successfully finance the development and operational costs, owners must look to multiple sources of financing from a variety of federal, state and local agencies, which are under very tight budgetary constraints or which are completely unavailable. By prohibiting the higher Credit, a substantial source of private equity financing is denied. The result is that many worthwhile and critically needed difficult properties (many of which are located in inner cities) are made financially infeasible. As an alternative, some developers will choose to structure HOME loans with the applicable Federal rate of interest in order to maintain the higher eligible basis. However, the funds used to pay interest could have been expended on project and tenant-based improvements if this provision in the Code did not exist.

The Congress has already acted to preclude over-subsidization of properties. Since 1989, housing credit agencies have had responsibility to assure that no more Credit than is necessary is allocated to low-income properties. Moreover, under Section 212(f) of the National Affordable Housing Act, HOME participating jurisdictions must also make a similar determination with respect to HOME funds. By repealing the QCT and DDA prohibition with below market HOME loans, the Congress would simply be allowing housing credit agencies to determine on a case-by-case basis whether, in light of all sources of available financing, the higher Credit amount is necessary. The Congress has justifiably entrusted these agencies with this discretion in most other circumstances; there is no reason to deny them that ability in this case.

2) Expand community service area costs eligible for Credit.

Although we generally support this proposal, we do not understand why it would be restricted to properties located only in qualified census tracts. There appears to be no rationale for this distinction. Community service buildings may be just as integral to project success in a non-QCT. We suggest that the proposal be amended to delete this limitation.

3) Change State credit authority limitation stacking rule.

The Coalition endorses the statement submitted by the National Council of State Housing Agencies in support of this proposal.

4) Expand the Credit to lead paint removal.

The Coalition opposes this proposal. If enacted, this provision would, for the first time since Section 42 was authorized, ignore income targeting requirements at the property level and allow the Credit against expenses incurred in non-low-income units. We believe this idea sets an unjustified and unnecessary precedent, which has no apparent policy rationale. We would point out that lead paint removal can financed with the Credit as a rehabilitation expenditure under Section 42(e) of the Code, provided that the remaining provisions of Section 42 are satisfied.

5) Expand the Credit to certain cooperative housing.

The Coalition possesses inadequate information with respect to this proposal to comment on it.

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Thank you for this opportunity to submit our views. Should the Committee have any questions, please feel free to contact our counsel, Richard S. Goldstein, Esq., Peabody & Brown, (202) 973-7730.

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July 27, 1995

The Honorable William Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Re: Expand Credit for Lead Paint Removal

Dear Mr. Chairman:

The Community Preservation Corporation ("CPC") supports the proposal being considered by the Ways and Means Committee to expand the utility of the Low-Income Housing Tax Credit for lead paint remediation. CPC is a not-for-profit corporation organized and supported by 100 commercial banks, savings institutions and insurance companies. It has worked to create a one-stop shop for small property owners to receive their private financing and public support for certain types of rehabilitation projects. Based in New York City and operating throughout the State, CPC has lent over $1.3 billion of public and private funds for the building and renovation of over 41, 000 housing units since its founding in 1974 -- with virtually no losses.

It is estimated that several hundred thousand units of housing in New York State, primarily multifamily rental properties built prior to 1940, are in economic distress and experiencing substantial deterioration. Most of these properties, not surprisingly, are located in the State's low and moderate income communities. It represents simple common sense to intervene as early as possible with these buildings to prevent their further deterioration. If caught early enough, they can be saved at relatively low costs, using mainly private funds for a combination of economic restructuring and physical rehabilitation. If left to deteriorate, this housing is vastly more expensive to preserve, requires more public funds for operation and restoration, and adds to the social problems of the communities.

It is important to note that the proposal before the Committee does not in any way increase the cost of the Low-Income Housing Tax Credit, but attempts to provide some regulatory relief and flexibility to those property owners seeking to use the credit to assist in financing the cost of lead-based paint remediation. One significant compliance problem in occupied older buildings concerns whether and how an owner can get existing tenants, most of whom are presumably below the 60%-of-median income limit for the credit, to provide the

certifications and other information needed in order to establish project and unit eligibility. In some areas, owners report problems in getting tenants of existing buildings to make such certifications, particularly where regulated tenancies or long-term occupancy inhibit owners from requiring such a certification as a condition to further occupancy or lease renewal.

The proposal being considered by the Ways and Means Committee would allow the Low-Income Housing Tax Credit to be used without tenant income certification in a building if it (i) is located in a census tract where 70% of household incomes are at or below 50% of area median income, and (ii) requires lead paint remediation. This technical correction would allow building owners to rehabilitate low-income housing units without meeting the burdensome income certification requirement that often precludes the credit's use for lead paint remediation. CPC endorses the Committee's efforts to decrease the incidence of lead paint-related hazard in low-income housing areas through the adoption of an amendment that we believe will provide the necessary regulatory flexibility without increasing the overall costs of the Low-Income Housing Tax Credit.

The Lead-Based Paint Hazard Reduction and Financing Task Force, created by Congress in Title X of the Housing and Community Development Act of 1992, also endorses this proposal, as shown in the attached pages of their recently released report.

The Community Preservation Corporation is pleased to lend its support to the Committee in working toward enactment of this proposal. We greatly appreciate the opportunity to submit these views.

Respectfully,

Michael Lappin

Michael D. Lappin
President & CEO

PUTTING THE PIECES TOGETHER: Controlling Lead Hazards in the Nation's Housing

REPORT

Lead-Based Paint Hazard
Reduction and Financing Task Force

Federal Income Tax Credit. Federal income tax credits can provide incentives to owner-occupants to undertake lead-based paint hazard controls. Because the value of a credit does not appear until taxes are paid, credits are not financing tools per se. They are useful primarily to owners who have the means to finance needed hazard controls out-of-pocket and who can wait several months to be "rewarded" by a tax credit. Nevertheless, for owner-occupants with sufficient cash reserves or ability to borrow, the tax system could be used to stimulate investment in lead-based paint hazard control by offering income tax credits for qualified hazard control activities.

In order to restrict the potential cost of forgone tax revenues, tax credits should be targeted to households with incomes at or below 80 percent of area median income and to higher priority properties. Further, the maximum credit should be limited to the cost of lead-based paint hazard controls or $1,500, whichever is less, as is currently the practice in Massachusetts. In order to ensure that work is properly done, taxpayers claiming a credit would have to document that work was properly performed, repairs were made, and dust lead levels were within established limits after the work was completed.

Deductibility of Expenses for Rental Properties. In addition to offering tax credits, the tax system could also stimulate control of lead-based paint hazards through the way it treats the deductibility of lead-based paint hazard controls for rental properties. The U.S. Internal Revenue Service regulation under Section 162 provides that the cost of "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life" may be deducted as an expense. If lead-based paint hazard evaluation and control expenses could be treated as "incidental repairs" and deducted from current income, such activities would be encouraged. The tax benefit would be immediate, rather than treated as a capital improvement. This is consistent with the fact that lead hazard controls are not currently reflected in the market values of properties.

Low Income Housing Tax Credit (LIHTC). The LIHTC is a substantial federal subsidy that could be used by localities to control lead-based paint hazards. For rental housing, the existing LIHTC already helps pay for repairs and construction of low-income rental housing. In return for the credits, owners must make units available to low-income tenants and keep rents affordable for up to 40 years. However, because of certain technical requirements, the LIHTC is difficult to use to rehabilitate low-income, occupied properties—the very units that often contain lead-based paint hazards and threaten the health of children. While little doubt may exist that low-income households predominate in a building located in a low-income census tract, existing tax credit rules currently require income certification of every unit for which credit is claimed. Income certification may be difficult or impossible to obtain in an occupied building because of tenants' reluctance to volunteer to owners and managers information about their incomes.

In order to facilitate the use of the LIHTC for lead hazard control activities in occupied properties, the income certification provisions of the program could be adjusted. Rather than require initial income certification of each unit, state housing agencies that allocate the tax credit could be permitted, but not required, to approve credit for rehabilitation and lead hazard control in projects located in census tracts in which at least 70 percent of the households have incomes below 50 percent of the area median income. Property owners would still be required to certify the income of new tenants and perform annual reviews of income eligibility of all households. In addition to other rehabilitation activities, properties receiving credits under these rules would carry out an approved Lead Hazard Control Plan as part of their renovation activities that disturb lead-based paint. The administering state agency would determine the portion, if any, of the state's tax credit allocation to make available under the special rules.

Recommendation 5-9:

Using the Federal Tax Code to Finance Hazard Control. The Task Force recommends use of the federal tax system to encourage investment in lead-based paint hazard control:

- ***Congress should create a federal income tax credit for lead-based paint hazard evaluation and control activities for lower income, owner-occupied properties.***
- ***The Internal Revenue Service should confirm that all activities relating to keeping pre-1978 housing units free from lead-based paint hazards be considered deductible expenses in rental housing, pursuant to relevant tax law.***
- ***The income certification requirements of the Low Income Housing Tax Credit should be revised to make it easier to use tax credits for occupied rental properties. Owners should be allowed to presume that the percentage of low-income tenants in a building is the same as the percentage in the census tract. To qualify for this presumption and avoid initial income certification, the building must be located in a census tract where at least 70 percent or more of the households are below 50 percent of area median income and lead hazard control is being performed as part of the rehabilitation plan.***

5.3 A TRUST FUND FOR CONTROLLING LEAD HAZARDS

The National Health and Nutrition Examination Survey (NHANES III) clearly establishes that the risk of lead poisoning disproportionately affects lower income and minority children living in central cities. Many of these children live in low-rent housing where the property owner cannot afford to control lead hazards. Others live in homes their parents own but cannot afford to repair. Thus, lead-based paint hazards in low-rent and low-value housing will not be substantially reduced unless sufficient amounts of public funds are dedicated to evaluating and controlling hazards in this housing.

This same housing often needs rehabilitation for other reasons as well: heating and plumbing systems need replacement; new roofs are required; electrical wiring needs repair. While existing federal, state, and local housing resources can be used for lead-based paint hazard control, lead-based paint hazard work should not be forced to compete with funds for other essential housing rehabilitation. Since the net result of such competition would be an overall reduction in the number of units that can be effectively repaired, alternative resources are needed.

To effectively control lead-based paint hazards in housing units with both extensive lead-based paint hazards and economic distress, Congress should establish a dedicated source of ongoing funds. Realistically, only an approach of this nature will deal with the most urgent hazards: those in privately owned, unsubsidized housing that is financially distressed. The funding source should be capable of generating one billion dollars per year for the next ten years—a sum sufficient to control lead-based paint hazards in the nation's high-risk, deteriorated, least financially solvent housing. Assuming an average cost of $7,500 per unit loan or grant for lead-based paint hazard evaluation and control in deteriorated low- income housing, a one billion dollar fund could treat 133,000 units per year, or 1.3 million units over ten years.

The Task Force recommends that trust fund revenues be allocated by a need-based formula to state and local governments for investments in lead-based paint hazard evaluation and control. State and local governments should be given maximum flexibility to use the funds, establishing their own financing mechanisms and operating procedures. However, the Federal Government, in order to achieve national objectives, should establish strong targeting requirements for investment of funds.

STATEMENT OF NATIONAL COOPERATIVE BANK, NATIONAL COOPERATIVE BUSINESS ASSOCIATION, NATIONAL ASSOCIATION OF HOUSING COOPERATIVES, AND PEOPLE'S HOUSING

On behalf of the members of the NATIONAL COOPERATIVE BANK, the NATIONAL COOPERATIVE BUSINESS ASSOCIATION, the NATIONAL ASSOCIATION OF HOUSING COOPERATIVES and PEOPLE'S HOUSING, we appreciate the opportunity to submit this statement in support of the Ramstad/Rangel proposal to expand the low-income tax credit to cooperative housing.

The Low-Income Housing Tax Credit, created by Congress with the Tax Reform Act of 1986 is responsible for supporting the creation of more affordable housing than any other federal housing program. In fact, 94 percent of all multi-family low-income housing construction results from the tax credit. The importance of the credit has grown to such an extent that virtually all multi-family low-income housing production is driven by the credit.

The current use of the credit, while tremendously successful, only encourages rental housing production in this country. We support the modest change in the credit proposed by Congressmen Ramstad and Rangel that is viewed by low-income housing developers as strengthening the credit. That change is to allow its use for cooperative housing, which creates homeowners and stakeholders in communities that desperately need it.

Studies have shown that a cooperative is the most effective, affordable and safe form of ownership for low-income housing. A cooperative is a corporation which owns the property and in which residents own all of the shares. Cooperatives are an excellent vehicle for obtaining financing, which is extremely important to the start-up of low-income housing projects.

Homeownership is a key to community stability and growth and the use of the tax credit for cooperative housing would provide local housing developers the choice of producing either rental housing or homeownership. The National Association of Housing Cooperatives estimates that the extension of the credit to cooperatives would result in an additional 5,000-10,000 homeowners annually in communities that would greatly benefit from affordable homeownership opportunities. Urban planners and community development experts agree that homeownership promotes a sense of pride and responsibility by low-income owners. This results in lower operating costs, lower crime rates, and more stable communities, all of which are crucial to the ability of low-income individuals and families to move up the social and economic ladder.

Despite the ideal nature of the cooperative model for development of low-income housing, the LIHTC as currently drafted effectively bars the use of cooperatives as a low-income housing vehicle. Under current law, the tax credit goes to the "owner" of the property. This works well in ventures funded by limited partnerships, whose partners are treated as the property owners but does not work for cooperatives whose resident shareholders "own" the property.

The intent of the low-income tax credit is to provide a tax benefit to investors to encourage them to provide money to a low-income housing project. Low-income residents have no money to "invest." Even if they could, they have insufficient income to benefit from a non-refundable tax credit. And even if they did, the IRS position is that no credit is available for low-income cooperative housing under law. Although the law was amended in 1989 to allow "leasing cooperatives" where the tenants have a right to purchase the property at some time in the future, leasing cooperatives have proven cumbersome to lenders and too difficult to explain to tenants.

Communities should have a choice and the Ramstad/Rangel proposal allows that. Cooperatives offer an innovative choice for low-income housing developers and investors. Many non-profit developers have reported their support for seeking this change to strengthen their communities. For example People's Housing in Chicago has written of the need to a member of Congress:

> *The LIHTC has been extraordinarily successful for rental housing, but by excluding homeownership has limited our local choices for rebuilding communities. We want to use housing as a tool for creating local stakeholders. For example, the Rogers Park community in Chicago where I work has a population of 65,000 and 87 percent of the housing is rental. We don't need more rental housing. We need*

affordable homeownership options to increase community stability, reduce transiency in our school, and attract long-term owners. Yet, we cannot continue our successful cooperative development program because equity financing has literally dried up.

The Coordinating Council of Cooperatives in New York City, which represents hundreds of moderate-income cooperative residents also supports this proposal and has written to Congress:

The tax credit program was intended to stimulate the production of affordable housing. While it has been an effective tool for the production of rental housing, it has effectively excluded cooperative housing.

Cooperative housing, through numerous studies has been proven to be both more cost-effective and more satisfactory for the tenants. An Urban Institute Study (1994) showed cooperative housing produced under federally-subsidized programs to be financially more viable than other programs. In addition, a City College of New York study showed that operating costs were lower for cooperatives and that residents were more pleased with their housing. These are not surprising results to anyone familiar with co-op housing.

Co-ops anchor entire neightborhoods and we have plenty of proof of this right here in New York.

These are just a few who have written to Congress supporting the proposed change.

REVENUE NEUTRAL. The Ramstad/Rangel proposal is "revenue neutral." The amount of low-income housing credits available would not change; rather, the cooperative housing option will provide another use for the already budgeted funds.

U.S Department of Housing & Urban Development. Creating "ownership" is an unassailable positive long-term solution to the housing needs of low-income communities. In fact, the U.S. Department of Housing and Urban Development calls out for expanded use of the cooperative model in promoting homeownership opportunities in their recent "National Homeownership Strategy: Partners in the American Dream" announced at the White House in June of this year. Quoting from their document:

The partnership should seek to increase the availability of financing for cooperative housing both through the development of new cooperative housing and the conversion of existing rental housing to cooperative resident ownership.

Renters often become more involved in the quality and long-term viability of their homes when they become members of a cooperative. Although cooperative housing does not provide all of the ownership advantages available through fee-simple ownership, households can exercise much greater control over their living conditions than they can as tenants. Yet, lack of adequate public and private financing for cooperatives is a major impediment. In addition, enhanced awareness of the benefits of cooperative housing, particularly for low-and moderate-income households who cannot afford the costs associated with fee-simple ownership, must also be addressed before cooperative home ownership can be significantly increased.

DESCRIPTION OF PROPOSAL. The Ramstad/Rangel legislative proposal is accomplished with two basic principles guiding the proposal. First, the concepts underlying the current taxation of housing cooperatives found in Subchapter T of the tax code and in section 216 (involving the flow-through of taxes and interest to patrons (i.e. residents)) would not be changed. Second, an investment in a section 42 cooperative should be on an equal economic footing with an investment in a rental low-income housing project.

The proposal identifies a new type of entity, the "Section 42 Housing Cooperative" and amends the Internal Revenue Code to make the credit available. The amendment consists of adding a new section 216A which is patterned closely after existing section 216; amendments to section 42 are minimal. The Section 42 Housing Cooperative has two classes of shares: patron shares owned by residents of the building and non-patron shares owned by the tax credit equity investor.

The low-income housing tax credit of section 42 would flow through to the owner or owners of the non-patron shares; it is expected that all other tax benefits, such as interest and real estate taxes, would likewise flow through to the non-patron shareholders. However, the proposal would allow for owners of patron shares to be treated in much the same way as tenant shareholders in existing section 216 housing cooperatives by permitting patron and non-patron shareholders to agree to allow all or a portion of the deductions for interest and real estate taxes to flow through to the patron shareholders.

The general rule of the proposal, and the expectation based on the current economics of tax credit financed projects, is that such tax benefits, along with the section 42 credit, would flow through in their entirety to the tax credit investor as in the traditional section 42 transaction. In other words, it is expected that only where the economics of a particular transaction would allow it and where the developers of a project believe that significant benefits could be derived from it, would the patron shareholders be allowed the deductions for interest and real estate taxes.

Cost: The proposal to extend low-income housing tax credits to housing cooperatives should not affect revenue in either a positive or negative fashion as the fixed pool of low-income housing tax credits available to each state will not be affected by the proposal.

Respectfully submitted by:

Charles E. Snyder
President & CEO
National Cooperative Bank

Terry Lewis
President
National Association of Housing Cooperatives

Russell Notar
President and CEO
National Cooperative Business Association

Donna Smithey
Executive Director
Peoples Housing
Chicago, Illinois

The National Cooperative Bank
The National Cooperative Bank (NCB) is a congressionally-chartered bank headquartered in Washington, D.C. NCB and its subsidiaries provide a broad array of financial services to the nation's cooperative business sector, creating economic growth and community development in urban and rural areas. NCB Development Corporation, the development finance affiliate of NCB, is among the top ten development banks in the country. It provides capital to start-up and existing cooperatives either directly or through developers and intermediary organizations.

National Association of Housing Cooperatives
The National Association of Housing Cooperatives (NAHC) is a national federation of housing cooperatives, professionals, organizations and individuals promoting the interests of cooperative housing communities. NAHC is the only national organization dedicated exclusively to the interests of housing cooperatives.

The National Cooperative Business Association

The National Cooperative Business Association (NCBA) is a national cross-industry membership and trade association representing cooperatives -- over 100 million Americans and 47,000 businesses ranging in size from small buying clubs to businesses included in the Fortune 500. Founded in 1916 and known for many years as the Cooperative League of the USA, NCBA's membership includes cooperative businesses in the fields of housing, health care, finance, insurance, child care, agricultural marketing and supply, rural utilities and consumer goods and services as well as association of cooperatives. NCBA represents cooperative before Congress and the federal agencies and promotes and supports cooperatives in the U.S. and overseas through training and technical assistance publications and programs.

Peoples Housing

Peoples Housing is a not-for-profit organization active in community development and creating urban health and prosperity in the Chicago area. Peoples Housing manages more than 400 units of low-income housing in 21 buildings.

WRITTEN STATEMENT OF CHRISTOPHER W. BRODY, ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION, BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES IN SUPPORT OF H.R. 747

Introduction

I am Christopher Brody, a member of the Board of Directors of the National Venture Capital Association and Chairman of its Committee on Taxes and Incentives. I am also a partner in Warburg, Pincus and Company, a venture capital firm. I am submitting this statement in support of H.R. 747, which would allow venture capitalists to deduct their investment expenses for purposes of determining alternative minimum tax ("AMT") liability.

H.R. 747 enjoys strong bipartisan support. It was introduced jointly by Congressmen Houghton and Rangel and is co-sponsored by numerous Committee members from both the Majority and the Minority. A provision substantially identical to H.R. 747 was included in H.R. 11 (the Revenue Act of 1992), which was passed by both Houses of Congress but was vetoed by President Bush. The provision was also included on a consensus list of "Prospective, Noncontroversial, and No- or Low-Cost Proposals" developed by the Joint Committee and approved by the Ways and Means Committee on July 8, 1992.

The enactment of H.R. 747 is of great importance to the venture capital industry. Under present law, venture capitalists can be taxed under the AMT on income substantially in excess of their economic income because they are denied deductions for the expenses they incur in structuring their investments. Venture capitalists commit substantial resources to these investments and incur expenses for consulting, accounting and other professional and support services that can be substantial in relation to their investment returns. Moreover, at the time such expenses are incurred, the potential for gain from the investment is entirely speculative. The mismeasurement of income that results from present law treatment can result in venture capitalists paying taxes on their investment capital gains at effective rates substantially in excess of 28 percent.

I. ROLE OF VENTURE CAPITAL:

I am a partner of Warburg, Pincus and Company and a member of the National Venture Capital Association's Board of Directors, and Chairman of its Tax Committee. I have been a full-time venture capitalist for more than twenty-five years, during which period our firm has provided long term equity capital to over two hundred businesses. Our firm has over one hundred employees dedicated to venture capital; over fifty of the employees are professionals, twenty-eight of whom are highly experienced partners in the firm.

The members of the National Venture Capital Association have invested in thousands of companies throughout the United States. We are often asked, "What is venture capital?" In its simplest definition, I believe that it is the process of providing both long term, patient, risk equity capital, with the substantial human resources of the venture capitalist working on an on-going basis with portfolio companies to help them achieve their goals. Venture capital portfolio companies are generally privately held at the outset,

although, in many instances, the companies to which we provide equity capital can be publicly traded.

Venture capital includes the following characteristics:

- We provide equity capital as long-term investors, *in partnership with management, in friendly transactions*.

- *We are actively involved*, not only in assembling and organizing capital in partnership form, and in making investments in portfolio companies, but in making a substantial commitment in human resources. We work closely with the management team, generally at the level of the board of directors and, while usually not involved with management on a day-to-day basis, are extremely active in reviewing strategy, key personnel decisions with respect to the senior management (personnel assessment, recruiting, and compensation), and key financing decisions, as well as identifying other important missing resources and helping obtain them. Sometimes we may serve as Chairman of the Board or Chairman of the Management Committee of our companies. The venture capitalist's commitment is always time intensive, whether the investment is successful or not.

- *We are not investment bankers, we do not take transaction fees, and we are only successful economically if our portfolio companies are successful*. Generally our capital is raised in partnership form, provided by limited partners, in a partnership which will make twenty to fifty investments over a four to six year period, providing diversification of risk as a result of being done in a portfolio fashion. The investments, when made, may be held as long as ten to twelve years (but more generally five to ten years).

Because venture capitalists make long term commitments, they may incur substantial expenses in connection with an investment before the investment achieves profitability. In many cases, profitability on an investment is never achieved. Thus, the disincentive produced by the AMT disallowance of deductions for investment expenses is particularly acute, because the venture capitalist knows for certain the expenses will be incurred, but can only speculate as to what future gains might be.

Although most of the funds in venture capital partnerships come from tax exempt sources, the partnerships are formed and managed by individuals who are subject to AMT. As a result, the disincentive arising from the AMT disallowance has a multiplier effect in reducing the funds available for venture capital. Conversely, the cost of correcting the problem is minimal in relation to the benefits that will be achieved in terms of encouraging the formation of venture capital partnerships and the attraction of additional equity investment to such partnerships and the underlying companies in which they invest.

II. THE PROBLEM:

Although the assemblage of funds for venture capital investing is exceptionally important for job creation, economic growth and America's international competitiveness, the disallowance of deductions for investment expenses under the AMT discourages this valuable activity. Current law essentially forces venture capitalists who are subject to AMT to run their business with after tax-dollars, while their gains are fully taxed.

At present, individuals who incur substantial state taxes and have substantial capital gain income in relation to ordinary income are generally taxed under the AMT instead of the regular tax. This occurs even though the maximum AMT rate and the maximum capital gain rate are both 28 percent, because deductions for state and local taxes and for investment expenses incurred to produce the capital gain are denied for purposes of determining the AMT.

Venture capitalists are allocated their proportionate share of the operating expenses of the limited partnerships of which they are general partners. These expenses include management fees, which are paid to a management company. They also include salaries for consultants and other professionals and support staff, legal and accounting services, office rent, computers and other equipment, travel, and other costs relating to not only the investigation of investment opportunities, but significant ongoing involvement with the portfolio companies after the investment has been made. These operating expenses are deductible under section 212 of the Internal Revenue Code to the extent they exceed 2 percent of adjusted gross income (the 2% floor). However, because section 212 deduction are considered miscellaneous itemized deductions, they are therefore not deductible for AMT purposes. Thus, for AMT purposes, even expenses in excess of the 2% floor are not deductible. The economic impact of this nondeductibility on a venture capitalist who must pay AMT can be extremely significant.

This is one of the rare circumstances in which the Tax Code permanently disallows a deduction for economic outlays. A venture capitalist who is subject to AMT effectively pays taxes on gross revenues, rather than net revenues (i.e., net of the expenses which were incurred in achieving the gross revenues). As a result, the effective rate on capital gains earned by venture capitalists can be well in excess of even ordinary federal income tax rates of 39.6 percent.

This problem is illustrated by the following example:

> If an investor has a $100,000 capital gain and a $30,000 investment expense (in excess of the 2% floor) incurred to produce the gain, the investor will be taxed on his $70,000 net gain under the regular tax and (assuming the maximum 28% rate applies), will pay $19,600 of tax. However, under the AMT, the investor is taxed at the 28% rate on the $100,000 gross gain, and must therefore pay $28,000 of tax. This translates to a 40 percent tax on the net gain earned from the investment.

The § 212 AMT problem tilts incentives away from venture capital to more passive, less value-added fund investing, such as mutual funds. The mutual fund industry received an exemption from the problem several years ago. The exemption enabled shareholders in publicly traded mutual funds to deduct their full share of investment expenses, including the first 2% of AGI, while H.R. 747 would only allow deduction for amounts in excess of the 2% floor.

Venture capital benefits public policy (through, for example, job creation), at least as much as mutual funds do. However, since 1987, while inflow to the venture capital industry has remained essentially flat at $3 billion to $4 billion per year, inflow to the mutual fund industry has grown from $74 billion to $280 billion per year.

III. THE LEGISLATIVE SOLUTION:

The § 212 AMT problem is unfair, inequitable, and probably unintended. Fortunately, there has never been any legislative opposition to fixing this inequity. The venture capital industry has supported legislation to allow a limited amount of investment expenses of partnerships as AMT deductions and, in 1992, legislation facilitating § 212 AMT deductions passed both the House and Senate without opposition as part of a larger tax bill, but was vetoed by President Bush for unrelated reasons.

The current proposed legislation is drafted to minimize the revenue consequences of solving the § 212 AMT problem. Under the bill, an individual could claim an AMT deduction for investment expenses from partnerships that exceed the 2% floor only to the extent of the individual's investment income from partnerships.

The legislation possesses strong bipartisan support in both Houses. In February 1995, Congressman Houghton and Congressman Rangel and their co-sponsors on the Ways and Means Committee, introduced H.R. 747 to address this problem. Since then, others have

joined the effort. Companion legislation will also be introduced in the Senate with prominent members of the Finance Committee and other Senators as co-sponsors. On November 7, 1994, Senators Dodd and Hatch, as part of a bi-partisan group of seventeen Senators, wrote to the Treasury Department requesting that this provision be addressed. On June 5, 1995, Senator Moynihan and Senator Hatch wrote all the Senators asking each one to be an original co-sponsor of companion legislation to H.R. 747, which they intend to introduce shortly.

Solving the § 212 AMT problem represents good tax policy because it corrects a mismeasurement of income, and good economic policy because it stimulates the formation of venture capital. It enjoys wide support both in the House and the Senate. Accordingly, Congress should act now to enact H.R. 747.

WRITTEN STATEMENT OF KENNETH W. GIDEON, WILLIAM J. WILKINS, AND TERRILL A. HYDE BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES IN SUPPORT OF H.R.747

This submission is made on behalf of the National Venture Capital Association and Warburg, Pincus and Company.

I. THE ALTERNATIVE MINIMUM TAX PROBLEM

The current operation of the alternative minimum tax ("AMT") presents two major problems for venture capitalists. First, the AMT mismeasures income and increases capital gains taxation of venture capitalists. Second, it subjects many venture capitalists who organize and manage venture capital funds to double taxation.

A. Mismeasurement of Income

The alternative minimum tax ("AMT") for individuals denies any deduction for investment expenses and other "miscellaneous itemized deductions," including deductions in excess of the 2-percent-of-adjusted-gross-income floor that applies under the regular tax. Individual investors and managing partners of venture capital funds are often subject to the AMT, through the interaction of the AMT's disallowance of deductions for high state income taxes and investment expenses. This causes capital gains generated by their venture capital partnerships to be taxed at effective rates in excess of 28 percent. Any individual in this position will be subject to tax on gross income (rather than net income) from his or her venture capital investments. This increases the investor's effective rate on net gain and other net income from the partnership.

For example, if there is a $100 capital gain and a $30 investment expense, a minimum tax of 28 percent, or $28, on the $100 gross gain is equal to a 40 percent tax on the $70 net gain.

B. Double Counting of Self-Charged Fees

As a consequence of the AMT disallowance, venture capitalists who organize and manage venture capital funds can also be double taxed under the AMT when they organize under a traditional venture capital structure.

A venture capitalist raises outside funding for venture capital partnerships, and provides services to those partnerships. Such a traditional financial arrangement is for the venture capital firm ("Venture Group") to receive a net profits interest in the venture capital partnership ("Investment Fund"). (Venture Group may also acquire limited partner interests for cash on the same terms as other investors.) In addition, either Venture Group or a service organization controlled by the same individuals ("Management Partnership") receives an annual management fee from the Investment Fund.

Under this arrangement, a portion of the annual management fee is in effect paid by the Venture Group when Venture Group and Management Partnership have significant overlaps in ownership. Management Partnership may make payments for services to individuals who are also partners in Venture Group, so that a substantial portion of those salaries are funded from the management fee paid by Investment Fund and borne in part by Venture Group. To the extent an individual venture capitalist earns income from Management Partnership that the same individual effectively pays through his indirect interest in Investment Fund, that income is "self-charged" in the sense that the same person who earns the fee, pays the fee. Failure to provide the individual venture capitalist with a deduction for the fee payment will result in double taxation: a dollar of investment income

that is used to pay a dollar of self-charged fee income will result in two dollars of income (one from Investment Fund and one from Management Partnership) unless the individual can claim the dollar deduction for the self-charged fee paid by Investment Partnership.

Because an individual venture capitalist may be subject to the AMT through the combination of high state and local income taxes and capital gains from successful venture capital investments, the individual will be double taxed on the self-charged portion of the annual fee because his or her investment expenses from the indirect interest in Investment Fund are denied under the AMT. This double tax effect, when combined with the disincentive arising from the disallowance of other expenses incurred in structuring investment partnerships (including the substantial payments for services to third parties), operates as a deterrent to the formation of traditional venture capital partnerships.

C. The Economic Effect of the AMT Problem

By mismeasuring the income of venture capital investors who are subject to the AMT and subjecting them to double taxation, the AMT problem discourages investment by these individuals in venture capital and other investments with significant investment expenses. It serves as a disincentive to venture capital investment at a time when there is a great need for investment in new and growing businesses, job creation, and increased productivity. The disincentive will either reduce overall investment activity or shift the activity to more passive forms, with less value added from active investigation and management (including shifting to mutual funds, which have obtained complete AMT and regular tax relief from investment expense limitations). The individual venture capitalists who are affected by the AMT are frequently the organizers and managers of investment capital, whose responses to tax disincentives are magnified many times over through the capital they raise and control.

II. TREASURY REPORT ON THE ALTERNATIVE MINIMUM TAX PROBLEM

The Treasury Department has recently completed a report that acknowledges these problems,[1] although it concludes that a change in current law is unnecessary. We disagree with the conclusion that a change in law is unneeded for several reasons.

A. Mismeasurement of Income

The Treasury Report acknowledges that the disallowance of investment expenses for AMT purposes results in a "mismeasurement of economic income."[2] The Report seeks to minimize the effect of this mismeasurement by suggesting that certain investment expenses may produce future income rather than current income, and that current deduction of such expenses would also produce a mismeasurement to the extent the expenses were more appropriately matched to future income.[3]

However, the introduction of the capitalization issue in this context is misplaced. First, disallowing the deduction of investment expenses is not the equivalent of capitalization. The disallowance represents a permanent loss of the deduction for AMT taxpayers: the expenses are never taken into account. In contrast, capitalized expenses are taken into account to offset gain on disposition of the asset.

Second, the Code already requires capitalization of expenses that produce future income. To the extent that existing capitalization requirements might be viewed as inadequate, the proposal seeks to avoid any mismatching of income and expense by limiting the deduction of

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[1]Treasury Department, Report on Section 212 Expenses and the Alternative Minimum Tax (19__) ("Treasury Report").

[2]Id. at 4.

[3]See id. at 3-4, 11.

partnership investment expenses to the amount of investment income earned from partnerships.

B. Effect on Investment

The Treasury Report acknowledges that the disallowance of the AMT deduction for investment expenses may cause investors to seek forms of investment other than venture capital funds and, to the extent it treats expenses differently if they are incurred by businesses than if they are incurred by investors, may decrease investment productivity by depriving businesses of the managerial skills of venture capitalists.[4] The Report notes that individual investors and overall investment in the economy may not be disadvantaged by the disallowance, however, to the extent investment alternatives are available that are not affected by the disallowance.[5]

This argument is not responsive to the venture capital industry's concern -- which prompted Congress' request for the Report -- that the disallowance of investment expenses produces a disincentive for individuals to invest in the venture capital industry. The Report should have compared long-term investments with and without the investment expense disallowance rather than comparing capital gain investments with ordinary income investments.

In addition, although acknowledging the role of individuals as fund managers, the Report does not address whether the disincentive to individuals caused by the AMT disallowance decreases amounts invested by institutional investors by discouraging formation of new funds or decreasing the size of such funds.

C. Qualifying Small Business Stock Exclusion

The Treasury Report acknowledges that the disallowance of investment expenses under the AMT "can offset some of the tax advantage of investing in qualifying small businesses."[6] The Report counters, however, by pointing out that investments in qualifying small business stock are still advantageous for individuals with disallowed investment expenses, except in situations in which the small business exclusion moves an individual with a large amount of otherwise deductible investment expenses into the AMT.[7]

Again, this argument is not responsive to the venture capital industry's concern that the AMT disallowance deflects individual investment away from venture capital into other investments that derive the full benefit from the exclusion. In addition, it does not take into account that investors cannot be assured, at the time they make their investment decisions, of either the profitability of their investment or the availability of the qualifying small business exclusion due to uncertainty as to whether the 60-month holding period requirement will be satisfied and whether the exclusion will be repealed before the end of the 60-month period.

D. Effect on Venture Capital

The Report concludes that the disallowance of investment expenses under the AMT has "little effect on venture capital" because, based on the National Venture Capital Association's own numbers, only 11% to 13% of the total capital invested in venture capital funds comes from individuals (the only category of taxpayer subject to the disallowance).[8]

As noted above, however, the Report does not consider the effect of the disallowance on venture capitalists who organize and direct funds or whether it provides a

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[4]Id. at 5-6.

[5]Id. at 11.

[6]Id. at 6.

[7]Id.

[8]Id. at 10.

disincentive to the organization of new funds or decreases the size of such funds.

Moreover, to the extent the disallowance operates as a disincentive to individuals to organize new funds or causes them to limit the size of funds, it has a multiplier effect because most of the capital invested in such funds is obtained from institutional investors who are not subject to the disallowance.

E. The Treasury Report's Conclusions

The Treasury Report finds no compelling need to revise the current law treatment of investment expenses for AMT purposes because the treatment "does not appear to have substantial economic impact, and in light of the continued need for budget restraint."[9] The Report also states that if the treatment of investment expenses were reformed, the Treasury would prefer an option that limits deductibility to an individual's investment income but that provides relief to all individuals, not just partnership investors.

First, it must be emphasized that most venture capital investment is through partnerships. Thus, a provision targeted to partnerships would benefit the venture capital industry as a whole. Venture capital partnerships have high value added through the extremely active involvement of the venture capitalists with their portfolio companies, not only in the due diligence pre-investment stage, but also on an ongoing basis in working with portfolio companies to help them achieve their objectives. A venture capital partnership will incur substantial expenses including salary for professionals and support staff, office rent, computers and other equipment, travel, legal and accounting services, utilities, and other costs relating to management and investigation of investment opportunities. While these venture capital partnerships offer investors higher potential returns than are available from passive investments, the expenses of earning these returns are high as well. The venture capital industry has been willing to limit its proposed solution to the partnership area, and to limit relief to expenses exceeding 2 percent of adjusted gross income, because such limitations provide the most effective relief for the least revenue cost. Moreover, the problem is most acute for managing partners of venture capital partnerships, who are effectively taxed twice on the part of their compensation they earn as managers and pay to themselves (but cannot deduct) as partners.

Second, while the Treasury Report withholds support for changing current law based on revenue concerns, the venture capital industry has always supported enactment of its proposal on a deficit-neutral basis.

Although the proposal to extend relief to individuals who make direct investments as well as those who invest through partnerships is a sympathetic one, such an extension would substantially increase revenue costs, making enactment of legislation unlikely. A partial solution might be to extend the relief to all flow through entities since data included in the Treasury Report show that inclusion of S corporations may not increase revenue costs significantly. Finally, enacting a partial solution that produces much needed relief to the venture capital industry is preferable to waiting until a global solution can be achieved when the benefits of the global solution are not as readily identifiable.

III. PROPOSED SOLUTION

The venture capital industry has supported legislation to allow a limited amount of investment expenses of partnerships as AMT deductions. This measure has enjoyed strong bipartisan support in both Houses, and was passed by Congress in 1992. Unfortunately, it was part of a larger tax bill that was vetoed by President Bush.

Under the current proposed legislation, an individual could claim an AMT deduction for investment expenses from partnerships that exceed a 2-percent-of-adjusted-gross-income floor, but only to the extent of investment income from partnerships. The proposed legislation

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[9] Id. at 12.

ameliorates the problems outlined above, and its enactment would promote sound tax policy by correcting a mismeasurement of income.

TESTIMONY OF PHILLIP MICHAEL WRIGHT
GEOTHERMAL ENERGY ASSOCIATION

Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to present this statement to you supporting alternative minimum tax ("AMT") relief in general and specific legislation which would permit the renewable energy investment tax credits ("tax credits") presently available to businesses as offsets to their regular tax, to also be applied against the AMT.

Mr. Chairman and members of the Subcommittee, my name is Dr. Phillip Michael Wright, and I am President of the Geothermal Energy Association. I am presenting this statement on behalf of our Association, which is comprised of about 50 U.S. member companies that bring the benefits of clean, reliable geothermal energy to society. We focus on issues of interest to geothermal development and, of course, a major issue is the ability to utilize the tax credits for geothermal property which were, with your support and assistance, made permanent in the Energy Policy Act of 1992. It is therefore not surprising that we support legislation which would provide for application of the tax credits against the AMT, which is almost always triggered in the case of companies involved in geothermal development.

Prior to commenting with more specificity on AMT relief, however, I would like to put geothermal resources in perspective. Put succinctly, the geothermal resource has significant potential, is a secure energy source in our national energy strategy, is compatible with the environment and can enhance the tax base and create jobs through development.

The geothermal industry is comprised of more than 50, mostly small companies, headquartered in various states, including California, Colorado, Florida, Hawaii, Maryland, Nebraska, Nevada, New Jersey, New York, Oregon, Texas, and Utah. Direct employment is about 10,000 people in the U.S., and our indirect effect is a minimum of 20,000 other jobs. We generate a total of 2,280 megawatts of geothermal power, producing 17 billion kilowatt-hours/year, in four states -- California, Hawaii, Nevada, and Utah. States having excellent potential for near-term development of geothermal power include Alaska, Arizona, Idaho, Oregon, New Mexico, and Washington. Geothermal energy is the second largest grid-connected renewable electricity source, after hydropower. We generate 17 times more electricity than solar energy and 7 times more than wind energy. The power we produce in the United States displaces the emissions of 22 million tons of carbon dioxide, 200,000 tons of sulfur dioxide, 80,000 tons of nitrogen oxides, and 110,000 tons of particulate emissions (whose adverse health effects are becoming more widely known) per year compared with the production of the same amount of electricity from an average U.S. coal-fired plant (coal data from DOE/EIA-0348(90)).

All of this reflects the fact that geothermal energy is environmentally benign, a fact which is of particular importance in an era of global warming stemming from excessive carbon emissions and air pollution caused by other harmful pollutants being emitted into the atmosphere. A state-of-the-art flash steam geothermal plant emits a small percentage of pollutants discharged by fossil fuel plants and emits none of the pollutants causing smog and acid rain. Binary plants such as those operating in California and Nevada produce essentially no air emissions of any kind.

As we all know, significant regulatory changes are underway in the electric utility industry as a result of the Energy Policy Act of 1992 and other factors. Utilities and their customers are becoming ever more strongly motivated solely by short-term

economics. In addition, natural gas prices have been very low in recent years. Tradition, regulation, and subsidies have favored the use of fossil fuels for electric power generation in our country for decades.

All of this adds up to a stagnant domestic geothermal market. To compete in the domestic market, we need to lower our costs through enhanced technology. And there can be no greater assistance in this area than allowing companies to actually utilize the tax incentive you have granted them by permitting them to apply the tax credits against the AMT.

H.R. 1215 is an important step in reducing the negative impact of the AMT on business in general, and on the geothermal industry in particular. Under H.R. 1215, the AMT would be repealed for taxable years beginning after December 31, 2000. In the interim, the impact of the tax would be lessened, as business preference and adjustment items would generally cease to apply after December 31, 1995, the most important of which is a more favorable depreciation adjustment (effective March 13, 1995). Under H.R. 1215, changes in the computation of the AMT during the phase-out period would help move our industry toward parity with the oil and gas industries which, twice in the last five years, have received relief from the AMT in tax legislation.

Accordingly, we support the AMT provisions contained in H.R. 1215.

However, we strongly urge you to consider a small adjustment to the overall relief during the phase-out period which would permit the tax credits to be applied against not only the regular tax, but also the AMT. Such relief has been introduced, over the past five years, on a bipartisan basis and in both Houses.

Permitting the tax credits to be applied against both the regular tax and the AMT will enable renewable projects to compete with conventional fossil fuels in the bidding for new utility projects. And such successful bidding will help decrease our dependence on imported oil -- the largest component of our trade deficit. Moreover, new geothermal plants will create a larger local and state tax base and more jobs; if built on federal lands such projects will generate production royalties. Finally, keeping the domestic market viable could place our industry in an excellent position to compete for foreign projects, thus keeping the United States at the forefront of power projects around the world and enhancing our balance of payments.

The tax credits can be the single-most effective federal program to promote renewable energy, stimulating investments and enabling the technology to develop and improve, provided they can be fully utilized. We urge this Committee and the Congress to permit the tax credits to be applied against the AMT.

Thank you for permitting me to present the views of the Geothermal Energy Association.

STATEMENT BY THE COMMITTEE FOR INVESTOR FAIRNESS

IN SUPPORT OF THE PROPOSAL TO

PERMANENTLY EXTEND THE GRANDFATHER

FOR PUBLICLY TRADED PARTNERSHIPS

Hearings on Miscellaneous Tax Proposals
House Ways and Means Committee
July 11-12, 1995

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to present the views of the Coalition for Investor Fairness on H.R. 1686, a bill introduced by Congressman Houghton and 10 other members of the Ways and Means Committee to permanently extend the grandfather from IRC § 7704 for certain publicly traded partnerships (PTPs).[1/] We would like to thank Messrs. Houghton, Herger, Kleczka, Jacobs, Bunning, Crane, Shaw, Neal and McCrery, and Mrs. Dunn and Mrs. Kennelly, for their strong support for this proposal.

We believe the 10-year limit on the grandfather for existing PTPs was inappropriate and unnecessary given the purpose for which section 7704 was enacted. The 10-year limit has been hanging like a sword of Damocles over our companies, inhibiting our growth and diverting our resources to less productive uses. We urge the Ways and Means Committee to eliminate this threat before it can cause any more damage.

Description of the Issue

Section 7704, which was enacted as part of the Omnibus Budget Reconciliation Act of 1987, provides that certain publicly traded partnerships shall be taxed as corporations. Publicly traded partnerships -- also known as master limited partnerships -- are defined as partnerships the interests in which are traded on an established securities market or are readily tradable on a secondary market.

The 1987 Act completely exempted certain types of PTPs from the reach of section 7704. To be an exempt PTP, 90 percent or more of the partnership's gross income must be "qualifying income." Qualifying income is defined as income from sources such as timber, oil and gas, minerals and real estate. An exempt PTP need not have been in existence in 1987 when section 7704 was enacted. Thus, even today, new PTPs can be created so long as they meet the requirements of this "natural resources carve-out."

[1/]The Coalition for Investor Fairness is made up of the following PTPs:

Airlease, Ltd., San Francisco, California
Alliance Capital Management, L.P., New York, NY
American Restaurant Partners, Wichita, Kansas
Borden Chemicals and Plastics, L.P., Columbus, Ohio
Cedar Fair, L.P., Sandusky, Ohio
FFP Partners, L.P., Fort Worth, Texas
LAACO, Ltd., Los Angeles, California
New England Investment, Boston, Massachusetts
Oppenheimer Capital, L.P., New York, NY
Red Lion Hotels and Inns, Vancouver, Washington
Sun Distributors, L.P., Philadelphia, Pennsylvania

Those PTPs that were already in existence in 1987 but that did not fall within the natural resources carve-out received far less fair treatment. Even though they had already been created, and had thus relied on the law in effect at the time, these PTPs received only a 10-year exemption from section 7704. It is this grandfather -- set to expire at the end of 1997 -- that we seek to extend permanently.

History of Section 7704

Publicly traded partnerships first emerged in the early 1980s. PTPs are no different in structure or operation than any other limited partnership permitted by the Internal Revenue Code. What is different about them is that interests in the partnerships ("units") can be traded freely on a stock exchange or over the counter.

The proposal to tax publicly-traded partnerships as corporations had its origins soon thereafter -- at least as far back as 1983. In that year, the staff of the Senate Finance Committee issued a preliminary report on restructuring the corporate tax provisions of the Internal Revenue Code. In that report, the staff suggested that all publicly traded partnerships be taxed as corporations.[2/] This suggestion was not acted upon at that time. In fact, in its final report, the Finance staff backed away from its initial recommendation.[3/]

In 1984, the Treasury Department released its report to the President on tax reform ("Treasury I"). Treasury I included a proposal to tax as corporations those partnerships having more than 35 partners. That proposal was deleted from President Reagan's proposals to the Congress for tax reform ("Treasury II") and was not acted on by the Congress in 1986.

The most important point of this chronology is what did not happen: Congress and the Administration chose not to change the tax treatment of PTPs. Clearly, the signal being sent to the PTP community was one of stability and reliance on current law. It was not until 1987 that the issue surfaced again, in the politically-charged debate over Gramm-Rudman sequesters. This time, the proposal -- to tax as corporations all partnerships that are publicly traded, regardless of their size -- came from Treasury. Treasury had been called upon to submit a list of revenue raisers it would find acceptable.[4/] The list included the provision on PTPs. A similar proposal was included in the Joint Committee's 1987 pamphlet of possible revenue options.[5/]

[2/] See The Reform and Simplification of the Income Taxation of Corporations, Preliminary Report of the Staff of the Committee on Finance, United States Senate, S. Prt. 98-95, 98th Cong. 1st Sess.

[3/] See The Subchapter C Revision Act of 1985, Final Report of the Staff of the Committee on Finance, United States Senate, S. Prt. 99-47, 99th Cong. 1st Sess.

[4/] The Reagan Administration had previously opposed any tax increases as a means of forestalling a likely Gramm-Rudman sequester predicted to occur late in 1987. Acknowledgement by Treasury that any revenue raisers were acceptable virtually guaranteed their enactment.

[5/] Joint Committee Print JCS-17-87. With respect to the proposal, the pamphlet states: "The Administration has expressed support for this proposal." See page 192. The proposal described by Joint Committee would have provided "a grandfather rule for existing partnership capital." Id. No reference was made to any limitation on the duration of the grandfather provision.

The PTP provision was included in the House-passed version of the Omnibus Budget Reconciliation Act of 1987[6]; the Senate bill did not contain a comparable provision. In the House-passed bill, existing PTPs not subject to the natural resources carve out were grandfathered for 7 years. The conference report generally adopted the House provision (section 10211 of the report) but extended the grandfather for existed PTPs to 10 years.

Until the proposal from Treasury in 1987, there was never any indication that any attempt to tax PTPs as corporations would apply to PTPs already in existence. Such a notion would have been unimaginable and unprecedented. Traditionally, as will be discussed in greater detail below, Congress had been unwilling to apply sweeping changes in tax law retroactively. PTPs in existence in 1987 had every reason to expect that this tradition would be followed in their case as well. For reasons never clearly explained, Congress chose to deviate from historic patterns and limit the term of the PTP grandfather.

We ask that Congress reverse this unfortunate decision before it is allowed to take effect. While the effects of the 10-year limit cannot be completely undone -- its mere existence since 1987 has had serious economic consequences to the existing PTPs and their investors -- those effects are far less horrendous than the those that would flow from failure to extend the grandfather permanently.

<u>A Permanent Grandfather is an Appropriate Policy Result</u>

A permanent grandfather from section 7704 for existing PTPs is not only the fair result, it is appropriate as a matter of tax policy. The committee reports accompanying the 1987 Act discuss in detail the concerns underlying enactment of section 7704. Primarily, Congress and Treasury were concerned about "long-term erosion of the corporate tax base."[7] The House Report expresses the fear that changes made by the Tax Reform Act of 1986 made it increasingly attractive for businesses to convert to partnership form. To the extent they did so, the intent of Congress in enacting those changes in 1986 was being circumvented. There appears to have been no debate at all over whether limiting the grandfather to 10 years addressed this concern. We believe strongly it did not.

Enactment of section 7704 was intended to stop the trend toward formation of new PTPs by eliminating any incentive for their creation. Events have demonstrated clearly that section 7704 achieved its purpose completely. Except for newly-created exempt PTPs,[8] the snowball effect that had barely begun by 1987 has been stopped dead in its tracks.

In light of the complete success of section 7704, we maintain there was absolutely no policy reason to place a 10-year limit on the grandfather for existing PTPs. The movement toward use of PTPs was barely underway by 1987. At the time Treasury testified on the proposal on June 30, 1987, there were only 126 known PTPs, many of which were exempt PTPs; <u>i.e.</u> those with "qualifying income." These PTPs relied on the law -- permitting partnership treatment of PTPs -- in effect when they were created. No serious threat to the corporate tax base would have been presented had all these PTPs been grandfathered. Limiting the grandfather for existing PTPs has achieved absolutely nothing and was totally unnecessary.

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[6]Over the strong objections of Chairman Archer, among others.

[7]House Rpt. 100-391, 100th Cong., 1st Sess., pg. 1065.

[8]Section 7704 does not apply to even newly-created PTPs that meet the requirements of the natural resources carve-out.

It is virtually unheard of for Congress to sunset a grandfather provision such as this one. Generally, when Congress enacts a change that alters the entire scheme by which an entity is taxed,[9] Congress applies the provision prospectively only; the change is generally not applied to entities in existence that have relied on the law previously in effect.[10] Until recently, we were unaware of other situations in which Congress chose to limit the duration of transition relief. We found this lack of precedent to be indicative of the highly unusual nature of the limit on the PTP grandfather. Recently, however, we were told of a change made in the Tax Reform Act of 1969 where Congress limited the duration of the transition relief to 10 years.

In the 1969 Act, Congress enacted a series of limitations on the ability of private foundations to engage in transactions with certain related individuals. Among those new provisions was an excise tax on "self dealing." The provision included a grandfather, through December 31, 1979, for leases of office space from a disqualified person to a foundation where the terms of the lease were at least comparable to the terms of an arms-length arrangement.

Later, however, Congress reversed itself and permanently extended that 10-year grandfather provision for all grandfathered leases then in effect.[11] Thus, in the one situation of which we are aware that Congress limited the duration of a grandfather, Congress later reversed its decision and extended the grandfather permanently. We believe Congress should follow this precedent for PTPs.

There has been a great deal of concern expressed in recent years over the retroactive application of tax changes. This concern is fully justified; Congress should not play "gotcha" with the tax code. Unfortunately, this is what happened to existing PTPs in 1987. They all had relied on the law in effect before 1987 that fully blessed publicly traded partnerships only to find that the rug had been pulled out from under them. By all rights, PTPs had every reason to believe their reliance was justified, especially since there was no policy reason for Congress to apply the law retroactively (albeit with a 10 year delay). Permanent extension of the grandfather can restore the promise broken in 1987.

Extension of the Grandfather Creates No Competitive Advantage

We wish to address a concern that may be raised about permanent extension of the grandfather: that it might create an advantage for those PTPs vis-a-vis their competitors. The House Committee report accompanying its version of the 1987 Act expressed that concern, stating that the availability of publicly traded partnerships created "an unintended unfair competitive

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[9] In contrast with project specific transition rules. For example, most of the transition rules in the Tax Reform Act of 1986 relating to repeal of the investment tax credit and changes in depreciation were subject to a 5-year "placed in service" requirement. However, in situations such as this, it is appropriate for Congress to limit the availability of prior law with respect to particular projects since those projects cease at some point to be able to claim reliance on such prior law in their planning and development.

[10] See, for example, section 447(d),(h) and (i), relating to the use of the cash method of accounting by certain family farming corporations.

[11] In fact, the permanent extension was enacted retroactively (i.e. after the grandfather had already expired) in the Deadwood Tax Act of 1980, P.L. 96-608, 96th Cong., 2d Sess.

advantage."[12] This concern is based on the assumption that the partnership form of doing business is advantageous compared with corporations. We believe this concern has little bearing on whether the grandfather should be extended.

First, several of the grandfathered PTPs do not compete directly with other entities. For example, Cedar Fair operates amusement parks in three states: Ohio (Cedar Point), Minnesota (Valley Fair) and Pennsylvania (Dorney Park). These parks draw visitors on a regional basis. Cedar Fair does not compete against other parks in those regions. Other grandfathered PTPs (such as cable operators) are in a similar position. Thus, the notion that Cedar Fair (and others) gain a competitive advantage is simply false.

Even those PTPs that do compete directly with other companies would receive no benefit from the grandfather that is not justified. There is nothing inherently evil about partnerships or their use. Indeed, for many businesses, partnerships represent the preferred mode of operation. The Internal Revenue Code specifically authorizes the use of partnerships and places few restrictions on their availability.[13]

Thus, any competitive advantage that partnerships have over C corporations is one <u>endorsed</u> by the Internal Revenue Code. In addition, there are disadvantages inherent in partnerships -- especially publicly traded partnerships -- that do not exist for C corporations. For example, unit holders in partnerships most often expect that the partnership will distribute all or most of the partnership's net income to the partners. Corporate shareholders, on the other hand, have no such expectation. Also, publicly traded partnerships are not viable investment vehicles for corporate or tax exempt investors.[14] For both these reasons, PTPs have a substantially more difficult time raising capital in the marketplace. While these limitations are not enough to outweigh the benefits of doing business as a partnership, they do stand as a counterbalance to the argument that PTPs have an inherent advantage.

Moreover, any benefit that PTPs derive from doing business as partnerships would not translate into a meaningful advantage over their competitors.[15] The nature of the marketplace is such that PTPs in direct competition with C corporations will not undercut their competitors' prices. To the contrary, PTPs will price their products and services according to what the market will bear, based on the primary factors of supply and demand, name recognition, and location. These factors would not be affected by the tax status of the entity. Even if

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[12] <u>See</u> Ways and Means Report, <u>supra</u> note X, at Y.

[13] This can be contrasted with the Subchapter S corporations, which are subject to several different requirements.

[14] Because PTP distributions are not corporate dividends, they do not qualify for the corporate dividends received deduction available under IRC § 243. This generally makes PTP units unattractive to corporate investors vis-a-vis corporate stock. In addition, distributions from PTPs are treated as unrelated trade or business (UBIT) income for tax-exempt investors. This effectively prevents them from investing in PTPs.

[15] Some have argued that PTPs are not advantaged vis-a-vis corporations and may even be disadvantaged . Because PTPs generally pay out all their cash flow to investors, the net result is that they end up with no more cash than if they had paid corporate tax. Moreover, PTPs typically have no tax-exempt investors, since PTP distributions are treated as subject to the unrelated business income tax. They are, therefore, effectively shut off from what would otherwise be a significant source of capital. To many PTPs, this is a significant disadvantage.

the yield to PTP investors is higher than for corporate shareholders, the competitive advantage is probably so tenuous as to be of no consequence. Certainly, any advantages to the PTPs now subject to the grandfather would be far outweighed by the detriment to the PTPs from the eventual loss of the grandfather.

That is the essence of our argument. In 1987, Congress addressed its primary concern by prospective application of section 7704. Limiting the duration of the grandfather to 10 years provided no additional benefit in this regard. To the extent Congress assumed that limiting the duration of the grandfather to 10 years would address a perceived competitive advantage, its assumption was incorrect. Consequently, there is no justification, as a matter of policy, for limiting the grandfather to 10 years.

Extension of the Grandfather Would Correct a Serious Mistake

Permanent extension of the grandfather should not be considered special interest legislation merely because of the limited number of entities that affected by the grandfather. It is appropriate for Congress to consider the effect of its decisions on existing companies, just as it would have been had the issue first been raised in 1987. The issue is whether Congress, having made a decision regarding transition relief in 1987, made the appropriate decision. It is our contention that, for the reasons set forth in this testimony, Congress made the wrong choice, a choice that will work serious hardship for existing PTPs and their owners with no corresponding benefit to the government or the tax system. Our proposal merely asks Congress to rethink its decision before the decision takes effect.

H.R. 1686 does not change the overall policy with respect to publicly traded partnerships. For better or worse, that policy choice was made in 1987 and we seek no change in it now. Rather, our proposal seeks to change the effective date of that 1987 change. In effect, Congress made the provision retroactive with respect to existing PTPs. The question is whether such limited transition relief is appropriate for PTPs in existence when section 7704 was enacted.

Nor should the fact that the decision was initially made in 1987 preclude further consideration of the issue so long as the original decision has not yet taken effect. Congress is called on to make decisions about appropriate transition relief in virtually every tax bill. Indeed, these types of decisions are ones that are particularly suited for members to make, since they generally involve the balancing of competing interests rather than technicalities of tax law.

The proposal to make the 10-year grandfather permanent is unique only because it is separated in time from the initial legislation. On the other hand, the proposal is generic in scope, applying to any PTP fitting the criteria. Had Congress chosen to make the grandfather permanent in 1987, the appropriateness of the decision would never have been called into question. The question should not be characterized any differently now than it would have been then. The question is still whether it is appropriate to provide only limited transition relief for PTPs in existence when the 1987 law was enacted.

We recognize that Congress should generally be reticent about revisiting decisions regarding transition. On the other hand, Congress should retain the flexibility to reconsider decisions that are shown to be inappropriate. To do otherwise would be to promote finality at the expense of fallibility. This is a correction that Congress can and should make easily since it has not yet taken effect.

Reasons for a Permanent Grandfather

PTPs in existence before passage of the 1987 Act relied on the law in effect at the time they became PTPs. They did not take advantage of any loophole; the structure used for the PTPs does not vary significantly from that of other types of partnerships. They merely combined that basic limited partnership structure with improvements in computer technology that allowed them to maintain ownership records of publicly-traded units and the various tax characteristics of the partnership interests.

It was not unreasonable for these PTPs to have relied on the law in effect before passage of the 1987 Act. As previously discussed, until Treasury "offered up" section 7704 in 1987, there was never any official endorsement of a proposal to tax certain partnerships as corporations. Indeed, existing PTPs had every reason to believe that any change would not be applied retroactively.

Any organization that became a PTP before the 1987 Act was passed incurred significant costs and expended large amounts of time in that process. The steps to convert from a corporation to a PTP is a costly and time-consuming one. For example, one of the existing PTPs -- Red Lion Hotels and Inns -- began planning for its April, 1987 conversion in January, 1986. The conversion process involved consultation with investment bankers, appraisals of the assets of Red Lion, planning by corporate finance, securities and tax lawyers, multiple filings with the SEC and state securities agencies, proxy statements and shareholder votes, etc. This process would not have been started or completed had there been any reasonable prospect that a change in the tax law would have applied retroactively.

To make matters worse, many of these same costs will be incurred once again if the 10-year grandfather is not made permanent before 1998. From a practical standpoint, it will be completely unworkable for these organizations to remain partnerships at the same time they are taxed as corporations. The result would be mixing apples and oranges. Therefore, absent relief, many grandfathered PTPs will be forced to convert to corporate form on January 1, 1998. To do so, however, will require the same investment banking advice, appraisals, and attorney fees.

Over and beyond the effect on the PTP itself will be the effect on the PTP investors. One likely result from loss of the grandfather will be the decrease in the yield on PTP units and a corresponding decline in their value. The primary burden of this decline in value will fall on investors, most of whom are individuals rather than corporations or institutional investors. Thus, the group affected most adversely by loss of the grandfather will be individuals. Many of these individual unit holders are average, middle class taxpayers who have invested in PTP units because of their high yield. In turn, many of these investors purchased their units before the 1987 Act was passed and were caught unaware by the change in the tax law. For these investors, we again stress that fairness demands that the grandfather be extended permanently.

All of these burdens will be imposed on the existing PTPs without any corresponding policy objective being achieved. Making PTPs incur these costs would provide no benefit to the government but would work a severe hardship on the PTPs and their investors. On the other hand, permanent extension of the 10-year grandfather would avoid all of these problems, without any detrimental effect on the government or on overall tax policy. We believe the scales tip heavily in favor of permanent extension.

Timing of Permanent Extension

It is absolutely crucial that the grandfather be extended permanently in this tax bill. As indicated previously, the planning "window" for conversion to a corporation is a long one, generally one to two years. For many PTPs, preliminary planning has already begun. There will come a point at which extension of the grandfather will no longer be meaningful since many PTPs will have invested so much in planning for their conversion to corporations. That point is not yet upon us. At the same time, however, we urge you not to assume that this decision can be deferred until 1997 and 1998 and still provide fair treatment to existing PTPs.

In addition, PTP investors have become very nervous about the effect of this issue on the partnership interests they acquired in good faith before the law was changed. They deserve a prompt and fair answer from this Congress.

Conclusion

Congress would achieve no tax policy goal by retaining the 10-year grandfather. That goal was fully achieved by making section 7704 apply prospectively. Instead, all that would be accomplished by retaining the 10-year grandfather would be harm to these PTPs and their investors.

In conclusion I want to note the diversity of the PTPs that would be affected by permanent extension of the grandfather. The PTPs affected are involved in a wide variety of industries, from motels and restaurants to chemicals, financial advising, and macadamia nuts. Undoubtedly, these businesses operate in many districts represented by members of this Committee. And this does not even take into account the over 300,000 individual investors in these PTPs.

We urge this Committee and the House as a whole to approve a permanent extension of the grandfather for existing PTPs this year.

Thank you, Mr. Chairman.

Coalition of

Publicly
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TESTIMONY OF
THE COALITION OF PUBLICLY TRADED PARTNERSHIPS
SUBMITTED FOR THE WRITTEN RECORD OF
THE HOUSE COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISCELLANEOUS TAX BILLS
July 11-12, 1995

The Coalition of Publicly Traded Partnerships appreciates the opportunity provided by the Committee to offer these additional comments to the testimony we provided orally at the hearing on the issues which are of concern to its members. The Coalition is a trade association representing publicly traded partnerships (PTPs) and the accounting, law, and service firms that work with them.

The oral testimony delivered to the Committee by Letitia Chambers, President of the Coalition, at the July 12 hearing covered four legislative provisions which the publicly traded partnership community wishes to see enacted in the near future, including H.R. 1686, sponsored by Congressman Amo Houghton and nine other Committee members, which provides a permanent extension of partnership treatment for "grandfathered" PTPs not meeting the qualifying income test enacted in 1987. This statement will expand on that testimony with regard to the grandfather extension, which is the first priority of the Coalition in the 104th Congress.

Background

The current status of the "grandfathered" PTPs derives from section 10211 of the Omnibus Reconciliation Act of 1987 ("the 1987 Act"), which placed restrictions on the types of PTPs which could enjoy partnership status. These provisions were the result of concerns of the Committee leadership at the time that if no restrictions were placed on publicly traded partnerships, the corporate revenue base would be seriously eroded as corporations adopted the PTP form to avoid the corporate income tax.

The Coalition argued at the time that these fears were highly overblown, and still believes that to be true. In the first place, the repeal of the *General Utilities* doctrine in 1986 had ensured that there would be no further corporate conversions by making the tax consequences prohibitively expensive. In addition, the PTP form is suitable only to certain types of businesses, primarily those generating a substantial cash flow which is available for distribution to investors. The businesses themselves are in a better position than Congress to know whether a PTP makes economic sense. Nevertheless, the concern was strong enough to prompt the Ways and Means Committee, and ultimately Congress, to take action.

Section 10211 of the 1987 Act created section 7704 of the Internal Revenue Code, which states that a PTP will be accorded partnership tax status only if 90 percent of its gross income comes from specified sources (primarily natural resource and real estate activities). PTPs meeting the test, including those PTPs formed since the Act, can continue to operate indefinitely as partnerships. PTPs not meeting this test are taxed as corporations. Section 10211(c) provided a transition rule under which PTPs in existence at the time of enactment would retain their partnership status through December 31, 1997, regardless of whether they met the gross income test, as long as they did not enter a substantial new line of business.

At the time this legislation was enacted, there were about thirty-five PTPs with the "wrong" kinds of income. Since then, the number has been reduced as PTPs have been acquired by other companies, have reincorporated (for reasons unrelated to their grandfathered status), or for other

reasons have ceased to be traded partnerships. There are now twenty-seven grandfathered PTPs remaining (see attached list). They are in a variety of businesses, and have hundreds of thousands of employees and unitholders in states across the nation.

The Legislation

H.R. 1686 simply removes the 1997 sunset date from the transition rule and gives this small group of PTPs the option of continuing their partnership status as long as they wish. It does not change the substantive rule of section 7704, nor the restriction on entering new lines of business, nor in any way alter the policy of Congress with regard to the taxation of publicly traded partnerships. It simply maintains the status quo.

This legislation has solid bipartisan support. The ten cosponsors include six Republicans and four Democrats. In the 103rd Congress, the bill was also introduced with a bipartisan group of sponsors led by Representative Mike Andrews. On the Senate side, where the legislation was introduced in the 103rd Congress by Finance Committee Chairman Packwood, it will also be introduced by a bipartisan group of cosponsors.

Enactment of the Grandfather Extension is Appropriate and Fair

A permanent grandfather is appropriate tax policy.

It is a long established principle of tax policy that legislation changing the tax law should be prospective in application. This principle recognizes that it is unfair to penalize taxpayers which have entered into transactions in reliance on the tax law existing at the time. Thus tax legislation routinely provides taxpayers who have entered or made a binding commitment to a transaction before a certain date with a transition rule allowing them to continue using the tax law on which they had relied with regard to that transaction. It is also quite routine for such a transition rule to be indefinite in term, allowing the taxpayer the benefit of previous tax law until the contract or transaction to which it applies has run its natural course.

Thus, the ten-year transition rule which was given to PTPs that were already trading or in registration at the time of the 1987 Act was not a special benefit. What was unusual was the limited term of the transition rule. It would have been more usual for the existing PTPs to be grandfathered for as long as they continued to operate. The legislative history of the 1987 Act offers no policy justification for limiting the grandfather in this way

There is in fact no policy justification for requiring the grandfathered status of these PTPs to sunset at the end of 1997. The policy goal of the PTP provisions of the 1987 Act, to strictly limit the use of the PTP form in order to ensure that it was not used for large-scale evasion of the corporate income tax, was met by the establishment of the gross income test in section 7704. New PTPs can now be formed only by a few industries, and only a few new PTP issues come on the market each year. No more PTPs with nonqualifying income will be formed. The concerns about the growth of PTPs have been addressed.

Moreover, looking at the larger picture, allowing the grandfather to expire would result in exactly the type of government interference with business and capital formation that the 104th Congress is trying to reduce. These companies chose the business structure that they felt would work best for them and for their investors and made a sizeable investment in that structure. Their investors showed their faith in this decision by purchasing partnership units and providing the companies with hundreds of millions of dollars in new capital. The desire of these companies to continue in partnership form shows that the decision has worked. Why should Congress force these companies to abandon a structure that is working well for them and to incur enormous conversion costs in the process?

Failure to extend the grandfather will impose unnecessary costs on PTPs and investors.

There is thus no reason to force the few remaining grandfathered PTPs into an unwanted corporate conversion, and many reasons not to. If the grandfather is not extended, the affected PTPs cannot simply go about their business as partnerships through December 31, 1997 and then continue on as corporations on January 1, 1998. There is an extraordinary amount of planning and work involved in developing the "exit strategy" that will best meet the needs of the company, in shepherding investors through the conversion process, in doing all the things necessary to comply with securities law, and in anticipating and planning for the tax consequences. To the extent that the company is focused on these matters, it is not engaging in productive activities that could contribute to profit, employment, and growth. This is a loss both to the company itself and to the economy as a whole.

The forced conversion will impose enormous costs on the PTPs and their investors. For the PTPs the costs will include legal, accounting, and other service fees; staff time; and opportunity costs, as resources that could be more productively employed in furthering the business of the company are diverted to the conversion. The investors, predominantly middle class individuals who bought their units with no expectation that the nature of their investment would be greatly changed, face the tax consequences of the various steps in the conversion (depending on how it is structured, the conversion may trigger recapture of tax benefits, realization of gain, etc.), as well as a drop in the value of their units caused both by the market reaction to the forced conversion and the diversion of resources away from activities producing profit and growth. In fact, many grandfathered PTPs feel that the pending sunset date is already be affecting the price of PTP units and depriving their investors of value. In return for all this, the federal government would gain only $68 million in additional revenue between now and the year 2000, according to the Joint Committee on Taxation.

A permanent grandfather is fair.

Besides imposing a large amount of cost and effort on these companies for no particular reason, failing to extend the grandfather would be simply unfair. The affected PTPs, no less than those that happened to have "qualifying" income when the law changed in 1987, were formed in good faith (and after the expenditure of considerable time and expense) under a tax code that provided them with partnership tax treatment. Like the qualifying PTPs, they did nothing more or less than what the law allowed them to do. It is unfair to force them to convert because they were not sufficiently clairvoyant to know at the time they were formed that their business' income would fall on the wrong side of a qualifying line that would be imposed at some future date.

An issue that is sometimes raised in this connection is the fairness of the grandfather extension to other companies in the same industries as the grandfathered PTPs which cannot avail themselves of PTP status. It should be remembered that these other companies had exactly the same opportunity that the grandfathered PTPs did before the law changed in 1987. They, too, could have structured all or part of their operations in PTP form. Presumably they did not do so because they decided that this was not the option that best met the needs of their company. If that has changed, it is unfortunate that the tax law no longer allows them this option, but it is not unfair. Having passed up an opportunity of which others availed themselves is a very different thing from having incurred the costs involved in structuring or restructuring a business in reliance on existing law and then facing the prospect of having to restructure again because the law has changed.

Why the grandfather needs to be extended this year

There are a little over two years left before the grandfather provision sunsets. As discussed above, the conversion, if it must occur, will require extensive planning and preparation. Coalition members have indicated that a two-year lead time is not unusual when it comes to planning something on this scale. It is therefore essential that the matter be resolved now, rather than in the final months before the sunset date.

In addition, there are indications that the pending expiration of the grandfather is already depressing the market price of the units for these PTPs. Even PTPs that are not subject to the

grandfather may be affected, as many people may be under the belief that *all* PTPs will undergo a forced conversion at the end of 1997.[1] It is in the interest of the tens of thousands of middle class investors who own PTP units to remove this drag on the value of their investment.

Conclusion

In the overall scheme of the policy issues with which Congress must deal this year, the extension of the grandfather provision for twenty-seven publicly traded partnership is a very small matter. For the PTPs that are affected, however, it is an issue of enormous consequence, affecting every business decision that they will make for the next two years. The Coalition of Publicly Traded Partnerships strongly urges that H.R. 1686, Congressman Houghton's bill providing a permanent extension, be included in the Committee's next tax bill. The reasons for doing so are clear:

- A permanent grandfather is appropriate tax policy, and serves the larger goals of this Congress.

- Allowing the grandfather to sunset would impose substantial costs on the affected companies and their investors for no good policy reason.

- Allowing the grandfather to sunset would be unfair to the grandfathered PTPs and their investors, as it would penalize companies that chose their business structure on the basis of the tax law in existence at the time and those that backed that choice with their capital.

- Extending the grandfather this year will allow the affected PTPs to plan for the future and remove the shadow that the sunset has cast over their long-term business planning and the value of their units in the marketplace.

The Coalition appreciates the Committee's attention to this issue and stands ready to provide whatever information and assistance might be needed.

GRANDFATHERED PUBLICLY TRADED PARTNERSHIPS

Hotels and Motels

1. AIRCOA Hotel Partners -- Denver, Colorado
2. PSH Master I -- Dublin, Ohio
3. Red Lion Inns -- Vancouver, Washington

Investment Advisors

4. Alliance Capital Management, L.P. -- New York City
5. New England Investment Company -- Boston, Massachusetts
6. Oppenheimer Capital, L.P. -- New York City
7. Pacific Investment Management Co. -- Newport Beach, California; Stamford, Connecticut

Cable TV

8. Falcon Cable Systems -- Pasadena, California
9. Galaxy Cablevision, L.P. -- Sikeston, Missouri
10. Jones Intercable Investors, L.P. -- Englewood, Colorado

Health Care/Nursing Homes

11. Forum Retirement Partners -- Indianapolis, Indiana
12. Integrated Health Care Facilities -- Milwaukee, WI
13. National HealthCorp, L.P. -- Murfreesboro, Tennessee

Restaurants

14. American Restaurant Partners -- Wichita, Kansas
15. Perkins Family Restaurants -- Memphis, Tennessee

Leasing

16. Airlease, Ltd. -- San Francisco, California
17. PLM Equipment Growth Fund -- San Francisco, California

Others

18. Borden Chemicals and Plastics -- Geismar, Louisiana
19. Boston Celtics, L.P. -- Boston, Massachusetts
20. Cedar Fair, L.P. -- Sandusky, Ohio
21. FFP Partners, L.P. -- Fort Worth, Texas
22. Los Angeles Athletic Club -- Los Angeles, California
23. The Marina, L.P. -- Noblesville, Indiana
24. Mauna Loa Macadamia Partners, L.P. -- Honolulu, Hawaii
25. ServiceMaster, L.P. -- Downers Grove, Illinois
26. Sun Distributors, L.P. -- Philadelphia, Pennsylvania
27. TENERA, L.P. -- Berkeley, California

July 25, 1995

SERVICEMASTER LIMITED PARTNERSHIP

Statement to the House Committee on Ways and Means
in Support of H.R. 1686 and Related Legislation

On behalf of ServiceMaster Limited Partnership ("ServiceMaster"), we appreciate this opportunity to provide a statement to the House Committee on Ways and Means regarding the following three matters:

(1) H.R. 1686, a bill introduced by Congressman Houghton and co-sponsored by nine other members of the Committee, which would provide for permanent classification as partnerships for the 27 publicly traded partnerships ("PTPs") which are now facing the end of the ten-year grandfather period imposed on them by the Omnibus Reconciliation Act of 1987 (the "1987 Act");

(2) A bill which would provide for simplified reporting and audit systems for large partnerships (the "Simplification Bill"); and

(3) An amendment to the Simplification Bill which would enable mutual funds to own PTP units without risk of disqualification under the RIC rules.

INTRODUCTION

ServiceMaster is a limited partnership which was formed at the end of 1986 as the successor to ServiceMaster Industries Inc. Since January 1, 1987, ServiceMaster's units have been traded on the New York Stock Exchange (symbol: SVM) and are currently owned by some 65,000 persons who reside throughout the United States. At December 31, 1994, ServiceMaster had some 34,000 employees and managed an additional 143,000 employees for its management services customers.

Through its subsidiary companies, ServiceMaster provides: supportive management services to health care, educational facilities and commercial and industrial facilities; a variety of specialty services to homeowners and commercial facilities (lawn care through the TruGreen/ChemLawn company, termite and pest control services through the Terminix Company, disaster restoration and cleaning services through the ServiceMaster Residential and Commercial Services company, light housekeeping services through the Merry Maids company, and home warranty contracts through the American Home Shield company); a comprehensive array of services to nursing homes, assisted living and other long-term care facilities; and both management services and consumer services in international markets through joint ventures or ownership of foreign operating companies.

ServiceMaster's experience as a PTP has resulted in benefits to its customers, employees and shareholders and has increased tax revenues for the federal government. As will be discussed further below, during its eight years in partnership form, ServiceMaster has generated taxable income which has increased each year and which is considerably in excess of the taxable income which would have been generated if the company had remained in corporate form over the same period, and ServiceMaster has provided jobs which have increased in number each year. All of this has occurred, however, only after ServiceMaster's predecessor company and its stockholders incurred a large tax expense in order to make the conversion to partnership form. The unanticipated limitation on ServiceMaster's life as a partnership which was imposed by the 1987 Act came as a bad surprise, and eight years later it remains an element in the tax law which is unfair and unnecessary. It is our hope that the 104th Congress will enact the legislation which corrects this situation and enable ServiceMaster to continue the growth in taxable income and employment which has occurred since the enterprise was reorganized as a partnership.

H.R 1686

A. The Erroneous Basis on Which the 1987 Grandfather Rule was Enacted.

The legislative history of the 1987 Act makes it clear that in 1987 Congress was under the impression that PTPs constituted a threat of "long-term erosion of the corporate tax base." In fact, however, that concern, to the extent it was valid at all, had already been largely alleviated by the demise of the General Utilities doctrine in the Internal Revenue Code of 1986, which made it prohibitively expènsive to convert existing corporate entities to partnerships. To the extent that there remained any likelihood of eroding the corporate tax base by PTPs, the 1987 Act closed down that possibility on a prospective basis by the addition of section 7704, under which new PTPs (other than PTPs in the real estate, mineral and natural resources industries) would be treated as associations taxable as corporations.

These two changes in tax law -- the demise of the General Utilities doctrine and the prospective application of section 7704 -- took care of all legitimate concern over the corporate tax base as it might be affected by PTPs. Unfortunately, however, Congress moved beyond these two points to address those relatively few PTPs which were in existence at the end of 1987 and which were not in the real estate, mineral or natural resources industries.[1] As to those organizations, which included ServiceMaster, Congress decreed that they could remain taxable as partnerships for only the 10-year period ending December 31, 1997. This was both unnecessary and unfair. It was unnecessary because these PTPs did not threaten any erosion of the corporate tax base. It was unfair with respect to those partnerships such as ServiceMaster which had earlier converted to partnership form in reliance on then existing tax law and at a significant tax cost (see point "B" below).

In effect, the 10-year grandfather provision was a retroactive change in the law which was both unnecessary and adverse, even though the impact was deferred for 10 years.[2] H.R. 1686 offers Congress the opportunity to correct a mistake made in 1987 and undo the damage to ServiceMaster and the other PTPs affected by the grandfather provision of the 1987 Act.

B. The Unfairness of the 1987 Grandfather Rule in the Light of the "Toll Charge" Paid by ServiceMaster's Predecessor and its Stockholders.

We have noted that at the end of 1986 ServiceMaster Industries Inc. converted to partnership form. This conversion was accomplished by the transfer of the corporation's assets to the new limited partnership in exchange for the partnership's units followed by the distribution of those units in liquidation of the corporation. The tax consequences of these transactions were that the corporation paid taxes on depreciation recapture and as a result of certain accounting adjustments and, pursuant to Section 331 of the Code, the stockholders paid taxes on their respective gains as measured by the difference between the value of the partnership units received minus the basis of their corporate stock.

These taxes, which should be understood as a kind of "toll charge" in order to move from corporate form to partnership form, were very large. We have estimated that the combined entity level and stockholder level taxes came to over $70,000,000. However, stating the results in aggregate terms has the effect of disguising the tax impact of the conversion in individual

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[1]At the present time, the number of such PTPs is down to 27.

[2] The prospect of returning to corporate form has already had an impact on ServiceMaster's share price. Thus, it is not entirely accurate to say that the impact of the grandfather was deferred for ten years.

terms. There were many stockholders, including particularly employee-stockholders who had built their stock ownership up over many years of service with ServiceMaster, whose tax liability on account of the reorganization exceeded their entire 1986 cash income! [3]

These tax costs were incurred on the assumption that ServiceMaster would be taxed as a partnership for the indefinite future, an assumption which was warranted under then existing law. Regrettably, that assumption had a short life. A year later, the 10-year limitation on the partnership form was imposed by the 1987 Act. Obviously, a 10-year grandfather provision was better than a forced immediate return to corporate form, but the fact remains that neither ServiceMaster nor its shareholders deserved the treatment accorded them by the 1987 Act in the light of the tax cost (not to mention the legal and accounting expenses of the reorganization) which they bore as a result of the conversion to partnership form.

C. The Benefits Attributable to ServiceMaster's Organization as a Partnership From the Government's Perspective

Analyzing the benefits and detriments of classification of ServiceMaster as a partnership from the perspective of the company and its limited partners is, of course, one aspect of the argument for enacting H.R. 1686. It is not, however, the only way to view H.R. 1686. We are absolutely convinced that ServiceMaster's form of organization as a partnership has been, and will continue to be, a benefit from the perspective of Congress through an increase in tax revenue. Put another way, H.R. 1686 is legislation which is a "win-win" proposition for both business and the government.

Since the conversion to partnership form at the end of 1986, ServiceMaster has generated taxable income greatly in excess of the taxable income which would have occurred had ServiceMaster remained in corporate form. We make this statement based on the fact that as a partnership ServiceMaster has been not only able to pay a good distribution on its units but has been able to retain cash which has been used to grow ServiceMaster's business to a much larger extent than would have been possible had the company remained in corporate form. What this has meant, among other things, is that taxable income originating with ServiceMaster has been and will continue to be greater than would be the case if ServiceMaster were a corporation. The conclusion is drawn from the data and projections shown in Appendix A. Appendix A indicates that the total taxable income generated by ServiceMaster as a partnership over the period 1/1/87 to 12/31/97 exceeds the taxable income figure over the same period by ServiceMaster in corporate form by more than $293,000,000 (and that figure does not include the $296,000,000 in taxable income which was generated by the 1986 conversion from corporate form to partnership form).

The taxable income generated and to be generated by ServiceMaster as a partnership is dramatically greater than the taxable income which could reasonably be expected from the enterprise in corporate form over the years 1987 - 1997. It is this difference which leads us to conclude that the United States Treasury, as well as ServiceMaster's owners, have benefitted from the decision made by ServiceMaster in 1986 to convert to partnership form and that both sides will benefit from an extension of the grandfather provisions as provided by H.R. 1686.

D. Conversion Back to Corporate Form will Not Create any Material Revenue Gain for the Government

The foregoing analysis may be challenged by an argument that if ServiceMaster were to convert to corporate form at the end of 1997, the total tax payments made by the corporate

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[3] It should be noted that no cash was distributed in the liquidating distribution. Therefore, all shareholders had to cover the tax liability which originated with the liquidation distribution, which was some $40,000,000 in the aggregate, from their own resources. There were many shareholders who had to dispose of some or all of their investment in ServiceMaster and/or take out loans. Meanwhile, the Company had to borrow about $30,000,000 to pay its own conversion-related tax liability.

entity and by its stockholders would exceed the total tax payments which would be made by ServiceMaster's limited partners alone if ServiceMaster were to remain in partnership form. We submit that this argument, which is founded on the concept of double taxation of corporate income, is specious in ServiceMaster's case because it fails to take into account the predictable change in the mix of the company's stockholders if the company were to return to corporate form.

At the end of 1986, institutions comprised a significant part of ServiceMaster's shareholder base. After converting to partnership form, however, the number of ServiceMaster institutional owners declined such that at the end of 1994 institutions held only 13% of ServiceMaster's units. This differs markedly from the mix of shareholders for most S&P companies, where institutional ownership currently averages between 60% and 65%. If ServiceMaster were to return to corporate form, there is no reason to believe that over the course of time the percentage of ServiceMaster shares held by institutions would not move to the S&P 500 average.

This analysis has significant tax consequences. At the present time, a significant amount of ServiceMaster's taxable income is subject to tax at the top individual rates of 36% and 39.6%. In corporate form, ServiceMaster's taxable income would be taxed at the corporate rate of 35%. However, the second tax on dividend distributions would be relatively small, since (i) ServiceMaster would expect to distribute only a portion of its after-tax income, (ii) such distributions would not be taxable to the extent that the shares on which such distributions were made were held by tax-exempt entities and (iii) such tax-exempt shareholders can be expected to significantly increase in relation to non-exempt shareholders. Thus, the second round of taxation -- the so-called "double tax" -- emerges as an insignificant factor in considering the merits of H.R. 1686.

E. Economic Growth: the Ultimate Objective for Both ServiceMaster and the Government

As the foregoing data has shown, ServiceMaster's experience over the eight years in which it has operated in partnership form has been one of steady growth in revenue and net income. Not the least of the benefits emanating from this history is the creation of new jobs, increased and improved retirement benefits for ServiceMaster's employees, and an enlarging base of taxable income which is fully taxed at the shareholder level subject only to the peculiarities of an individual shareholder's tax position. It is fair to say that ServiceMaster has not only moved consistently with its own objectives but has also been a contributor to the national objectives of reducing the deficit and lessening reliance on social security.

The last point deserves a further and concluding comment. A recent article on the dollar and the deficit noted the contention that reducing the budget deficit means either curbing government spending or raising taxes. The writer took issue with this view:

> "But there is a third way: economic growth. By adopting policies that expand entrepreneurial opportunity and foster business growth, and at the same time restrain government spending, it is possible to generate higher revenues to help balance the budget."[4]

We submit that there is great wisdom in this view. We also submit that H.R. 1686 is consistent with this thinking. As ServiceMaster's post 1986 track record shows, the ability to operate in partnership form has generated significant economic benefits for the partnership and its owners and for the government alike. H.R. 1686 will permit these benefits to continue to accrue while, at the same time, correcting action taken in 1987 which was unnecessary and unfair. For these reasons, H.R. 1686 deserves favorable consideration by the Ways and Means Committee.

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[4] Shelton, "The Dollar and the Deficit", Wall Street Journal, July 13, 1995, page A10.

THE SIMPLIFICATION BILL

Although no bill is presently pending which incorporates the large partnership simplification provisions contained in earlier legislation,[5] the Ways and Means Committee invited testimony on this matter at the recent hearings on miscellaneous tax reform. ServiceMaster supports this legislation and urges the Ways and Means Committee to include simplification provisions in the legislation now under consideration.

In advocating the permanent extension of the grandfather provision of existing PTPs, ServiceMaster believes that it has a corollary responsibility to recognize the concerns of the Internal Revenue Service in regard to audits of large partnerships. The IRS has proposed a new audit system in which adjustments to taxable income determined after an entity-level audit can be added to, or subtracted from, the partnership's taxable income for the year in which the adjustment takes effect. This is a reasonable solution to a difficult problem, and in the interests of fairness on all sides of the table, we commend it to the Committee for further action.

Earlier versions of the large partnership simplification legislation also provided for a K-1 for use by large partnerships which would be much easier to integrate with the income tax returns of shareholders. While ServiceMaster is proud of its own efforts to makes its K-1 forms as simple as possible, the fact remains that the present K-1 form is intimidating to many investors, including particularly the small investor. Yet it is just this small investor for whom a PTP such as ServiceMaster should be an attractive investment.

In our view, large partnership simplification is an "idea whose time has come" and we hope that the Ways and Means Committee will make simplification a part of its 1995 miscellaneous tax reform package.

MUTUAL FUNDS

Finally, we urge the Committee to include, as part of the Simplification Bill, an amendment to the regulated investment company provisions under section 851 of the Code. These provisions require that mutual funds receive at least 90% of their gross income from specified sources. Gross income from an investment in a PTP does not qualify for inclusion in respect to the 90% requirement. Therefore, mutual funds are hesitant to invest in ServiceMaster's units for fear that the investment might cause the fund to have non-qualifying gross income of more than 10% of total gross income.

There is no policy reason for discouraging mutual funds from investing in ServiceMaster units. While one can argue that mutual funds ought not to take large positions in private partnerships, this argument has no relevance to a publicly traded partnership such as ServiceMaster, which is subject to the Securities Exchange Act of 1934 and which represents as appropriate an investment for a mutual fund as any other publicly traded security.

For these reasons, we urge the Committee to add to the Simplification Bill an amendment to section 851(b) of the Code which provides that income from publicly traded partnerships is to be considered as qualifying income for purposes of section 851.

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[5] Large partnership simplification rules were included in tax bills adopted in 1992 but which were vetoed by then President Bush. Large partnership simplification rules were included in the H.R. 3419, 103rd Cong., 2nd Session (The Tax Simplification and Technical Corrections Act of 1993), but this legislation was not adopted.

CONCLUSION

For the reasons set forth above, we urge the Ways and Means Committee to --

1. Recommend to the House the enactment of H.R. 1686;

2. Reintroduce a Simplification Bill along the lines of the previous bills on this subject; and

3. Include a provision in the Simplification Bill which would enable mutual funds safely to invest in units of PTPs.

We appreciate the opportunity to present this Statement to the Committee on Ways and Means and we thank the Committee for its consideration of our views.

C. WILLIAM POLLARD
Chairman
ServiceMaster Limited Partnership

CARLOS H. CANTU
President and Chief Executive Officer
ServiceMaster Limited Partnership

APPENDIX A

(Figures are in millions)

		1984	1985	1986											
1	Net income for the three years preceding conversion to partnership form	30.5	32.7	32.7											
2	Compound growth rate for these three years, using 1983 as the base year		8.5%												
3	Taxable income for the year 1986 (last year in corporate form)		54.3												
					1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
4	Corporate taxable income (pro forma) for the 11-year period from 1/1/87 to 12/31/97 based on the compound growth rate from line 2				58.9	63.9	69.4	75.3	81.6	88.6	96.1	104.3	113.2	122.8	133.2
5	Total taxable income (pro forma) as a corporation		1,007.3												
6	Actual partnership taxable income: 1987 – 1994 excluding unusual items (Note 1)				1987 10.8	1988 14.9	1989 16.5	1990 28.8	1991 50.4	1992 78.6	1993 104	1994 193.4			
7	Compound growth rate based on eight years in partnership form (Note 2)		17.2%												
8	Projected partnership taxable income: 1995 – 1997 based on the compound growth rate from line 7 with 1994												1995 226.7	1996 265.7	1997 311.3
9	Total partnership taxable income (totals from lines 6 and 8)		1,301.1												
10	EXCESS OF TOTAL TAXABLE INCOME AS A PARTNERSHIP OVER PRO FORMA TOTAL TAXABLE INCOME AS A CORPORATION OVER THE PERIOD 1/1/87 – 12/31/97 (LINE 9 MINUS LINE 5)		293.8												

Note 1 Taxable income in the early years of the partnership was decreased by depreciation and amortization deductions arising from the step-up in basis of the partnership's assets as a result of the 1986 conversion to partnership form. This step up in basis was, of course, a product of the reorganization being a taxable event. The taxable income generated by the reorganization itself was the corporation's tax divided by the corporate rate of 31% plus the shareholders tax divided by the capital rate of 20% (30,000,000/.31) + (40,000,000/.20) = 296,774,191
This figure should be added to line 10 to see the total difference in taxable income generated by ServiceMaster as a partnership compared to ServiceMaster as a corporation.

Note 2: An eight-year compound growth rate is used but the last few years would be more representative of the actual expected growth rate for the years 1995 – 1997 (which we believe will be in excess of 20%).

STATEMENT OF STEPHEN W. SCHLEY

CHAIRMAN

FOREST INDUSTRIES COUNCIL ON TAXATION

ON MISCELLANEOUS TAX PROPOSALS

SUBMITTED TO THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 11, 1995

My name is Stephen W. Schley. I am President of the firm of Pingree Associates, Inc. of Bangor, Maine. I am also the Chairman of the Forest Industries Council on Taxation, the national trade association which represents the forestry industry on all federal forestry tax issues. In addition, I am a member of the Board of Directors of the American Forest and Paper Association, the national trade association of the paper and forestry industry. I wish to thank you for providing me the opportunity to submit to the Committee this statement on legislation which is vitally important to tree growers throughout the nation, a proposal to modify the application of passive loss rules to timber activities. I am also submitting this statement on behalf of the thirty-two organizations listed on the attached page which have endorsed the proposal.

There are a multitude of benefits provided to society by sound forest management practices -- practices enhanced by a climate of fair taxation as owners manage for optimum productivity.

These practices serve to significantly enhance the overall environmental quality of our forests and their surrounding communities. Our professionally managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs and create aesthetic beauty.

In order to discourage investments in alleged "abusive" tax shelters, Congress enacted passive activity loss rules (Sec.469, I.R.C.) as part of the Tax Reform Act of 1986. Under these rules, if a taxpayer, owning an interest in a trade or business, does not "materially participate" in the business, limitations are imposed on the current deductibility of his or her share of the business losses.

The losses can only be currently offset against income from other trades or businesses in which the taxpayer also does not materially participate. However, the losses may eventually be offset against any gain realized when the taxpayer disposes of his or her entire interest in the business.

IRS regulations provide that taxpayers are treated as material participants if they can meet one of several tests. Each test requires that the taxpayer must devote a minimum number of hours to the business in order to qualify. The test which generally applies to small tree growers requires that the taxpayer devote at least 500 hours per year to the tree growing business. The other test generally applicable to tree farmers requires a minimum of 100 hours of personal work before the taxpayer can even hope to qualify and then only if other "appropriate facts and circumstances" are present.

We do not believe tree growers should be required to work 500 hours or 100 hours or any other arbitrarily determined number of hours to qualify as a "material participant".

A typical small timber owner normally performs all of the tasks and makes all of the decisions necessary to manage the tree-growing business while bearing all the risks of loss. Yet, managing a small tree farm typically does not require 500 hours per year of the owner's time, and in many cases, not even 100 hours per year. Thus, many owners simply cannot satisfy the artificial hourly requirements and become subject to the passive loss rules.

Efficient timber management requires periodic expenditures for activities such as thinning, disease control, and fire prevention notwithstanding the fact that there may be 15 to 25 or even 50 year intervals between tree harvests. Moreover, even in years when no direct management expenditures are incurred, indirect expenses such as property tax payments are required. With little or no income in the years between harvests, small timber owners' expenditures become passive losses deductible many, many years in the future, severely impacting the owners'already modest cash flow.

The unanticipated application of the passive activity loss anti-tax shelter rules to small tree growers has proven to be a deterrent to efficient timber practices in that owners are reluctant to make what is tantamount to annual nondeductible expenditures to manage and maintain their timberlands. There is no reason to apply the anti-tax shelter rules to small tree farmers. Timber growing is not a tax shelter. All expenditures represent hard currency outlays. Leveraging is unavailable because of the substantial amount of uninsurable risks. And, there are no current depreciation deductions.

We must create a self-sustaining resource of trees to ensure raw materials for timber workers' jobs as well as provide a continuing supply of reasonably affordable building materials for consumers. And it is increasingly obvious that our most reliable source could be the millions of acres of privately owned forest lands. Timber farming is a long-term, high-risk venture, subject to the vicissitudes of disease, fire and a highly unpredictable marketplace. In some regions, tree farmers must wait 75 years from the planting of a seedling to the harvest of a mature tree. These landowners suffered a severe setback with the enactment of the passive loss rules of the 1986 Tax Reform Act which, in many cases, ended their ability to deduct normal business expenses.

We believe the proposal under consideration by the Committee to correct the passive loss problem is needed to encourage more active management of existing private timberlands, and the growth of the private timber base.

This proposal clarifies when individual owners, or principals in partnerships, would be able to deduct normal operating expenses pertaining to management of their treelots. This would be achieved through a new set of "material participation" criteria correcting what we believe to be an unintended result of the 1986 reforms. This provision was included in H.R. 11 (102nd Cong.) which passed both Houses of Congress in 1992.

We commend Congressmen Wally Herger (R-CA) and Ron Wyden (D-OR) for developing this very important proposal and for their efforts in championing the cause of tree farmers throughout the nation.

LIST OF COSPONSORING ORGANIZATIONS FOR RTA

American Forest and Paper Association
Forest Industries Council on Taxation
Forest Farmers Association
Southern Forest Products Association
Southeastern Lumber Manufacturers Association
Maine Forest Products Council
Small Woodland Owners Association of Maine
Oklahoma Forestry Association
Arkansas Forestry Association
Southern State Foresters
Georgia Forestry Association
Louisiana Forestry Association
North Carolina Forestry Association
South Carolina Forestry Association
Mississippi Forestry Association
Texas Forestry Association
Virginia Forestry Association
American Pulpwood Association
National Association of State Foresters
Hardwood Manufacturing Association
National Hardwood Lumber Association
Hardwood Research Council
Hardwood Forest Foundation
Alabama Forestry Commission
Stewards of Family Farms, Ranches and Forests
The Wilderness Society
The National Woodland Owners Association
The Oregon Small Woodlands Association
The Washington Farm Forestry Association
1,000 Friends of Oregon
The Idaho Forest Owners Association
The Forest Landowners of California

Total: 32

Statement of James J. Hickey, Jr., President
The American Horse Council
on the
Proposal to Amend the Passive Loss Rules for Farming
Submitted to the
Committee on Ways & Means
U. S. House of Representatives
July 13, 1995

Introduction

The American Horse Council (AHC) appreciates the opportunity to submit this testimony on the proposal to modify the application of the passive loss rules to farming activities included in the miscellaneous tax reform proposals being reviewed by the Committee. The AHC represents the horse industry in the U.S. and includes 204 equine associations, representing over 1 million individual horsemen and women and all breeds and types of equine activities.

The horse industry has been adversely impacted by changes made in the Tax Reform Act of 1986. Tens of thousands of jobs have been lost at racetracks, horse shows and breeding farms around the country. Hundreds of breeding farms, many a source of pride for their entire state, have been closed.

These losses can be reversed by focusing the Internal Revenue Code to encourage investment, economic growth and new jobs. The Contract with America is intended to foster a climate that encourages investment and produces more jobs and more revenue to the federal, state and local governments. This proposal has the same intent.

The U.S. Horse Industry

The U.S. horse industry is a very diverse $15.2 billion industry that employs and supports hundreds of thousands of workers. Horse owners and breeders spend $13 billion in annual investment and maintenance costs on horses. $200 million worth of horses are exported each year, far more than are imported. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban growth.

Pari-mutuel horse racing is legal in 42 states and involves the racing of Thoroughbreds, Standardbreds, Quarter Horses, Arabians, Appaloosas and Paints. In 1993, over 57 million people attended the races, generating nearly $500 million in direct revenue to states from pari-mutuel taxes, track licenses, occupational licenses, admission taxes and miscellaneous fees.

Another 40 million people view equine sports each year at horse shows and rodeos. There are 7,000 sanctioned horse shows a year with thousands of local, unsanctioned additional shows. These shows contribute $200 million annually to our economy with rodeos contributing over $100 million. 27 million people over twelve ride each year, more than half on a regular basis.

The equine industry is very labor-intensive. Machines cannot be used to breed horses, train horses, feed horses and properly care for and exercise horses. Hundreds of thousands of people work full-time in the horse industry, including owners, trainers, grooms, jockeys, drivers and riders, veterinarians, instructors, van operators, racetrack employees or for supporting industry that depend on it. Many of these jobs involved unskilled or semi-skilled workers, who might be unemployable outside the horse industry.

In Kentucky, an economic impact study conducted by the University of Kentucky found that $5 billion can be attributed to the direct and indirect effects of the equine industry; $1.3 billion of wage and salary earnings is attributable to the industry; and 80,000 jobs are provided. The study also highlighted that the majority of people involved in breeding horses operate small, family-run farms, a fact that receives little attention. The number of people who are employed full-time in the horse business is always underestimated.

California's horse industry generates a total GNP of $2 billion, followed by New York's $1.3 billion and Texas' $1 billion. Many other states have very substantial breeding, racing and showing industries.

What supports the horse industry, including the job base, the breeding farms and the revenue stream in the form of taxes to all levels of government, is the investment in the horses themselves. The horse industry relies on outside investment to operate, just as other businesses do. Without owners willing to buy, breed, race and show horses, the hundreds of thousands who are employed full-time in and supported by the industry cannot work. Without such investment, jobs and revenue are lost.

Effects of the Tax Reform Act of 1986 on the Equine Industry

Since the Tax Reform Act of 1986, the horse industry has experienced a near catastrophic economic decline. Most horse owners and breeders believe that the limits on passive losses was a major reason for the decline. The material participation requirements chilled the interest of investors in horses, which has led to a significant downturn in the industry.

Since the mid-1980s, the number of horses bred and registered has decreased for all breeds. The affect of this decline on the industry has been dramatic. It has lead to fundamental changes in the industry, to losses in jobs and less revenue to the states and the industry. Horse trainers who once had twenty horses in their barn and grooms necessary to care for them now have three and four horses and fewer workers. Many have had to take part-time jobs outside the industry. Veterinarians, who once worked exclusively on the track or at shows, are now making visits to farms to care for horses and make ends meet.

Many racetracks are experiencing a significant shortage of race horses and have difficulty in filling races with a competitive number of horses. This results in less betting, less revenue to the states and a loss of more jobs.

Comments on the Clarification of the Passive Loss Requirements

The legislative history of the 1986 Act indicates that in order to satisfy the material participation requirement a person's involvement must be regular, continuous and substantial. According to the Statement of Managers, a genuine exercise of independent discretion and judgment is required; a person may not simply consult periodically or ratify general management decisions. Based on that history, if a person does everything that is required to be done to conduct the activity, even if the amount of actual work to be done is low in comparison to other activities, it seems that this should be deemed material participation. IRS regulations, however, require more stringent rules to meet the material participation test.

The AHC supports the proposal included in the listed miscellaneous tax reform proposals to modify the rules set forth in the Treasury Department regulations to clarify how an individual who owns and breeds horses can be an active participant and satisfy the passive loss limitations.

More specifically, in determining whether an individual is an active participant the proposal would: (1) allow an individual to count all time spent by an individual, even if others spent more management time or are paid for management services; (2) eliminate any specific minimum number of required hours; and (3) allow partners (other than limited partners) and S corporation shareholders to combine their participation in meeting the requirements to avoid being treated as a passive activity. These changes to the regulations would apply only to businesses engaged in equine activities.

The horse industry is unique with respect to the material participation requirements. It is difficult for many owners to breed, train, ride, drive or show their horses because of the expertise and physical ability that is required. It is a specialized activity requiring experienced, trained full-time professionals. The owner of a broodmare who boards the mare at another's farm may find it difficult to satisfy the minimum hourly requirement imposed by the IRS regulations during the eleven month gestation period nature requires to produce a foal. The owner of a race horse can seldom train and care for the horse himself; he needs the expertise of professional trainers, grooms, exercise riders and others. The passive loss rules, therefore, are often viewed as difficult for many to satisfy.

This proposed change is consistent with the intent and will of Congress in enacting the 1986 tax reforms and, we believe, the intent of Congress today. The current IRS approach is based on a fixed, hours-per-year activity standard that is inappropriate for the equine industry. This limited change is fair and will encourage investment and the jobs that follow from that investment.

The AHC appreciates the opportunity to submit this testimony and appreciates the Committee's interest.

TESTIMONY OF THOMAS B. DOBBINS
AMERICAN CONSULTING ENGINEERS COUNCIL

The American Consulting Engineers Council (ACEC) appreciates this opportunity to submit written testimony in support of the S Corporation Reform Act of 1995. ACEC is the largest national organization of engineers engaged in the independent practice of consulting engineering. ACEC has more than 5,000 member firms employing nearly 200,000 professional engineers, surveyors, scientists and technicians involved in many different engineering disciplines who design over $100 billion in construction projects annually. More than 75 percent of these firms are small businesses with fewer than 25 employees. Approximately 40 percent of our member firms are S corporations.

The latest Treasury Department statistics show that there are between 1.6 and 1.9 million S corporations in the United States. S corporations account for 40 percent of all U.S. corporate taxpayers, and about 11 percent of the entire corporate tax base. From these statistics, we know that S corporations are an integral part of the American economy, and that they tend to be mostly small to medium sized businesses.

The rules and regulations that govern S corporations were last updated in 1982 and have become a hinderance to the growth of small business and the economy in general. Many of the current provisions of the Internal Revenue Code concerning S corporations that were intended to encourage growth in the small business community are now restricting them from expanding in the 1990s. The S Corporation Reform Act of 1995 addresses this gap between the current regulations and the operating and capital needs of today's S corporation. The provisions of this legislation would remove many barriers allowing S corporations to:

- expand and streamline their businesses;
- simplify tax and estate planning;
- have better capital access;
- maintain family ownership and other traditional structures; and
- avoid the consequences of unnecessary, obsolete tax traps.

Removing these barriers would allow S corporations to realize their full economic potential and make greater contributions to the domestic economy.

Current law limits the number of shareholders an S corporation can have to 35, and further prohibits many types of shareholders -- including most trusts and all tax-exempt entities -- from owning S corporation stock. In addition to simply eliminating potential capital sources, there are two important effects of these prohibitions.

Problem:

Family businesses which may be run by either more than one family or by several generations of a single family easily hit the shareholder limit. As a result, participation will have to be denied to important family members who know the business best, or to junior members who hold the most potential for the future.

Relief:

The S Corporation Reform Act of 1995 would allow all family members to be counted as one shareholder. This provision would enable businesses owned by large families to operate as S corporations and still allow employees and others to hold stock in the corporation. In addition to this, the S Corporation Reform Act of 1995 raises the number of shareholders from 35 to 75.

Problem:

Shareholder restrictions prevent S corporations from creating employee stock ownership programs (ESOPs). ESOPs are important sources of capital for many companies, and they are equally important sources of long-term security for many workers. Moreover, permitting employees to participate in the success of their company is arguably the best way to motivate that company's workforce. ACEC firms often use stocks as a form of compensation to their employees and under the current law they are limited in doing this as an S corporation.

Relief:

The S Corporation Act of 1995 would allow companies to establish ESOPs and also permit tax-exempt organizations, such as charities and pension plans, to be eligible shareholders. The proposed legislation would also permit non-resident aliens to own S corporation stock which would increase the corporations access to capital and enhance their ability to expand into foreign markets.

H.R. 2039 also allows S corporations to own both S and C corporation subsidiaries. This is important to ACEC member firms when they are involved in many different types of work. This very common for a consulting engineering firm. The parent firm would be able to control the smaller divisions all functioning as S corporations or C corporations. This allows a small firm to expand and grow without being severely punished for its success through extraneous tax burdens.

Problem:

Current regulations limit capital access for s corporations through numerous restrictions. First, S corporations are permitted to only have one class of shareholders. They are not permitted to have two-tiered equity structures, or to issue debt that is convertible to equity. Because of these limitations, S corporations are unable to access capital from many types of investors and lenders who typically prefer to be sheltered from the direct risk associated with holding common stock. They also cannot obtain equity capital without giving up some control over the business to the new investors, since all S corporation shares must take the form of a voting interest in the company.

Relief:

The S Corporation Act of 1995 would allow S corporations to issue preferred stock, which would allow investors who prefer to be sheltered from the direct risks of holding common stock to be shareholders.

Conclusion:

There are thousands of S corporations in every state that support and will benefit from the S Corporation Reform Act. This legislation improves a small business' access to capital and the result is a stronger and expanding economy. In this time of economic recovery this is especially important because S corporations are responsible for creating 75 percent of new jobs in this country. The S Corporation Act of 1995 would allow S corporations access to the capital they so desperately need in order to continue to drive this nation's economy.

The American Consulting Engineers Council appreciates the opportunity to submit these comments to the Committee and is encouraged by the bipartisan support this legislation has received in both the House and the Senate. It is our hope; and the hope of our 5,000 member firms that this momentum will continue and these much needed changes be passed into law this year.

Sincerely,

Thomas B. Dobbins
Director, Governmental Programs

Statement of

ROBERT G. KALIK, PRESIDENT
AMERICAN VINTNERS ASSOCIATION

For the hearing record of the

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

TAX REFORM FOR S CORPORATIONS
July 12, 1995

This statement is submitted on behalf of the American Vintners Association (AVA), the national trade association of American Wineries with a membership of over 450 wineries in 38 states, to express our strong support of the "S Corporation Reform Act of 1995".

There are over 1,400 American wineries located in forty-six states producing wine with a retail value of over 12 billion dollars annually. The overwhelming majority of these wineries are family-owned, small business farm wineries. These wineries generate tourism, protect marginal farm land from development, help familiarize many city and suburban residents to farms and farming, and provide rural employment opportunities for both skilled and unskilled workers. Besides California, such diverse states as Washington, Oregon, New York, Ohio, Maryland, Virginia, Texas, Colorado, Michigan and Missouri have experienced a huge surge in winery numbers, popularity and prestige.

According to an AVA survey of its membership, approximately 40% of wineries are S corporations, a ratio which we believe reflects national statistics for all businesses. Cakebread Cellars, a member winery located in the Napa Valley is not untypical of winery S corporations. The Cakebread Cellars winery was founded by Jack Cakebread and his wife in 1973. In the evolution of its growth over the last twenty-two years, their business has been joined by two sons and three daughter-in laws. The winery has been a great success growing in size and achieving critical acclaim for the quality of its products. But the business and financial challenges faced by Cakebread Cellars are huge and compromised by the inflexibility of current S corporation law.

Financing ongoing business needs, exacerbated by the need to replant vineyards because of infestation of a small root feeding insect known as phylloxera, has been especially difficult because S corporation law has severely limited the corporation's ability to raise equity capital. The proposed reforms to S corporation law would permit Cakebread to issue preferred stock and convertible debt, and increase the number of allowed shareholders. These changes would greatly improve Cakebread Cellars' ability to raise the capital needed to continue building the business.

Changes proposed to S corporation law broadening the type of trusts which may own S corporation stock would greatly facilitate keeping family businesses alive and within the family upon the death of the first generation. In the absence of the flexibility contained in the reform legislation, the Cakebread family, as well as the overwhelming majority of S corporation founders, have had to devote an inordinate amount of time and effort to non-productive, complex, succession planning essential to avoid a forced sale of the business upon the death of the founders in order to satisfy tax obligations.

S corporations were designed as a vehicle for family-owned businesses. Current law too often leads to sale of the business rather than continuation of family ownership. This should be remedied.

In these times, when the nation's priorities are focusing on individual economic initiative and family cohesiveness, S corporations are more than ever a desirable mechanism for facilitating those goals. Hundreds of wineries and hundreds of thousands of other family businesses, need sensible reform of current S corporation law. The American Vintners Association thanks you for the opportunity to submit this statement and urges swift passage of S corporation reforms.

June 13, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

As a Certified Public Accountant (CPA) who works with many types of businesses that are designated as S Corporations, I wanted to bring a clarification issue to your attention as your subcommittee considers legislation to reform the Internal Revenue Code governing S-Corporations. I also respectfully request that you include my comments in your hearing report for July 11 and 12 on miscellaneous tax issues.

First, it should be noted that reform legislation overall is desperately needed and the proposal Congressman Clay Shaw plans to introduce does an outstanding job of solving many of the more serious problems faced by family businesses with respect to S Corporations. Therefore, although I wholeheartedly support passage of reform legislation, it is requested that your subcommittee address one minor issue.

In Section 214(c)(5) of the bill the general definition of passive investment income includes gross receipts from royalties, rents, dividends, interest and annuities. Following that provision, there are various exceptions provided in 214(c)(5)(B),(C) and (D).

As currently worded there is no distinction made in the statute between true passive rents (such as a net lease arrangement) and a bonafide operating business that receives a significant amount of revenue from rental operations. It seems illogical to "punish" an operating business and treat such a corporation the same as a corporation receiving nonoperating or "true" passive investment income.

The general rule in the statute regarding rents should be clarified or an exception should be created that would remove rents from the passive category if a certain percentage of gross receipts from rents exceeds 40-50 percent of the total corporate gross receipts for the year or if significant services are rendered or substantial costs are incurred by the corporation in operating the rental business.

Thank you for your time and consideration of my comments. Again, please know that I appreciate your efforts to improve this area of taxation and wish you and Congressman Shaw luck in seeing this very important legislation enacted.

Sincerely,

Gary N. Babick

Gary N. Babick, CPA

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STATEMENT FOR THE RECORD
SUBMITTED BY COOPERS & LYBRAND L.L.P.
AND
THE COALITION ON S CORPORATION REFORM

HOUSE COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISCELLANEOUS TAX REFORMS
July 11 and 12, 1995

Chairman Archer and Members of the Committee --

Coopers & Lybrand appreciates this opportunity to submit written testimony on behalf of the Firm and certain of our clients in support of tax reform for S corporations, with special emphasis on the S corporation reform legislation that Ways & Means members E. Clay Shaw (R-FL), Rob Portman (R-OH) and Robert Matsui (D-CA) will introduce this Congress.

Our purpose in preparing testimony for these hearings is to communicate to Congress how current tax rules seriously restrict the planning and structuring capabilities of existing S corporations. Today, businesses operating as S corporations are limited by tax rules that hinder their growth and ability to obtain financing. S corporation tax laws are fairly complex and contain traps that reduce the benefits of S corporation status. In addition, current law impedes the ability of S corporations to compete both on a domestic and international market level.

Concern over this situation has grown, particularly since an increasing number of corporations have adopted the S corporation format. In 1993, the last year for which statistics are available, slightly over 48 percent of corporate tax returns, or nearly 1.9 million returns, were filed by S corporations. While some may argue that limited liability company (LLC) status is an easy solution to S corporation-related problems, this does not address the fact that 1.9 million *existing* S corporations remain mired in complex, archaic tax rules that have not kept up with today's business environment. Moreover, it is not financially feasible for many S corporations to convert to LLC status, since they would be required to pay tax on gain on appreciated assets upon conversion to LLC status.

BACKGROUND

S corporation laws were first enacted in 1958. They were substantially revised by the Subchapter S Revision Act of 1982, which simplified considerably the taxation of S corporations. Still, S corporations did not become truly popular until 1986, when Congress, for the first time since 1913, inverted the tax rates so that individuals were subject to a lower tax rate (28%) than corporations (34%).

Many S corporations were formed at this time to combine the advantages of the pass-through of income and losses at the lower individual tax rates, and the limited liability of the corporate form. Although the marginal tax rates were reinverted by the passage of the 1993 tax act (individuals now pay a maximum 39.6% tax rate, while corporations pay a top rate of 35%), it is still practical for most S corporations to keep their S status to avoid the double tax imposed on regular corporate earnings. Further, there are significant tax costs to convert into S corporation status. A built-in gains tax applies at the corporate level when a newly converted S corporation disposes of appreciated assets held during existence as a regular corporation. This tax taint stays with these assets for ten years after the conversion. This built-in gains tax and the higher individual marginal tax rates would dampen the possible conversions of regular corporations to S corporation status when this legislation is enacted into law.

CURRENT RESTRICTIONS ON S CORPORATIONS

Despite streamlining over the years, the S corporation rules remain overly restrictive for many small businesses. The existing S corporation rules do not reflect the practical considerations of doing business in today's complicated and often sophisticated world. The small business community and the tax professionals who serve it have long contended that current rules put S corporations at an unfair disadvantage compared to regular corporations, partnerships and limited liability companies.

For example, S corporations are limited to 35 shareholders, none of whom can be either partnerships, other corporations or non-resident aliens. Tax-exempt organizations and certain trusts are not eligible to be S corporation shareholders. S corporations may not issue preferred stock or own more than 80 percent of another corporation's stock. Shareholder-employees of S corporations are taxed on certain tax favored fringe benefits. C corporations enjoy an enhanced charitable contribution benefit to which S corporations are not entitled. There should be no reason why S corporations should not be granted the same charitable giving benefits.

Additionally, S corporation status would be lost if one of the eligibility rules is violated and earnings would then be subject to a double tax. Because the rules are somewhat arcane, many small businesses may not even know the pitfalls they should guard against to sustain S corporation status, and may unwittingly violate the S corporation rules.

S CORPORATION TAX REFORM

The current effort to bring the S corporation rules in line with the complexities of modern small business operations and to level the playing field between S corporations, regular corporations, partnerships and LLCs arose when the American Institute of Certified Public Accountants (AICPA) and members of the American Bar Association's (ABA) S Corporation Committee joined with the U.S. Chamber of Commerce in 1992 to draft a package of proposed legislative changes to the S corporation rules. We are delighted that Reps. E. Clay Shaw, Rob Portman, and Robert Matsui, long-time advocates of small business, will introduce the *S Corporation Reform Act of 1995* in the House within the next few days. This is companion legislation to S. 758, the S

corporation reform bill introduced by Senate Finance Committee members Orrin Hatch (R-UT) and David Pryor (D-AR).

During the 103rd Congress, S corporation reform legislation enjoyed strong bipartisan support in both the Senate and the House of Representatives; the health care reform debate, however, effectively kept the 103rd Congress from acting on other important initiatives. We urge the members of the 104th Congress to work toward the enactment of the S corporation legislation this year.

This legislation represents the greatest change to the tax treatment of S corporations in over a decade and would achieve a number of major goals including: improving the ability of S corporations to obtain financing; removing traps for unwary S corporations; making S corporations easier to pass from generation to generation, thus preserving the ability of family-owned businesses to use the S corporation format; and removing certain tax barriers that currently impede the ability of S corporations to compete with regular corporations and partnerships. By removing these artificial barriers, the legislation would ensure S corporations have fewer constraints on how to conduct normal day-to-day business transactions. This increased efficiency eventually could translate into creation of additional jobs and boost the economy.

One of the most important additions to this year's bill is the provision that would permit S corporations to own both C corporation and S corporation subsidiaries. This change would increase flexibility because an S corporation and its wholly-owned subsidiaries would be treated as one corporation and would file one tax return. Currently, if an S corporation owner wishes to start a new business but does not want to subject existing business assets to the liability exposures of the new venture, the new business must be structured as a sister S corporation rather than as a subsidiary. Not only would the proposed legislation allow S corporations to own regular corporate subsidiaries, but it also would permit wholly-owned corporate subsidiaries to be treated as a branch or division of the parent -- thus as one pass-through entity. This proposal offers the parent flexibility in structuring corporate operations without risking termination of S status.

ADDITIONAL PROVISIONS IN HOUSE BILL

We also would like to voice our strong support for two provisions that will be included in the House version of the legislation:

Issuance of Convertible Preferred Stock. First, the House bill includes a provision that would allow S corporations to issue *convertible* preferred stock. In the 1990's, small businesses can benefit from venture capital for their financing needs. Nevertheless S corporations, unlike regular corporations and partnerships, are prohibited from issuing the preferred stock interests necessary to attract venture capital. This rule exists probably because such financing was not common when the prohibition on multiple classes of stock for S corporations was enacted. Permitting S corporations to issue convertible preferred stock would enable these businesses to have access to start-up and growth capital by permitting them to issue one of the same financial instruments

currently used by C corporations. We are told that this change is essential for venture capitalists to invest in S corporations.

Increasing Number of Shareholders to 75. Second, we support increasing the number of permitted S corporation shareholders from 35 to 75, or 100. In its current form, the Senate bill contains a provision increasing this number to 50 and adopts favorable family attribution rules. These are worthy changes but unfortunately do not fully address situations where S corporation shareholders representing separate families wish to leave their interests to heirs. Since there appears to be no magic or strong policy rationale for limiting the number to 50, we support the provision in the House bill increasing the number to 75, and we urge the Committee to consider even increasing the number to 100.

COMMENTS ON OTHER PROVISIONS

S Corporations Permitted To Hold Both C and S Corporation Subsidiaries. The legislation would repeal the current rule that disallows an S corporation from being a member of an affiliated group of corporations, thus enabling an S corporation to own up to 100 percent of a C corporation's stock. It does preclude, however, an S corporation from being included in a group filing a consolidated tax return. In addition, S corporations would be permitted to own wholly-owned S corporation subsidiaries. Thus, a parent S corporation and its wholly-owned subsidiary would be treated as one corporation and would file one tax return. This provision offers tremendous structuring flexibility to existing S corporations by allowing them to put operations into wholly-owned subsidiaries and be treated as one S corporation.

Allow Exempt Organizations as Shareholders. A new source of financing would be provided to S corporations by allowing certain exempt organizations including pensions, profit sharing plans, and employee stock ownership plans (ESOPs) to acquire S corporation stock. S corporation income that flows through to these organizations would be treated as unrelated business income (UBI) to the organization or entity. In addition, charities would be allowed as shareholders of an S corporation for purposes of allowing more flexibility in estate planning and charitable giving.

This provision will encourage charitable contribution of S corporation stock by shareholders who often cannot make outright cash contributions. Charitable organizations could have their S corporation stock redeemed over time by the S corporation giving them cash to pursue charitable activities. In the meantime, the S corporation shareholder receives a charitable deduction. Encouraging these types of gifts at a time of budget deficit reduction and planned curtailment of social services makes sense from a tax policy perspective. Any concerns about taking unfair advantage of the charitable deduction rules are unfounded because similar opportunities are already available to C corporation shareholders and partners in partnerships, and the IRS has adequately administered this to curb abuses.

Expand Eligible Trust Rules. Current law eligible trust rules are just too restrictive. The legislation appropriately proposes to expand the types of trusts allowed to hold S corporation stock. Accumulating and sprinkling trusts, common estate planning techniques, would be eligible shareholders. Each potential current beneficiary of the trust would be counted as a shareholder

under the counting conventions of the maximum number of shareholder rules. In a situation where there are no potential current beneficiaries, the trust would be treated as a shareholder. For taxation purposes, the portion of the trust consisting of S corporation stock would be treated as a separate taxpayer and would pay tax at the highest individual tax rate.

Allow Nonresident Aliens as Shareholders. This provision would provide the opportunity for nonresident aliens to invest in domestic S corporations and S corporations to operate abroad with a foreign shareholder by allowing nonresident aliens (individuals only) to own S corporation stock. This provision would give S corporations access to another important source of capital. Any effectively-connected U.S. income allocable to the nonresident alien would be subject to the withholding rules that currently apply to foreign partners in a partnership to assure that U.S. revenues are not deflected. This provision would make it much easier for S corporations to attract foreign investors, as well as expand operations outside the United States. The legislation's withholding requirement will assure that non-resident investors pay U.S. tax on their S corporation earnings.

Financial Institutions Permitted to Hold Safe Harbor Debt. An S corporation is not considered to have more than one class of stock if outstanding debt obligations to shareholders meet the "straight debt" safe harbor. Currently, the safe harbor provides that straight debt cannot be convertible into stock. However, the legislation would permit a convertibility provision so long as that provision is the same as one that could have been obtained by a person not related to the S corporation or S corporation shareholders. Additionally, the straight debt safe harbor would be amended to allow creditors who are persons actively and regularly engaged in the business of lending money to hold such debentures. Permitting S corporations to offer different interests to outside investors is another feature designed to provide flexibility to better attract capital.

Charitable Contributions of Inventory. This provision would allow the same deduction for charitable contributions of inventory and scientific property used to care for the ill, needy or infants for subchapter S as for subchapter C corporations. In addition, S corporations are no longer disqualified from making "qualified research contributions" (charitable contributions of inventory property to educational institutions or scientific research organizations) for use in research or experimentation. The S corporation's shareholders would also be permitted to increase the basis of their stock by the excess of deductions for charitable contributions over the basis of the property contributed by the S corporation.

Eliminate Rule Taxing Certain Fringe Benefits of S Corporation Stockholder-Employees. The current rule that limits the ability of "more-than-two-percent" S corporation shareholder-employees to exclude certain fringe benefits from wages would be repealed for benefits other than health insurance. Under the bill, fringe benefits such as group-term life insurance would become excludable from wages for these shareholders. However, health care benefits would remain taxable.

Distributions by S Corporations During a Loss Year. Basis adjustments for distributions made by an S corporation during a taxable year would be taken into account before applying the loss limitation for the year. This would result in distributions during the year reducing adjusted stock

basis for purposes of determining the tax status of the distributions made during that year before determining the allowable loss for the year. A similar concept would apply in computing adjustments to the accumulated adjustments account.

S Corporations as Shareholders in C Corporations. The current rule treating an S corporation as an individual in its status as a shareholder of another corporation would be repealed, permitting IRC Section 332 liquidations and IRC Section 338 elections. These changes would confirm an S corporation's ability to participate in tax-free structuring transactions, and are important for flexibility in structuring business operations.

Curing Certain Invalid Elections. The legislation would provide the IRS with the authority to extend its current automatic waiver procedure for inadvertent terminations due to defective elections. Additionally, the IRS would be allowed to treat a late Subchapter S election as timely if the Service determines that there was reasonable cause for the failure to make the election timely. The provision would apply to taxable years beginning after December 31, 1982. This is an important provision which allows taxpayers to recover from inadvertent traps in complying with the complicated S corporation eligibility rules.

Certain Financial Institutions Defined as Eligible Corporations. Under the bill, financial institutions that do not use the reserve method of accounting for bad debts would be eligible to elect S corporation status.

Repeal Passive Income as a Termination Event. This provision would repeal the current rule that terminates S corporation status for certain corporations that have both subchapter C earnings and profits and that derive more than 25 percent of their gross receipts from passive sources for three consecutive years. The bill would not repeal the rule that imposes a tax on those corporations possessing excess net passive investment income. It would liberalize this tax by raising the threshold triggering the tax to 50% of passive receipts from passive income sources rather the present law 25% threshold. The rate of the passive income tax would be increased if applicable.

Treatment of Liquidation Losses. Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation.

Repeal Restrictions on Qualified Loans. The legislation provides that subchapter-S shareholder-employees no longer will be deemed to be owner-employees under the rules prohibiting loans to owner-employees from qualified retirement plans.

Elimination of Pre-1983 Earnings. S corporation earnings and profits attributable to taxable years prior to 1983 would be eliminated. This change will simplify distributions for those S corporations in existence prior to 1983.

Other Technical Changes. Other technical changes made to current S corporation rules include expanding the post-death qualification for certain trusts; modifying shareholder election to close the S corporation's tax years when a shareholder terminates interest; expanding the post-termination transition period; providing a consent dividend for AAA bypass elections; and allowing at-risk suspended losses to be utilized during the post-termination transition period.

Coopers & Lybrand L.L.P. would like to add its voice to that of our clients in support for the legislation. We are joined by many in the business community and on Capitol Hill. We cannot stress enough the need for timely S corporation tax reform in light of the unfair obstacles that face existing S corporations through today's tax code. As the budget reconciliation process seems to be the most logical vehicle to carry S corporation reform to enactment, we strongly advocate adding the S corporation reform provisions to the final budget reconciliation bill, or another tax vehicle this year. We thank you for giving us the opportunity to present our views on this important subject. If we can be of any assistance to you in your consideration of this legislation, please feel free to contact National Tax Partners Sam Starr at (202) 822-4279 or Pamela Pecarich at (202) 822-4239.

Thank you.

Coopers & Lybrand L.L.P.

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David L. Uzick
President

July 7, 1995

The Honorable William Archer
c/o House Ways & Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Re: S Corporation Reform

Dear Chairman Archer:

I am writing to you today with regard to the upcoming Ways & Means Committee hearings on S Corporation Reform. I am well aware that you were an original cosponsor of similar legislation in the 103rd Congress, and I strongly commend you on your efforts to bring this very seriously needed legislation into law.

I originally became aware of this legislation as a member of the S Corporation Reform Project (S-CORP). I am sure that you are aware that S-CORP represents over 40,000 S corporations throughout the country, and was instrumental in developing broad bipartisan support for this legislation in both the House and Senate.

N-E Thing Supply was founded in 1977 as a provider of maintenance supplies and equipment to the multi-family housing industry. We had a very modest beginning as three people working out of a twelve hundred square foot space in a small retail center. We have since grown to employ almost a hundred people operating out of a 68,000 square foot distribution facility in Houston, with satellite sales offices in Austin and San Antonio. In 1994 we formed a subsidiary company called N-E Service, L.C. which provides maintenance and rehabilitation services to the single- and multi-family housing industries.

While I am sure that the existing rules governing S corporations made sense in the past, I am equally sure that many of these rules are no longer appropriate and serve only to hinder growth and unduly punish otherwise successful businesses. Admittedly, there are a number of issues in both the House and Senate versions of this proposed legislation that do not currently affect N-E Thing Supply. However, I would like to make you aware of some of those aspects that have the potential to benefit our company if they are enacted.

Open and competitive access to capital is a key element to any growing company's success. Under current rules, S corporations are not allowed to issue convertible debt, which removes access to a large market of investors and lenders who provide that type of capital. This restriction further precludes us from obtaining equity capital without giving up some control over our business, since all shares retain a voting interest in the company. The ability to issue a convertible preferred stock would greatly enhance our ability to grow our company by allowing us to compete for investment capital on a level field with all other forms of business entities.

San Antonio
District Office
800 N. W. Loop 410, #378, South Tower
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10555 Stella Link
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2512 South IH 35, #335
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Another significant obstacle under current S corporation rules are restrictions on ownership of subsidiary companies. On more than one occasion, we have declined the prospect of acquiring a troubled business in our industry due in large part to our inability to the make the acquisition as a wholly owned subsidiary. In fact, when we formed our N-E Service subsidiary last year, our only practical option was to have it adopt a limited liability company (LLC) structure which, while allowing us to own a 99% interest, left much to be desired. The legal fees alone for formation of this start-up company were approximately $20,000, almost ten times what it would have cost to form as a wholly owned S corporation. We are also faced with additional costs associated with the complexities of operating two types of business structures, much of which could have been avoided if the subsidiary could have adopted either a C or S corporation structure.

Another area of concern is the current limitations on ownership in S corporations. I have devoted my entire adult life towards building a vibrant and financially stable business. I have sought not only to provide for my family, but also for the families of the dedicated and hard-working employees of our company. Although I have thus far been reasonably successful in attaining those goals, I feel that they are unduly jeopardized by current restrictions regarding S corporation ownership. Since I am very active in the business, the company's value would, at least temporarily, diminish in the event of my demise. Under current law, my heirs could be forced to sell my estate's interest in N-E Thing Supply simply because a trust would not be allowed to retain ownership of the S corporation. It is very unfair that my survivors could be placed in the position of being forced to liquidate their most important asset at the most inopportune time.

The same restrictions that negatively impact our ability to retain ownership in our family also preclude us from sharing ownership with our employees. Extending ownership rules to include certain estate trusts and ESOPs would enhance our ability to grow and share the benefits of our accomplishments with those very individuals who contribute to our success.

In the final analysis, this legislation makes excellent sense for the over 1.9 million S corporations in America today. The tax-paying owners of S corporations would benefit by having enhanced access to capital and improved estate planning. Employees of S corporations would benefit by their ability to participate in ESOPs. The economy in general would benefit by allowing this large pool of businesses to actively participate in acquisitions and strategic mergers, resulting in more financially stable and growing enterprises.

Congressman Archer, once again let me express my appreciation for your leadership in moving this legislation forward in a timely fashion. I hope the other Committee members and the full Congress will make S corporation reform a reality in 1995.

Sincerely,

David L. Uzick
President

STATEMENT
by
The S Corporation Coalition
on
S CORPORATION REFORM
Scheduled for Hearings before the
HOUSE WAYS AND MEANS COMMITTEE
July 12, 1995

The S Corporation Coalition is pleased to submit testimony to Ways and Means Committee in support of S corporation reform. The S Corporation Coalition is a group of companies from across the country representing a wide range of industries that strongly supports the needed reform of the Subchapter S rules that is contained in the S Corporation Reform Act of 1995 (S. 758) that was introduced in the Senate. We understand that legislation similar to the Senate bill will soon be introduced in the House, and we strongly support this House effort. As explained below, the S Corporation Coalition believes that reforming the rules of subchapter S in the manner set forth in S. 758, and expected to be included in the House reform bill, would enhance S corporations' access to capital, would help preserve family-owned businesses, would remove many of the technical traps that are imposed by the current S corporation rules, and would simplify many of the cumbersome and complex rules that currently apply to S corporations.

THE NEED FOR REFORM

The 1958 enactment of the S corporation rules provided major tax reform for small businesses. It allowed these businesses to obtain the benefits of limited liability that are associated with corporate status without being burdened by the double tax placed on corporations and their shareholders. Thus, the S corporation rules removed tax considerations from the small business owner's decision to operate in corporate or non-corporate form.

Important reforms were made to these rules in 1982. However, in the last 13 years, business needs have changed and reform is needed once again. S. 758 and the companion legislation expected to be introduced in the House this week by Congressman E. Clay Shaw (R-FL) and other members of this Committee, would provide this needed reform by eliminating antiquated S corporation rules that impede the growth of small businesses and that burden them with unnecessary administrative complexity. Moreover, this legislation would expand the ability of S corporations to raise capital to finance the growth of their businesses and would provide rules that would help to preserve family-owned businesses.

Some have argued that reforming the rules of Subchapter S is not needed because of the recent growth in the limited liability company (LLC) form of business enterprise. According to these arguments, most newly-formed entities will choose to be taxed as LLCs, rather than as S corporations, rendering S corporation reform a wasted effort. These arguments, however, are over-generalizations and, as a result, do not accurately reflect taxpayer behavior. In addition, even if one were to accept the suggestion that all newly-formed entities will choose to be organized as LLCs, S corporation reform is far from a wasted effort – it is essential to provide existing businesses operating as S corporations tax treatment that is close to that of LLCs.

Importantly, there currently are over 1.9 million S corporations. These corporations cannot change to LLC status without incurring significant costs. For these corporations, reforming the current rules is greatly needed – it would help them to attract capital, to keep businesses in their families, to reduce their compliance burdens and to avoid technical traps contained in the current rules. Furthermore, even disregarding the large number of existing businesses that would be assisted by reforming the rules of Subchapter S, there still are and will be situations in which newly-formed enterprises will elect to be taxed as S corporations. For example, a corporation doing business in more than one state may have concerns (e.g., liability and state tax concerns) about choosing to be taxed as an LLC. In addition, an enterprise with a single owner may not obtain tax classification as a partnership for an LLC. As a result, the S corporation form of doing business will often be chosen in this situation. Thus, reforming the S corporation rules is a necessary step and should be viewed as a complement to the growth in popularity of LLCs. America's small businesses are looking forward to this necessary reform and welcome the Subcommittee's interest in this critically-important issue.

NEEDED REFORM

The S Corporation Coalition strongly supports the S corporation reform provisions contained in the S Corporation Reform Act as introduced in the Senate. We anticipate that substantially similar legislation will soon be introduced in the House, and also strongly support that effort.

EXPANDING ACCESS TO CAPITAL

The S Corporation Reform Act contains several provisions that would expand S corporations' access to capital and would allow S corporations to structure their activities more simply and efficiently. These provisions are essential to the continued growth of our Nation's small businesses.

1. Permit S Corporations to Issue Preferred Stock

Under current law, S corporations may not issue more than one class of stock. By permitting S corporations to issue preferred stock (including, possibly, convertible preferred stock), S corporation reform legislation would increase access to capital from investors who insist on having a preferential return, such as venture capitalists. The bill also would facilitate family succession by permitting an older generation of shareholders to relinquish control of the corporation while still maintaining an equity interest.

2. Expand Safe Harbor Debt to Permit Convertible Debt

The S Corporation Reform Act also would permit an S corporation to issue debt that may be converted into stock of the corporation without concern that the debt will terminate the S election, provided that the terms of the debt are substantially the same as the terms that could have been obtained from an unrelated party. The provision also would permit the debt to be held, not only by a qualified shareholder, but also by a person who is actively and regularly engaged in the business of lending money. The current law provision, which does not provide a safe harbor for debt that can be converted into stock, unnecessarily impairs the ability of an S corporation to raise investment capital.

3. Increase the Number of Permitted Shareholders

Currently, a corporation is not eligible to be an S corporation if it has more than 35 shareholders. S. 758 would increase the number of permitted shareholders to 50. Increasing the number of shareholders would remove one barrier to the expansion of existing S corporations and would make S corporation status available to more closely-held businesses, allowing them the benefits of limited liability. In addition, increasing the number of permitted shareholders would enable S corporations to raise more capital through shareholder contributions. (We understand that the House companion bill may provide even greater relief from the current 35 shareholder limit.)

4. Permit Tax-Exempt Organizations to be Shareholders

The S Corporation Reform Act also would increase S corporations' access to certain capital markets by permitting charities and pension plans to be eligible shareholders of S corporations. Under the bill, an S corporation would be able to establish an employee stock ownership plan and would have access to additional capital from charitable organizations and pension funds. To prevent abuse, the bill would provide that the flow-through income of an S corporation would be treated as unrelated business taxable income to a tax-exempt shareholder to the extent that the income would have been so treated if the S corporation's activities were conducted directly by the tax-exempt shareholder.

5. Allow Nonresident Alien Shareholders to Own S Corporation Stock

Under current law, S corporations may not have nonresident alien shareholders. The bill would enhance an S corporation's ability to expand into international markets by providing it with the ability to offer an equity interest to an individual it is trying to recruit to grow its business

overseas. In addition, the bill would expand and simplify S corporations' access to foreign capital markets. This bill also would obviate the need to raise such capital through a partnership in which the S corporation is a partner. The bill would subject nonresident alien shareholders to U.S. withholding tax on S corporation income.

6. <u>Permit an S Corporation to Have Wholly-Owned S Corporation Subsidiaries</u>

The bill also would permit S corporations to have wholly-owned S corporation subsidiaries. Currently, many S corporations that conduct two or more separate businesses choose to do so by establishing separate S corporations for each business so that they can protect against risks of the other businesses. The legislation would permit an S corporation to serve as a holding company for the various operating entities which would simplify the management of the group. For example, the holding company could enter into contracts on behalf of the group, serve as common paymaster, and perform other centralized management services. One of the most important business reasons for permitting a combined group of S corporations is that it would facilitate obtaining financing for the group by providing management with the ability to present a single well-diversified enterprise to creditors.

7. <u>Permit an S Corporation to Hold Subsidiaries</u>

The S Corporation Reform Act also would allow an S corporation to own more than 80 percent of a C corporation's stock. This provision would enhance an S corporation's ability to achieve significant non-tax objectives in structuring its operations, such as limiting its liability and eliminating complications in dealing with banks, insurance companies, and other financial institutions. For example, it would allow an S corporation to isolate one or more of its businesses in subsidiaries and thereby not subject one business to the risks of another. Currently, S corporations engage in much more complicated structuring to achieve the same result.

PRESERVING FAMILY-OWNED BUSINESSES

The S Corporation Reform Act also contains a number of provisions that would make it easier for families to retain ownership of S corporations and that would advance the goal of preserving our Nation's family-owned businesses.

1. <u>Expand the Types of Trusts that Can Own S Corporation Stock to Include Certain Complex Trusts that Qualify as "Electing Small Business Trusts"</u>

The S Corporation Reform Act would enable S corporation shareholders to accomplish many estate planning goals not currently available because of current-law limitations on the types of trusts that can be S corporation shareholders. Specifically, the bill would enable S corporation shareholders to establish complex trusts with multiple beneficiaries and would permit the trustee to have discretion as to which beneficiary to make distributions. This flexibility is needed for a variety of legal reasons in situations in which there is more than one trust beneficiary -- for example, in situations in which a beneficiary is a minor who cannot manage the assets. Providing this type of flexibility is consistent with a major underlying purpose of the S corporation -- to provide a vehicle for family-owned corporations.

2. <u>Count all Members of a Single Family That Own an S Corporation's Stock as a Single Shareholder</u>

The S Corporation Reform Act would allow an election to be made, with the consent of all shareholders, to count family members as one shareholder for purposes of the S corporation limitation on the number of shareholders. This election would be available to only one family in any corporation. The effect of this provision would be to permit businesses owned by large families to be S corporations, while still enabling employees or others to own an equity interest in the business. This provision would be particularly helpful to a business owned in large part by a multi-generational family that currently may face the loss of its S status if it allows additional family members a stake in the business.

REMOVAL OF TECHNICAL TRAPS FOR THE UNWARY

As explained below, the S Corporation Reform Act would eliminate many of the antiquated Subchapter S rules that add significant complexity to the compliance burdens of small businesses and that have proven to be technical traps for unwary taxpayers acting in good faith. By eliminating these rules, the S Corporation Reform Act would provide much-needed simplification of the Tax Code for America's small businesses. (Indeed, some of the provisions in the S Corporation Reform Act have been included in simplification bills addressed by previous Congresses.)

1. Permit the Secretary of Treasury to Treat Invalid Elections as Effective and Permit Late Elections

Because of the complexity of the S corporation rules and the need for sophisticated tax advice, taxpayers seeking to elect S corporation status are not always successful in making valid S elections. Even worse, certain taxpayers may not be aware that they did not make valid S elections, notwithstanding their good faith efforts to comply with the many complex rules of Subchapter S. Although current law permits the Internal Revenue Service (IRS) to grant relief to an S corporation that inadvertently terminates its S election, it does not permit the IRS to validate invalid elections or to extend the period of time for making S elections. Further, taxpayers seeking inadvertent termination rulings typically incur significant professional fees and filing fees.

The S Corporation Reform Act would remedy these situations by extending and modifying the authority of the IRS to grant relief. First, the bill would allow a corporation that made an invalid S election to request the IRS to validate its S election retroactively. The bill sets out criteria for the IRS to use in determining whether it should validate such elections; these criteria are the same as the current law criteria relating to inadvertent terminations of S elections.

Second, the bill would instruct the Treasury to provide for an automatic waiver procedure in inadvertent termination cases in which the Secretary deems appropriate. This automatic procedure would obviate the need for a ruling from the IRS, which, in turn, would reduce the time and money currently spent on the ruling process.

Third, the bill would provide that, if a corporation fails to make a timely S election (*i.e.*, by the 15th day of the third month of the first S corporation year) and the Secretary determines that there was reasonable cause for such, the Secretary may treat the election as timely made. The standards currently applicable to requests for extension of time to make certain elections should apply in determining whether to grant relief to late S elections.[1]

2. Require Only Consent of Affected Shareholders to Interim Closing of the Books on Termination of Shareholder Interest

Current law requires that, if a shareholder terminates an interest in an S corporation during the taxable year, the corporation and *all* persons who are shareholders during the taxable year must agree to close the books on the date of termination. Thus, shareholders must consent even if they are unaffected by the election.

The bill would eliminate the requirement that all shareholders consent to the closing of the books and instead would require only that the "affected shareholders" (i.e., the shareholder whose interest is terminated and all shareholders to whom such shareholder transferred shares during the year) consent to the closing. This change would provide simplification and would ease procedural problems in preparing and filing timely corporate tax returns.

3. Repeal Excessive Passive Income as a Termination Event

Under current law, if more than 25 percent of the gross receipts of an S corporation are passive investment income, a corporate level tax will be imposed on the "excess" passive income of the corporation. In addition, the S election of the corporation will be terminated if, at the close of three consecutive years, the corporation has subchapter C earnings and profits and more than 25 percent of its gross receipts are from passive investment income.

[1]See Treas. Reg. § 301.9100.

Although the automatic termination of S status if a corporation has excess passive investment income can be avoided through careful planning, it provides a trap for some corporations -- particularly for those that do not have the benefit of sophisticated counsel. Moreover, the price for falling into this trap is exceptionally high -- losing S status entirely. The bill would remove this trap, while retaining sufficient disincentives to excessive passive investment income. Specifically, the bill would provide that a corporation would not lose its S corporation status if it has excess passive income for three consecutive years. Further, the bill would increase the threshold for taxing excess passive income from 25 percent to 50 percent of gross receipts. It also would clarify that items of income that are connected with an S corporation's trade or business would not be considered passive income. However, the bill also would provide that the corporate level tax rate applied to any excess passive income would increase by 10 percentage points for each successive year (up to a specified maximum increase).

4. <u>Permit Deemed Dividend to Avoid Passive Investment Income Tax</u>

Under current law, the passive investment income tax only applies if an S corporation has both passive investment income and accumulated earnings from years in which it was a regular C corporation. Therefore, a corporation currently can avoid having to pay the passive investment income tax by distributing its accumulated C corporation earnings; this distribution may be in the form of cash or property and must be made within the taxable year.

The S Corporation Reform Act would allow an S corporation to elect to be treated as if it had made a dividend distribution without actually distributing cash or property. This provision would permit an S corporation without adequate cash flow to make a distribution of its C corporation earnings and to be absolved from the passive investment income tax. This provision also would provide relief in situations in which a loan agreement prohibits an S corporation from making actual distributions. Moreover, this "consent dividend" would be a more expedient method of distributing C corporation earnings for those corporations that simply do not wish to make actual distributions.

5. <u>Expand to Two Years the Period of Post-Death S Qualification for Certain Trusts</u>

The tax law generally provides that certain trusts may not own the stock of an S corporation for more than 60 days following the grantor's death. In many circumstances, the 60-day period is insufficient to permit an executor or administrator to discover the need to transfer the shares of stock and to take the legal actions necessary to transfer the shares. As a result, the current rule has resulted in the inadvertent termination of the S election of many corporations. The bill would extend the current 60-day period to two years and, therefore, should reduce the number of such inadvertent terminations.

6. <u>Expand the "Post-termination Transition Period" To Cover Determinations Made on Audit</u>

Under current law, a corporation that terminates its S election is generally permitted to make a tax-free distribution of its earnings from its S corporation years during its "post-termination transition period." In addition, a shareholder is entitled to take losses that carry over from a corporation's S years if the shareholder obtains additional basis in his/her stock during the post-termination transition period.

Under current law, the definition of post-termination transition period does not include situations in which a corporation terminates its S status and, some time after the end of such period, adjustments are made by the IRS on audit to its S years. For example, a shareholder with suspended losses would not be able to use those losses even though audit adjustments by the IRS result in additional stock basis. The bill would rectify this technical problem by expanding the definition of post-termination transition period generally to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer, if the determination (1) follows the termination of the corporation's election, and (2) adjusts an item of income, loss, or deduction arising during its S years.

7. Permit Tax-Free Distributions in Loss Years

In general, a shareholder in an S corporation must reduce his/her stock basis for losses in the current year before reducing such basis for current-year distributions. In addition, a distribution in excess of a shareholder's stock basis is taxable to the shareholder. Therefore, if a shareholder receives distributions during the year, distributions may become taxable if losses during the year eliminate the shareholder's stock basis.

Because the shareholders of an S corporation may not know whether the corporation will have a loss in the current year, which could potentially deplete a shareholder's basis, there is always the possibility that a current distribution will be made taxable because of operating losses during the year. The bill remedies this situation by providing that basis first would be decreased by distributions and then by losses. The effect of this change would be to effectively delay losses (and attendant basis reduction) until after distributions are taken into account. This change would eliminate the uncertainty as to taxability of distributions and would parallel the treatment of distributions by partnerships.

8. Preservation of One Level of Tax on Liquidation of S Corporations

When an S corporation is liquidated, the corporation recognizes income as if it had sold all of its assets at their fair market value. The gain recognized by the corporation is taxed to the shareholders and increases their basis in stock. In addition, the Tax Code provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as received in full payment for his/her stock. These rules may effectively result in double taxation of an S corporation because any ordinary income realized at the corporate level on the distribution of its assets may not be offset by the capital loss that is recognized at the shareholder level on the liquidating distribution.

For example, assume that an individual purchases all of the stock of an S corporation for $50,000. The corporation's basis in its only asset, its inventory, is $20,000. If the individual causes the S corporation to distribute its assets in liquidation to its shareholder, the corporation is deemed to have sold its assets for their fair market value of $50,000. As a result, the shareholder is taxable on $30,000 in ordinary income, which raises his/her stock basis to $80,000. The corporation then distributes the $50,000 in assets to its shareholder in complete liquidation, generating a capital loss of $30,000. Only $3,000 of the capital loss may be offset against the $30,000 of ordinary income recognized by the shareholder. The shareholder may use the remaining capital loss in future years, but only to the extent of capital gains. Thus, the shareholder is effectively taxed twice on the lion's share of the income realized on the corporation's sale of assets. This double taxation is contrary to the single-tax regime of Subchapter S.

The bill would eliminate this potential trap (and the perverse result of double taxation) by providing that the portion of any loss recognized by a shareholder on amounts received in complete liquidation of an S corporation will be treated as an ordinary loss to the extent the shareholder's stock basis has been increased for ordinary income of the S corporation attributable to the liquidation.

CONCLUSION

The S Corporation Coalition supports legislation that provides much needed S corporation reform. We support legislation that not only eliminates technical traps for S corporations created by current law, but also promotes simplification of the tax laws, enhances an S corporation's ability to access capital, and recognizes the importance of family-owned businesses.

STATEMENT ON BEHALF OF SOLO CUP COMPANY

IN SUPPORT OF EXCEPTION TO 35-SHAREHOLDER

LIMIT FOR FAMILY-OWNED S CORPORATIONS

Hearings on Miscellaneous Tax Proposals
House Ways and Means Committee
July 11-12, 1995

Mr. Chairman and Members of the Committee:

Solo Cup Company greatly appreciates your willingness to consider the various proposals for reform of Subchapter S of the Internal Revenue Code. Solo Cup Company would like to commend Mr. Shaw and others for introducing H.R. 2039 and for so vigorously working for its passage.

FACTS ABOUT SOLO

Solo Cup Company is an Illinois-based company. Solo was founded in 1936 as a manufacturer and distributor of paper cups. Over the years, the company has expanded its offering of paper products and, in the early 1970s, began producing disposable plastic cups and related plastic products. Today Solo is one of the leading suppliers to the consumer market and food service industries in the Unites States. Solo presently employs 3,600 people in the U.S. and has facilities in 14 states and in Puerto Rico, Panama and Canada.

Solo is presently an S Corporation. Under current law, S Corporations can have no more than 35 shareholders. In particular, Solo supports two provisions contained in H.R. 2039: an increase in the number of permissible shareholders from 35 to 50 and permitting a family owning S Corporation shares to elect to be treated as one shareholder.

HISTORY AND EFFECTS OF THE 35-SHAREHOLDER LIMITATION

The current 35-shareholder limit has evolved since the adoption of Subchapter S. Originally, Subchapter S could only be availed of by corporations with 10 or fewer shareholders. The shareholder limit was increased to 15 in 1976 for certain corporations and was extended to 15 for all S corporations in 1978. The limit was expanded to 25 in 1981, and, finally, the rule was revised again in 1982 when the current 35-shareholder limit was enacted. Throughout this time period, the purpose of the numerical shareholder limit has always been to limit the benefits under Subchapter S (no tax at the corporate level) to closely-held businesses while ensuring that large, widely-held corporations remain subject to the classical system of two levels of tax.

While the purpose of the 35-shareholder limit is sound, the limit can have the unintended effect of making it difficult for a family to retain ownership of their business within the family. As many small business owners age, they seek to transfer some of their shares to their descendants. However, families with a reasonably high number of children and grandchildren face a dilemma because of the 35-shareholder rule.

A simple example illustrates the problem. Assume that all of the shares of X Corporation (an S Corporation) are owned equally by three siblings, A, B and C. A, B and C each have three children, and each of the children has three children of their own. If A, B and C want to give their X Corporation stock to each of their children and grandchildren, the business would no longer qualify as an S Corporation: there would be 39 shareholders!

Of course, A,B and C are not required to give shares to all their grandchildren; they could each leave the shares only to their children or only to the children and some, <u>but not all</u>, of the grandchildren. But this approach creates problems of its own. Grandparents generally seek to equalize the gifts and bequests they make to their grandchildren. If some grandchildren do not receive S Corporation stock, the grandparents will need a sufficient amount of other assets in order to equalize the value of property being transferred to each grandchild. Otherwise, their non-tax-motivated estate plan would be thwarted.

Thus, the 35-shareholder limit creates a dilemma for the family-owned S Corporation. The owners must choose one of three approaches:

(1) Continue operating the business as an S Corporation at the cost of being unable to leave property equally to all their grandchildren;

(2) Sacrifice the company's S Corporation status in order to achieve their estate planning goal; or

(3) Sell the company.

From the perspective of good tax policy, it is unclear why this decision if forced on the owners of the S Corporation. All they seek is to leave property to their children and grandchildren in equal amounts. Essentially, they are penalized for having too large a family.

It is universally acknowledged that the 35 shareholder limit is an arbitrary line. While clear boundaries are necessary for good tax administration, they should not be so rigid that owners of S Corporation shares are forced to choose which of their grandchildren will not receive stock in the family business in order to maintain their S Corporation status. Surely the tax code ought not compel family-owned businesses to forego their S election merely to keep the business ownership in the family.

Instead, Subchapter S should be designed to foster family ownership of businesses. The tax laws should not be configured in a way that forces families to choose between losing their company's S status and keeping the business within the family in accordance with their legitimate, non-tax motivated estate planning objectives.

<u>SUPPORT FOR H.R. 2039</u>

H.R. 2039, introduced by Mr. Shaw and others, contains two provisions affecting the number of shareholders an S Corporation can have. The first would increase the number of permissible shareholders from 35 to 50. Solo strongly supports this change. It would go far to alleviating potential problems caused by the present 35-shareholder limit.

Because of the potential family owners of Solo, however, the increase in permissible shareholders from 35 to 50, is insufficient standing alone to alleviate Solo's concerns. The second proposal in H.R. 2039 sought by Solo would completely address its concerns. That proposal would create an exception to the 35-shareholder rule for family-owned businesses. In particular, the proposal would permit one family to elect to be treated as a single shareholder for purposes of the 35-(or 50) shareholder limit. To qualify, all shares in the family must be held by lineal descendants (or their spouses or former spouses) of a common ancestor. A family would qualify to make the election no matter how many shareholders it had.

The bill defines "common ancestor" as an individual who is no more than six generations removed from the youngest generation of shareholders at the time the S election is made or when the provision becomes effective, whichever is earlier. This insures that corporations could not trace their common ancestor

all the way back to Adam and Eve (which would arguably make every corporation eligible for S status). At the same time, it insures that a family need only qualify once under this exception.

Other proposals have been made that would allow corporations owned by large families to retain their S Corporation status. In particular, it has been suggested that "families" be treated as one shareholder for purposes of the 35-shareholder limitation. Such an "attribution" approach would be acceptable to Solo. However, the attribution approach has been criticized by some as moving too far away from the limited ownership requirements currently embodied in Subchapter S. Unlike H.R. 2039, an attribution approach would extend the benefits of Subchapter S to a corporation owned by 35 families of unlimited size. For example, a corporation owned by 35 families of 50 individuals each could, under the attribution approach, qualify for S status even though it had 1,750 shareholders. H.R. 2039, on the other hand, does not permit this "multiplier" effect. H.R. 2039 is much more limited and only creates a one-family exception to the 35-shareholder limitation.

CONCLUSION

At a time when small businesses are responsible for creating the majority of new jobs in this country, the tax rules should not penalize families that seek to maintain ownership of their business in the family. The increase in the permissible number of shareholders from 35 to 50 and the family-business exception would make it easier for the owners of a family-owned corporation to keep ownership of the business within the family. As a result, family ownership could be maintained in a manner that preserves the integrity and original purpose of the shareholder limitation. These proposals make sense from a tax policy standpoint and would help ensure that these small businesses continue to grow and prosper.

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

Written Testimony of Donald B. Susswein
Counsel, The Coalition for Asset Backed Securities
in Support of H.R. 1967
Before the Committee on Ways and Means
U.S. House of Representatives
July 27, 1995

Introduction

Thank you for the opportunity to submit written testimony on H.R. 1967. My name is Donald B. Susswein. I am a tax partner with the law firm of Thacher Proffitt & Wood. I am pleased to be testifying for the Coalition for Asset Backed Securities in support of H.R. 1967 -- the "FASIT" legislation introduced by Congressman Clay Shaw (R. FL), and Congressman Charles Rangel (D. NY), and co-sponsored by a majority of the members of this Committee.[1]

The Coalition For Asset Backed Securities is a diverse group of banks and other institutions that make loans, as well as companies that issue and underwrite securities backed by loans. These securities are often referred to as asset backed securities. In addition to our individual members,[2] I am pleased that the Coalition is joined in its support of the FASIT legislation by a broad spectrum of financial services trade associations including the American Bankers' Association, America's

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[1]As of July 27, 1995, the following Members of the House Ways and Means Committee have co-sponsored H.R. 1967:

E. Clay Shaw, Jr.	(R-Fla.)	Charles B. Raangel	(D-N.Y)
Philip M. Crane	(R-Ill.)	Robert T. Matsui	(D-Calif.)
William M.Thomas	(R-Calif.)	Barbara B. Kennelly	(D-Conn.)
Nancy L. Johnson	(R-Conn.)	Benjamin L. Cardin	(D-Md.)
Jim Bunning	(R-Ky.)	Jim McDermott	(D-Wash.)
Amo Houghton	(R-N.Y.)	Gerald D. Klecka	(D-Wis.)
Wally Herger	(R-Calif.)	John Lewis	(D-Ga.)
Jim McCrery	(R-La.)	L.F. Payne	(D-Va.)
Mel Hancock	(R-Mo.)	Richard Neal	(D-Mass.)
Dave Camp	(R-Mich.)		
Jim Ramstad	(R-Minn.)		
Dick Zimmer	(R-N.J.)		
Jim Nussle	(R-Iowa)		
Sam Johnson	(R-Tex.)		
Jennifer Dunn	(R-Wash.)		
Mac Collins	(R-Ga.)		
Rob Portman	(R-Ohio)		
Phil English	(R-Pa.)		
John Ensign	(R-Nev.)		
Jon Christensen	(R-Neb.)		
Greg Laughlin	(R-Tex.)		

[2]The Coalition for Asset Backed Securities includes the following companies and associations:

Advanta Corp./Colonial National Bank	Investment Program Association
American Bankers' Association	Lehman Brothers
America's Community Bankers	Merrill Lynch & Co., Inc.
Chemical Bank	Morgan Stanley
Citicorp/Citibank	Public Securities Association
Equipment Leasing Association of America	Salomon Brothers, Inc.
First Boston Corporation	Securities Industry Association
Goldman Sachs & Company	Union Bank of Switzerland
Household International	

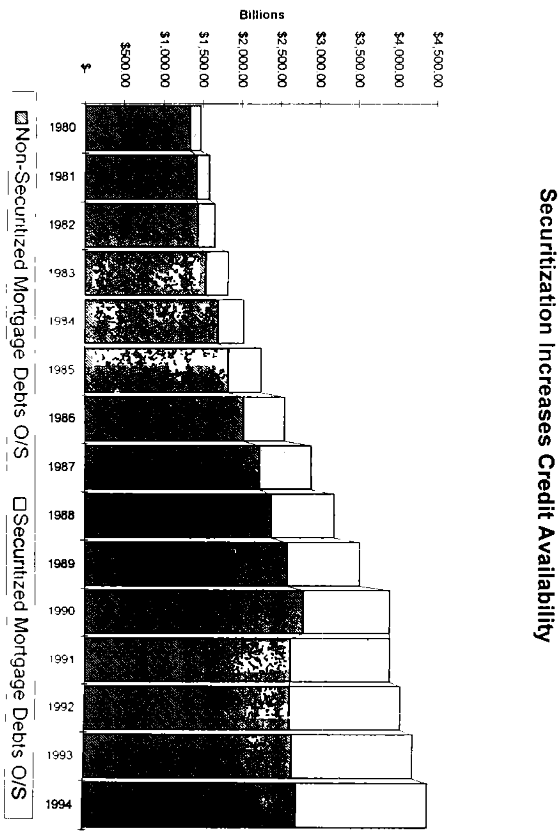
Community Bankers, the Public Securities Association, the Securities Industry Association, and the Equipment Leasing Association of America.

We support FASIT because it would help increase the supply of credit for lending, increase the safety and soundness of the nation's financial system, and reduce the private sector's reliance on explicit or implicit guarantees of the Federal Deposit Insurance Corporation ("FDIC") or other Federal agencies. The bill would accomplish these goals by making it easier to turn pools of relatively illiquid loans on the books of banks and other lenders into highly liquid, marketable securities that rely for their creditworthiness solely on the underlying loans or on guarantees or other forms of credit enhancement provided by the private sector.

<u>The Importance Of Securitization</u>

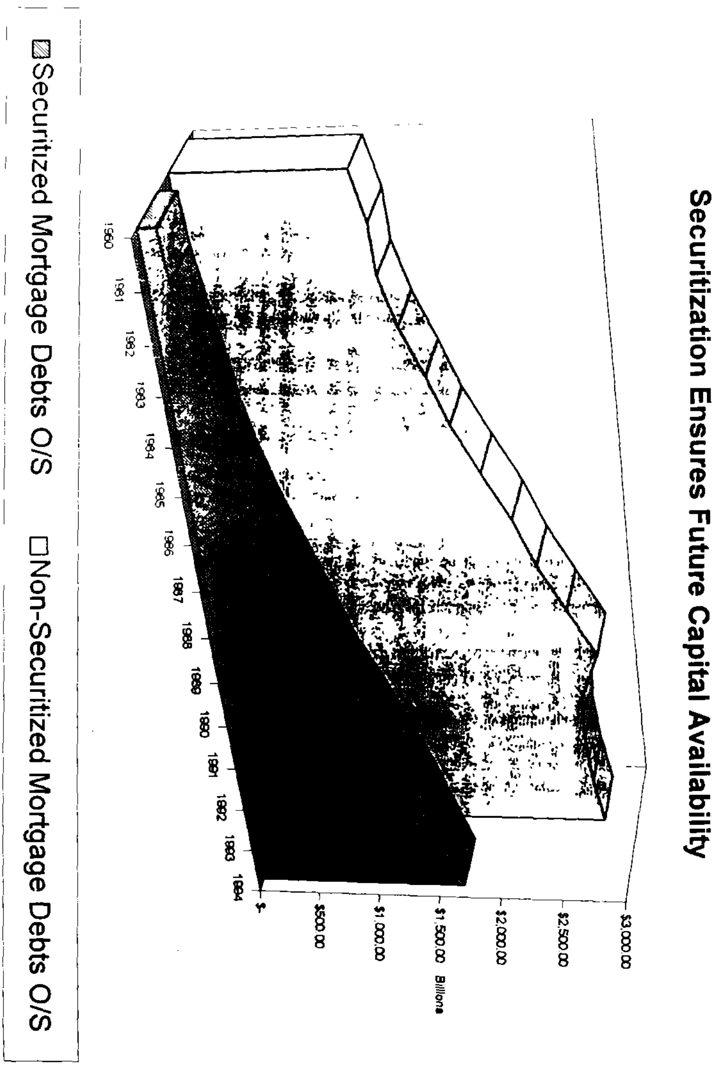
The FASIT legislation would build on Congress' highly successful experience with similar tax legislation that promoted the securitization of mortgage loans. In part as a result of the REMIC provisions of the 1986 Tax Act, the country has experienced an era of unprecedented credit availability, liquidity, and diversification of financial risk in the mortgage markets over the last eight years. This has occurred despite the fact that many other sectors of the credit and financial markets have experienced their share of economic difficulties during the same period.

To illustrate this point, we have prepared a chart showing the amounts and sources of mortgage money over most of the last decade.



As you can see, the total supply of mortgage money has been steadily increasing, despite the fact that the portion provided without reliance on securitization -- shown in the darker area -- has been declining both as a percentage and, in several recent years, as an absolute amount. This chart bears the title "Securitization Increases Credit Availability," but it could be called "The Credit Crunch That Never Happened." It illustrates the fact that securitization has helped keep the supply of mortgage money in line with the demand for mortgage credit, even as many traditional sources have been forced by economic circumstances to curtail their participation in this market.

A second chart presents the same data in another format. Entitled "Securitization Ensures Future Capital Availability", it illustrates that the importance of securitization is growing. Indeed, securitization appears to be the wave of the future.



Securitization of loan pools is attractive from an economic and business perspective because of several advantages it offers to lenders and borrowers over other forms of financing.

First, because securitization increases the amount of information investors have about the risks involved in holding a pool of loans, investors become more comfortable with those risks and more willing to invest in the pool.

Second, securitization makes it possible to segment the different categories or types of economic risk associated with a pool of loans. As a result, it is often possible to make a better match between various risks and the investors that are most knowledgeable about -- and comfortable with -- undertaking those risks. For example, some investors may be more comfortable evaluating and assuming the risk of borrower default, while others may be more comfortable evaluating and assuming the risk that market interest rates will rise or fall.

Third, by converting a pool of loans into a marketable security -- even if that security is retained by the original lender -- the loans become more liquid, and therefore more valuable. Liquidity -- which can be defined as the ability to readily sell or liquidate a loan or security at a price closely reflecting its inherent value -- also makes for safer and sounder financial markets.

Fourth, by increasing information, risk segmentation, and liquidity -- the first three items already mentioned -- securitization makes it easier for lenders and investors to achieve appropriate diversification of their portfolios. Diversification can help prevent a localized economic problem -- such as a sudden change in the price of energy, real estate, or other commodities crucial to the local economy -- from dragging down all of an area's local financial institutions and potentially causing serious regional or national financial problems. Lenders and bank regulators do their best to avoid taking undue risks -- but there are always unpredictable or unanticipated factors. Diversification helps manage the risk of the unknown.

FASIT Is The Tax Counterpart To Recent SEC Actions Rationalizing The Legal Rules Applicable To Asset Securitization

Because of these economic and business advantages, securitization is becoming one of the most economically efficient ways to obtain and provide funds for lending activities. This trend was furthered by actions taken recently by the Securities Exchange Commission to rationalize the securities laws governing asset backed securities.

After decades of issuing rulings allowing particular types of assets -- such as mortgage loans or consumer loans -- to be securitized with the blessings of the SEC, the Commission decided to adopt a generic approach to the treatment of what they referred to as "structured financings." Under this new approach, any structured financing could proceed as long as certain structural safeguards and investor protections were satisfied, without regard to the type of loan or asset involved. The SEC's explanation of its action is worth noting, because it echoes the thinking underlying the FASIT legislation.

In describing the law applicable before 1992, the Commission explained, the securities laws treated --

"similar types of structured financings very differently, depending solely on the asset securitized."

As a result, they explained --

"Some sectors of the economy, including small business, generally are unable to use structured financings as sources of capital, and many United

> States investors are denied the opportunity to purchase sound capital market instruments."[3]

In many ways the FASIT legislation is the tax code counterpart to the SEC's actions to promote asset securitization. Like the SEC's actions, FASIT would eliminate much of the disparity in tax treatment between certain selected classes or types of assets, which are currently allowed to obtain direct access to the capital markets through statutorily sanctioned vehicles, and other types or classes of assets which do not yet enjoy that treatment under the tax law. FASIT accomplishes this with a generic rule, like the SEC's approach, which allows all types of loans to be securitized as long as appropriate structural limitations and safeguards are in place. In the case of FASIT, however, the structural limitations and safeguards are designed to protect the tax policy concerns of the Treasury Department.

Tax Issues In Securitization

To understand exactly what FASIT does, and why it is beneficial, it is necessary to understand a little about the way asset securitizations are structured under current tax law.

Securitization of loans depends on the ability to pass through to investors all or a significant portion of the interest income that is earned on a pool of loans without the imposition of an intervening corporate tax. As a tax matter, this is essentially what occurs when a bank makes loans with funds that it has obtained from deposits or other borrowings. Corporate taxes are paid by the bank only on the portion of the interest income received that is not paid out as interest to its depositors or other creditors. The portion that is paid to depositors is not subjected to an entity level tax, but is simply included directly in the depositor's required tax computation.

Traditional securitizations typically involve the use of a special purpose financing vehicle as the holder of the loans, and issue debt securities instead of raising funds from bank deposits, but the tax principle is the same. That is, assuming that the financing vehicle is a corporation, corporate taxes are paid only on the portion of the interest income received that is not paid out to the holders of debt instruments issued by the entity. As a result, a key tax issue is determining how best to structure the transaction so that the securities qualify as debt, rather than as an ownership interest in the special purpose entity.

With REMICs, or similar entities structured under the tax law as fixed investment trusts or partnerships, the task of securitizing loans becomes much easier because 100 percent of the income paid out to investors is passed through without the imposition of an intervening corporate tax. This complete pass-through treatment is available regardless of whether the securities are classified as debt or as equity (i.e., ownership interests). Thus, the problem of determining how best to structure a security so that it satisfies the business objectives of the parties and still qualifies as debt for tax purposes is eliminated. As long as the broad structural requirements of these statutory vehicles are satisfied, the issuer is free to structure the security so that it optimally satisfies the parties' economic and business needs.

Once pass-through treatment is assured, the technical rules governing REMICs, grantor trusts, and partnerships concern themselves with ensuring that there is an appropriate allocation of income among different classes of owners. Rules of this sort do not pose any problems for loan securitization since loan securitization is motivated by economics, not by tax considerations. Thus, once pass-through treatment is assured, issuers' tax objectives become the same objectives generally viewed as the goals of "good tax policy"; that is, to ensure that each investor's

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[3]Securities and Exchange Commission Release No. IC-19105/November 19, 1992, Investment Company Act of 1940.

taxable income reflects its true economic income -- no more and no less.

Key Tax Provisions Of FASIT

Like the REMIC provisions before it, the FASIT legislation will help make loan securitization easier by creating a new pass-through structure specifically designed for loan securitization. Unlike REMICs, FASITs will be available for all types of loans or other instruments treated as debt for Federal income tax purposes. This will include leases treated as financings for tax purposes.

In general, FASITs must be beneficially owned by U.S. banks or other U.S. corporations. Although the FASIT itself will not be subject to any tax, its net income will be included in the U.S. income tax return of its owner or owners, and thus will, in virtually all cases, be subject to corporate income tax. An exception, intended to facilitate small business loan securitizations, will allow businesses operated as partnerships or S corporations to retain ownership of FASITs used to securitize loans to their customers, such as trade receivables.

Loans will be transferred or sold to the FASIT so that it can issue securities backed by the loans it has acquired. As with REMICs, FASITs will be permitted to issue securities that qualify as debt of the FASIT for Federal income tax purposes even though they are issued in non-debt form (i.e., as certificates of ownership of the underlying assets) for state law purposes.

Issuing securities in the form of ownership certificates is necessary in order for regulatory agencies and financial accounting statements to properly recognize the fact that the assets of the FASIT are the sole source of payments on the securities, and the fact that any risk of loss on the assets that is borne by the owners of the FASIT has been limited to a reasonably estimable amount. At the same time, treating such certificates as debt of the FASIT for tax purposes means that the portion of FASIT income passed through to the holders of the certificates is not included in the FASIT income that is passed through to the corporate owners of the FASIT.

A disparity of this sort between state law form and tax law characterization is consistent with the well established principle that the tax treatment of a transaction is governed by its substance rather than its form. The FASIT legislation makes the rules for qualifying securities as debt, based upon their economic substance, clearer and more straightforward. In so doing, FASIT makes the tax rules governing the most advanced type of securitization structures more accessible to a wider variety of issuers and their tax counsel. Based on the experience with REMIC, this should make for more competition among a broader universe of issuers, underwriters, and their tax advisors, and a more liquid and more efficient marketplace.

In addition to making the applicable legal rules and standards more accessible, FASIT will also ease some of the common law rules that are generally perceived as governing this type of securitization.

Under current case law, it is generally perceived that issuers of securities purporting to qualify as debt for tax purposes on the basis of their economic substance -- notwithstanding their non-debt form -- should be able to point to "strong proof" that the securities have the economic characteristics of debt. Tax advisors have generally adopted a self-imposed guideline that insists on a high investment grade rating (e.g., "A" or better) to assure themselves that the "strong proof" standard can clearly be satisfied.

Under the FASIT legislation, debt securities can be issued as long as they do not have a yield that is more than 5 percentage points higher than the yield on Treasury obligations with a comparable maturity. As compared to the conservative practice of tax counsel to the leading issuers, this will permit more subordinated debt securities to be issued. It should be pointed out, however, that even debt

securities at the top end of that yield limitation are still fundamentally debt-like. The 5 percentage point standard is actually borrowed from current tax law rules that govern when certain high-yield discount bonds will be subject to special rules deferring accrued interest deductions.[4] These rules effectively assume that obligations yielding 5 points more than Treasury bonds could and do qualify as debt. Thus, the FASIT legislation will not be authorizing the issuance of debt securities that are fundamentally different from debt securities that are currently outstanding in the markets.

The yield limitation, which limits how much income can be passed through to the holders of FASIT debt instruments, is important because all remaining income -- the income associated with the true equity-like risk of investing in a pool of loans -- will be taxable to the U.S. banks or other U.S. corporations that retain or acquire the ownership interests of the FASIT.

Importance Of Subordination

The benefits to be obtained from making the tax laws governing securitization clearer and more accessible to more lenders and their tax counsel should be self-evident. Transactions will be structured more efficiently and with fewer transaction costs.

The benefits to be obtained from allowing somewhat greater issuance of subordinated debt securities are less obvious, but quite important and worth mentioning in some detail -- particularly since this is the principal part of the proposal that represents a change from current practice.

Under current law, as previously discussed, many asset-backed securities offerings must effectively be highly rated (e.g., "A" or better) in order to give comfort to conservative tax counsel. High ratings are desirable for other purposes as well, such as the goal of issuing as many securities at as low an interest rate as possible.

High ratings can often only be obtained with the assistance of external credit enhancement. This means some form of guarantee provided by an independent bank or other financial institution. Typically the guarantee -- which may take the form of a letter of credit, pledged account, or similar arrangement -- does not guarantee against all losses but assumes what is called a "second loss" position. This is comparable to the risks assumed by an insurer on a fire insurance policy with a very large "deductible". Only when losses exceed a catastrophic level does the guarantee typically become applicable.

The losses being insured against by the credit enhancer, in effect, are not the normal risks of underwriting and making loans, but the risk, say, of an unanticipated severe recession which causes abnormally high levels of soundly underwritten loans to go into default. In many respects, this is comparable to the type of risk that is currently borne by the FDIC with respect to conventional lending by commercial banks. The FDIC insures depositors against losses, but the FDIC is required to pay only if losses are so severe that they have first depleted substantial portions of a bank's equity capital. In this respect, the FDIC is assuming the "second loss" risk.

Because there is no FDIC guarantee (or other Federal guarantee) involved in asset securitization, the entity providing the credit enhancement must have excellent credit itself. Typically this means that the credit enhancer must have a top investment rating, such as a long-term bond rating of AAA from Moody's Investor Servicers, one of several nationally recognized rating agencies.

The need for credit enhancement has placed an increasing importance on what is,

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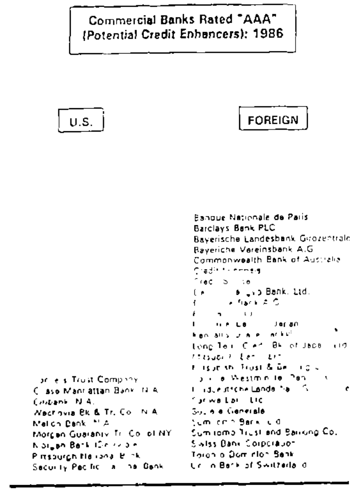
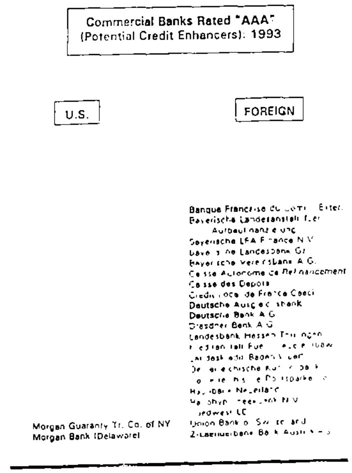
[4]See, Section 163(e)(5), Internal Revenue Code of 1986.

unfortunately, a limited and somewhat volatile supply of top rated financial institutions throughout the world. For example, the number of triple-A rated institutions able to provide credit enhancement, has declined substantially both in the U.S. and throughout the world as a result of the economic difficulties of the last decade.

To illustrate this, we have prepared two other charts which show the AAA-rated commercial banks in the U.S. and abroad in 1986 and 1993.



Source: *Moody's Long-Term Bank Ratings*



Source: *Moody's Long-Term Bank Ratings*

In 1986, there were 9 U.S. AAA-rated commercial banks. In 1993 there were only two. Today, there are none. This has meant an increasing reliance on foreign commercial banks as suppliers of credit enhancement. Even this supply has diminished and, perhaps more importantly, has become quite volatile. The institutions on the list in 1986 and 1993 are almost completely different. Foreign banks are no less subject to the vagaries of economic cycles than our own domestic financial institutions.

There has been much talk about the potential for the U.S. credit markets to become dependent upon foreign buyers of U.S. debt instruments. Much of the discussion has focused on an imagined scenario in which foreign investors cease buying U.S. Treasury obligations. For those who view loan securitization as a key financing technique, a more realistic threat may be posed by the growing dependence of U.S. lenders on a limited number of suppliers of credit enhancement. A major change in a single foreign government's bank rules, for example, could wipe 5 or 6 institutions off of the list of potential credit enhancers overnight. Such a scenario would substantially reduce credit availability for U.S. borrowers.

One alternative to credit enhancement in the form of guarantees is credit enhancement through further securitization. Instead of obtaining, say, a guarantee against $10 million of loan losses and paying a fee for that, the same economic function can be provided by raising $10 million in cash from the issuance of securities, conditioning the repayment of the $10 million upon losses not exceeding a particular level, and paying the security holders a higher interest rate to compensate them for assuming those risks. This is the economic function intended for the newly authorized subordinated FASIT securities, with yields as high as 5 points over Treasury yields.

By allowing this function to be provided through the public securities markets, rather than through the issuance of guarantees by a limited number of credit enhancers, the market of potential suppliers is immediately increased. It is expanded rather dramatically from a fluctuating group of one or two dozen mainly foreign banks or other financial institutions to thousands of sophisticated investors and money managers throughout the world.

In theory, opening up these markets occurs at the cost of a potential corporate income tax -- if one could assume that these functions would otherwise continue to be provided by corporations subject to U.S. taxation. But the unreliability of that assumption is the very problem. If we could be assured of high levels of credit availability, diversification, and liquidity without making any policy changes, there might be no need for legislation of this nature. However, we cannot simply take for granted a continued availability of capital for lending any more than we can take for granted the continued availability of gasoline or crude oil.

As the economy continues to improve, and loan demand increases, this problem may become even more severe than the "credit crunch" that has been experienced recently. Other solutions and approaches to provide securitization have been, and perhaps will continue to be, proposed. These may include easing various capital regulations, creating new Federal agencies to guarantee various types of loans, or even involving the U.S. government in direct lending. There is nothing inconsistent between FASIT and these other approaches. While some may have merit, it clearly makes sense to first go forward with what is a comparatively modest step of broadening the marketplace to allow institutional investors to invest more freely in subordinated loan-backed securities of the type authorized by the FASIT legislation.

Conclusion

To summarize;

- Loan securitization is increasingly becoming the way U.S. corporations obtain funds for lending.

- As demonstrated with the experience under REMIC, securitization's benefits for the economy and the financial markets are widely accepted and understood.

- Greater clarity in the tax rules applicable to these transactions will help make them more efficient and less costly for all concerned.

- Through relatively modest tax changes we can also expand the number and type of participants that can provide the crucial function of credit enhancement -- making our domestic lending markets more "credit independent."

FASIT can accomplish these objectives, and we strongly support it for that reason.

Statement of the

National Association of Real Estate Investment Trusts®

Before the

Committee on Ways and Means

regarding the Hearings on

Miscellaneous Tax Reforms

Submitted by Kenneth B. Roath, NAREIT Chair and Chairman, Health Care Property Investors, Inc.

July 27, 1995

The National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits this statement in connection with the Ways and Means Committee review of miscellaneous tax reforms, as described in Press Release No. FC-8 (June 30, 1995). NAREIT will comment on the "package of proposals to simplify and improve REIT provisions," and specifically will endorse H.R. 2121, the Real Estate Investment Trust Simplification Act of 1995 as introduced on July 26, 1995, by Messrs. Shaw and Matsui and ten other co-sponsors.

NAREIT represents over 250 real estate investment trusts (known as "REITs"), over 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 analysts, investment bankers, lawyers, accountants, and others who provide services to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of real estate that beforehand were only available to large, sophisticated investors. Capital formation has been essential to the growth and success of REITs ever since, and the promise of a large scale, widely held real estate capital market has begun to become a reality. The market capitalization of publicly held REITs has blossomed from under $9 billion at the beginning of 1991 to about $50 billion today. This success story is due in no small part to the tax modernization reforms Congress has adopted over the years.

NAREIT applauds the work done by Messrs. Shaw, Matsui and the other co-sponsors of H.R. 2121 for developing an excellent package of amendments. This bill would eliminate or reduce many problem areas in the existing REIT tax regime while retaining the core principles existing since Congress created REITs in 1960. We hope that Congress will include these proposals in any 1995 tax legislation.

The remainder of this statement describes the provisions of H.R. 2121 and explains why such amendments are necessary.

TITLE I. REMOVAL OF TAX TRAPS FOR THE UNWARY

SECTION 101: Shareholder Demand Letter

Sections 856(a)(5)[1] and 856(a)(6) require that a REIT have at least 100 beneficial owners and that it not be "closely held" within the meaning of the personal holding company rules. A REIT that is disqualified because it fails to meet the requirements in section 856(a) generally may not elect REIT status again for a period of 5 years.

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[1] "Section" refers to a section of the Internal Revenue Code of 1986, as amended ("Code"), unless otherwise indicated.

In addition, section 857(a)(2) disqualifies a REIT for any year in which it does not comply with Internal Revenue Service ("IRS") regulations prescribed to ascertain the "actual ownership" of the REIT's outstanding shares. Sections 1.857-8(d) and (e) of the Income Tax Regulations (the "Regulations") require a REIT to demand, from its shareholders of record, a written statement identifying the "actual owner" (for income tax purposes) of the stock held in such shareholder's name. The Regulations specify which shareholders must be sent such letter, based on the total number of REIT shareholders and the percentage of shares held by each record holder. This demand letter must be sent within 30 days of the close of the REIT's taxable year.

Failure to comply with the rules in Regulations section 1.857-8, through inadvertence or otherwise, technically causes disqualification of REIT status for the taxable year, notwithstanding that the REIT may satisfy the substantive share ownership rules in section 856(a)(6). As in the case of any disqualification under section 856(a), a REIT that is disqualified under the shareholder demand letter regulations may not elect REIT status again for a period of 5 years without IRS consent.

Even those REITs that comply with the demand letter regulations, and are not aware of any violations of the ownership test, cannot know for certain whether they complied with such tests; the ownership information is not in the hands of the REIT and the REIT cannot compel its shareholders to respond to the demand letter. This uncertainty is increased for publicly-traded REITs that have a large portion of their shares held in "street name."

H.R. 2121 proposes that a failure to comply with the shareholder demand letter regulations should not, by itself, disqualify a REIT if the REIT otherwise establishes that it satisfies the substantive rules in section 856(a)(6). Under these circumstances, a $25,000 penalty ($50,000 for intentional violations) would be imposed for any year in which the REIT did not comply with the shareholder demand letter regulations and the REIT would be required, when requested by the IRS, to send curative demand letters. We note that the proposal is more rigorous than the test contained in the Omnibus Budget Reconciliation Act of 1993 relating to the 50% exclusion for gain from the sale of small business stock. Nevertheless, NAREIT agrees that the proposal in H.R. 2121 strikes the right balance between the "atomic bomb" consequences of present law and the need to provide a disincentive for REITs not to send out demand letters.

Also under H.R. 2121, a REIT would be deemed to satisfy the share ownership requirements in section 856(a)(6) if it complies with the shareholder demand letter regulations and does not know, or have reason to know, of an actual violation of the ownership rules. Thus, a REIT that complies with the regulations, but is unable to discover an actual ownership violation and has no reason to suspect such a violation, would not be disqualified before it has reason to know of such violation. This amendment is vital to protect companies that exercise their best efforts to comply with the ownership rules, but somehow later discover that, e.g., the attribution rules led to a technical violation.

SECTION 102: Property Management - De Minimis Rule For Tenant Services Income

The REIT tax provisions include several independent contractor rules. The primary rule is found in section 856(d)(2)(C), which generally provides that "rents from real property" do not include amounts received with respect to the property if the REIT furnishes services to the tenants, or manages or operates the property, other than through an independent contractor. Congress modified this rule in 1986 by adding the flush language at the end of section 856(d)(2)(C). This language permits the REIT to receive amounts for furnishing customary services or managing property, without using an independent contractor, provided such amounts would be excluded from unrelated business taxable income under section 512(b)(3) if received by a section 511(a)(2) exempt organization.

Congress' relaxation of the independent contractor rule has helped the industry in efficiently managing rental properties on a competitive basis. However, certain problems persist. Under the existing language of section 856(d)(2)(C), the receipt of even a de minimis amount of non-qualified income or rendering a small amount of impermissible

services with respect to a given property may disqualify all rents received with respect to such property. The disqualification of the entire property's rents could jeopardize the REIT's qualified status.

The present independent contractor rule creates significant administrative burdens for REITs because of the need to ensure that no REIT personnel ever perform any disqualifying service. In addition, due to the inherent ambiguity of the rule, significant time and expense are incurred by both REITs and the IRS in applying for and issuing private letter rulings that delineate permissible and impermissible services. Further, even a vigilant and conservative REIT cannot control whether a particular employee performs a service to its tenants that may taint the rents on a property. Last, the present rule unreasonably penalizes a REIT for providing services (which may be directly related to the operation of its property) to a tenant (by tainting all amounts received from that tenant) that it may, with much less chance of disqualification, provide to third parties.

H.R. 2121 proposes a de minimis exception to the independent contractor rule. This proposal would simplify REIT administration and would remove the risk of disqualifying a REIT that inadvertently performs nominal, although impermissible, services. Further, the proposal would not encourage intentional disregard for the independent contractor rule, because of the relatively small amount of services that it would permit.

H.R. 2121 would provide a simple, bright line test that the IRS could administer easily. NAREIT applauds this proposal as bringing common sense relief to an area in which an inadvertent footfall could have significant adverse consequences.

SECTION 103: Attribution Rules Applicable to Tenant Ownership

Section 856(d)(2)(B) generally disqualifies rents received from any person, if the REIT owns 10% or more of the ownership interests in such person or has an interest equal to 10% or more in the assets or net profits of such person. For purposes of determining the REIT's ownership interest in a tenant, the attribution rules of section 318 apply, except that 10% is substituted for 50% when it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3). Under section 318(a)(3)(A), stock owned, directly or indirectly, by a partner is considered owned by the partnership. In addition, under section 318(a)(3)(C) a corporation is considered as owning stock that is owned, directly or indirectly, by or for a person who also owns more than 50% (10% for REITs) of the stock in such corporation.

The attribution rules may create an unintended result when several persons who own collectively 10% of a REIT's tenant, also own collectively 10% of the REIT. So long as these persons are unrelated and their individual interest in each entity is less than 10%, then no violation of section 856(d)(2) occurs. However, if each of these persons happen to obtain an interest, no matter how small, in the same unrelated partnership, then the attribution rules may cause the rents received from the tenant to be disqualified under section 856(d)(2). Such a result could occur even though section 318(a)(5)(C) specifically provides that the stock ownership interests of a partner are not to be attributed to another partner via the partnership.

Under one understanding of current law, the problem arises because all of the partners' shares of stock in the tenant are attributed to the unrelated partnership under section 318(a)(3)(A). Since the partnership also is considered as owning the partners' shares in the REIT, section 318(a)(3)(C) treats the REIT as owning all of the shares in the tenant that are deemed held by the partnership. Thus, the rule in section 856(d)(2) is violated.

The potential for disqualification, under one reading of current law, is detailed in the following example: Pension Plan A holds stock representing 10% of the value in REIT. The remaining shares of REIT are publicly held. Pension Plan A and Corporation B each hold a 1% interest by value in Partnership, and the remainder of Partnership's interests are publicly held. Partnership holds various securities in entities other than REIT. Tenant, which leases retail space from REIT, is 10% owned by Corporation B, with the remaining interest publicly-held. Under section 318(a)(3)(A), Partnership is deemed to own A's 10%

interest in the value of REIT and B's 10% interest in Tenant. Further, section 318(a)(3)(C) provides that REIT is deemed to own any stock held by its 10% shareholder. As a result, REIT could be deemed to own Partnership's deemed interest in Tenant. If so, the Tenant's rent payments to REIT would be disqualified.

These attribution rules disqualify amounts as rent even when the relationship between the tenant and the REIT is tenuous at best and abuse of the REIT concept is inconceivable. In any event, the rules are largely unenforceable because one partner will not know what the other partners own. The problem is particularly problematic with institutional investors that own small percentage interests in multiple partnerships owning securities and other assets unrelated to a REIT.

One understanding of the interplay between section 318(a)(3)(A) and (a)(3)(C) with the facts described above is equivalent to applying attribution rules to shares of stock held by partners. As noted, this is contrary to the policy set forth in section 318(a)(5)(C), which prohibits the reattribution of stock constructively owned by a partnership (via a partner) to another partner in the partnership. Without this partner-to-partner attribution, neither A nor B in the examples above, directly or indirectly, hold the 10% interest in both REIT and Tenant that section 856(d)(2)(B) requires for disqualification. Congress solved a similar problem of "partner to partner" attribution in another REIT context. In determining whether a REIT is "closely held" for purposes of section 856(a)(6), the attribution rules in section 544 apply. In 1986, Congress enacted section 856(h), which provides in part that the attribution rules in section 544 will apply as if they did not include the phrase "or by or for his partner".

H.R. 2121 would modify the application of section 318(a)(3)(A) (attribution to partnerships), for purposes of section 856(d)(2), so that attribution would occur only when a partner owns a 25% or greater interest in the partnership. Applying a percentage threshold (rather than suspending entirely the application of section 318(a)(3)(A)) would prevent the potentially abusive technique of placing "dummy" partnerships between individuals and the REIT. NAREIT appreciates the common sense approach adopted by H.R. 2121 because it would simplify monitoring the ownership interests of all involved parties.

TITLE II. CONFORMITY WITH REGULATED INVESTMENT COMPANY RULES

SECTION 201: Credit For Tax Paid By REIT On Retained Capital Gains

Under the regulated investment company ("RIC") provisions, RICs (also known as mutual funds) always have been permitted to pass through a credit to their shareholders for taxes paid on retained capital gains. This treatment helps preserve the capital base of the company, while respecting the principle of a single level of taxation.

Under section 857(b)(3)(A)(ii) and section 4981(c)(1)(B), a REIT need not distribute capital gains to its shareholders, but may be subject to tax on such undistributed gains under section 1201(a). A subsequent distribution of such gains is taxable to the REIT's shareholders, resulting in a double tax.

This double tax is inconsistent with the original Congressional intent to create a real estate entity parallel to RICs, and limits a REIT's ability to effectively manage assets. Because of the potential double tax on capital transactions, a REIT usually is compelled to either distribute any sale proceeds or not complete the transaction.

H.R. 2121 would amend section 857(b)(3) to mirror the rules applicable to RICs. NAREIT believes that such conformity is long overdue.

SECTION 202: 30% Gross Income Test Repeal

Section 856(c)(4) provides that an entity does not qualify as a REIT, unless less than 30% of the entity's gross income is derived from the sale or exchange of 1) stock or securities held less than 1 year, 2) property in a transaction that is a prohibited transaction,

and 3) real property (including interests in real property and interests in mortgages on real property) held less than 4 years.

Congress patterned the 30% rule for REITs after the analogous "short-short" rule for RICs. The RIC rule provides, in part, that an entity does not qualify as a RIC unless less than 30% of its gross income is derived from stocks or securities held less than 3 months. The Tax Simplification and Technical Corrections Act of 1994 (H.R. 3419), as passed by the House of Representatives on May 17, 1994, would have repealed the short-short rule for RICs.

Congress originally enacted both the REIT 30% rule and the short-short rule for RICs to ensure that a REIT or a RIC is not trading in, or a dealer of, property.[2] In addition to the 30% rule, the original REIT legislation disqualified a REIT if it were found to own any property held for sale to customers in the ordinary course of business (i.e., dealer property). However, Congress in 1976 replaced the dealer property rule with the existing prohibited transaction rule in section 857(b)(6), which imposes a 100% tax on dealer property income.

Numerous other provisions in the REIT tax regime provide adequate assurance that REITs remain passive investors in real property. For example, the 100% tax on dealer property sales removes any economic incentive for such transactions. Moreover, REITs must derive at least 75% of their gross income from rents, interest on mortgages, dividends (or gains) on shares in other REITs or gains from sales of real property (other than dealer property). A REIT must derive at least 95% of its gross income from the foregoing sources, plus other designated sources of passive income. In addition, REITs are restricted from performing any services for tenants (other than basic property management and customary services), or from deriving any income based on the income or profits of another. The restrictions on prohibited transactions and the passive nature required for virtually all REIT income ensure that REITs are passive investors in real property and, thus, make the 30% rule unnecessary.

The 30% rule also creates significant administrative problems for REITs and inhibits management's flexibility in maintaining a portfolio of real estate. For example, the application of the 30% rule may jeopardize a REIT's qualification when gain is involuntarily recognized. These situations may include restructuring a debt security held by a REIT, prepaying a shared appreciation mortgage or a sale of property by a partnership in which the REIT is a non-controlling member. In addition, the rule restricts the ability of some REITs to sell property when market conditions are most favorable.

H.R. 2121 would repeal the REIT 30% rule. NAREIT supports such repeal, since the rule is redundant and creates serious administrative problems for REITs. However, in the interests of conformity with the RIC rules, NAREIT agrees that the 30% rule should be repealed only if Congress eliminates the "short-short" rule for RICs.

TITLE III. OTHER SIMPLIFICATION

SECTION 301: Earnings & Profits - Distribution Rule

Enacted in 1986, section 857(a)(3) requires newly-electing REITs to distribute, during their first REIT taxable year, earnings and profits ("E&P") that were accumulated in non-REIT years. The ordering rule in section 316 complicates the E&P distribution requirement, by treating all distributions as being made from the most recently accumulated E&P. Under this rule, the unexpected realization of income near the end of the year can convert previous distributions of accumulated E&P into distributions from current E&P. For example, assume a company distributes $200x in November, which represents its current E&P to date ($100x) and its entire accumulated E&P ($100x), and makes no other distributions during the year. If the company earns an additional $10x in December, its

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[2] See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 6 (1960).

accumulated E&P as of the end of the year is $10x, notwithstanding the prior $200x distribution.

The effect of the E&P rule in section 316 could be disastrous for a newly-electing REIT that is required to distribute all of its accumulated E&P during its first REIT year. The year-end receipt of any form of unanticipated income, such as unexpected overages from shopping mall tenants, could cost the new REIT its qualification. Most REITs (and most taxpayers, for that matter) cannot determine precisely the amount of their income before the end of the year. Ordinarily, the receipt of nominal amounts of income near the end of the year do not cause problems for REITs, since REITs only must distribute 95% of their income. When such receipts must be distributed, the "subsequent declared dividend" election in section 858 normally may be used.

However, the requirement in section 857(a)(3) effectively overrides the 95% income distribution requirement, since no accumulated E&P can be distributed until the REIT distributes 100% of current E&P. In addition, the section 858 election, which historically was available for all required distributions, cannot be used for section 857(a)(3) distributions since this election is available only for distributions of current E&P.

The ability to retain a small percentage of current earnings and the section 858 election both have been part of the REIT tax rules since 1960. Until 1986, REITs were not required to distribute any portion of their accumulated E&P. The adverse effect of the new accumulated E&P distribution requirement on both of these provisions is an unintended consequence of the 1986 change

H.R. 2121 would deem section 857(a)(3) distributions as being made first from accumulated E&P, then from current E&P. This provision would ensure that year-end receipts of unanticipated income would not cause a new REIT to be disqualified The proposal would not affect the requirement that such REIT also must distribute 95% of its current income, nor would it otherwise alter the traditional ordering rule for E&P distributions. NAREIT strongly supports this non-controversial change.

SECTION 302: Foreclosure Property

A REIT is permitted to conduct a trade or business using property acquired through foreclosure for 90 days after it acquired such property, provided the REIT makes a foreclosure property election. After the 90-day period, the REIT may no longer conduct such trade or business, except through an independent contractor from whom the REIT does not derive or receive any income. Property is eligible for a foreclosure election if a REIT acquired it through foreclosure on a loan or default on a lease, but not if a REIT acquired it because a lease expired.

If it makes the foreclosure property election in section 856(e)(5), a REIT may hold foreclosure property for resale to customers without being subject to the 100% penalty tax under the prohibited transaction rules. Non-qualifying income from foreclosure property generally is subject to the highest corporate tax rate. The foreclosure property election is valid for 2 years, but may be extended up to 6 years with the IRS' consent. Under section 856(e)(4)(C), foreclosure property status is lost if, at some time after 90 days from the date such property is acquired, the property is used in a trade or business conducted by the REIT (other than through an independent contractor from whom the REIT does not derive any income).

H.R. 2121 would make the period covered by an election three years and the initial foreclosure property election valid until the last day of the third full taxable year following the election. NAREIT concurs with the proposal because the present 2-year period is not a realistic time period for disposing of foreclosure property, especially in a depressed real estate market. In addition, NAREIT supports this proposal because it would reduce record-keeping and filing requirements associated with managing foreclosure property and the need for the IRS to review extension requests.

Further, H.R. 2121 would modify the rule in section 856(e)(4)(C) that requires a REIT to use an independent contractor to manage foreclosure properties. This modification would make the rule parallel to the primary independent contractor rule in section 856(d)(2)(C). NAREIT endorses this proposal because it would reduce the technical complexity and administrative costs associated with managing foreclosure property: it would provide a single, consistent standard for managing both foreclosure and non-foreclosure properties.

SECTION 303: Special Foreclosure Rules For Health Care Properties

Health care REITs play an important economic role in both the health care and REIT industries. For example, REITs have invested about $10 billion in health care properties, either as owners or lenders. This amount represents approximately 13% of the real estate investment by all REITs. These properties range from nursing homes and extended care facilities to acute care facilities.

These REITs face unique problems under the foreclosure property rules when the lessee/operator of a health care facility terminates its lease, either through expiration or default. Unlike most other forms of rental properties, if a health care property lease terminates, it is extremely difficult to close the facility because medical services to patients must be maintained. In fact, a variety of government regulations mandate measures to protect patients' welfare, which greatly restrict the ability to simply terminate the facility. In addition, because of the limited number of qualified health care providers, it can be very difficult to find a substitute provider that also will lease the property.

When a health care REIT acquires property either through a loan foreclosure, lease default, or lease expiration, the REIT must be able to ensure that the facility will remain open beyond the initial 90-day period. For many patients, especially those in rural areas, there may be no available alternative facilities in the locality. Frequently, if space is available in an alternative facility, such facility may not accept government-paid patients (i.e., Medicare, Medicaid or county assistance), which account for 70% of the residents in properties of health care REITs. Patients in facilities owned by health care REITs typically include the frail elderly, the chronically ill and the disabled who require long term care. They cannot, and should not, be evicted and forced to relocate away from supportive family and friends, which could jeopardize their health and cause treatment setbacks.

The 90-day time period during which a REIT is permitted to operate a facility is inadequate for the REIT to conclude a lease with a health care provider. Health care properties typically are acquired in a sale-leaseback transaction in which the original owner continues to operate the facility as a lessee. After this lessee vacates the property, it is very difficult to find a qualified health care provider that is willing to assume not only the operational responsibilities for the facility, but also the long-term financial risks associated with being a lessee. This is particularly true when the original lessee abandoned the facilities because of financial problems.

Regulatory requirements further complicate and delay the releasing process. Potential lessees may be required to obtain up to 30 separate licenses from separate government agencies before they can assume control of a facility. In addition, many states impose certificate of need requirements when facility operators are changed. These proceedings can become adversarial and protracted.

Therefore, in order to keep a health care facility operational after the 90-day period has expired under the foreclosure property rules, a REIT must be able to hire a licensed health care provider that also qualifies as an independent contractor *(a party from whom the REIT does not derive or receive any income or profits)*. The limited pool of licensed providers that could qualify as independent contractors may be dramatically reduced, since many of these providers already lease other health care properties owned by the REIT. As existing lessees of the REIT, these providers generate income to the REIT, and thus may be viewed by the IRS as disqualified from serving as independent contractors with respect to a second REIT property.

The problems that arise from foreclosing on a defaulted lease or mortgage also exist in the case of a health care provider/lessee who abandons the facility upon the expiration of a lease. A final decision whether or not to renew the lease may not be made until expiration occurs, giving the REIT little or no lead time to find a substitute provider/lessee. Even if adequate notice is given to the REIT that the provider/lessee intends to quit the business, this notice does not increase the pool of health care providers that could qualify as independent contractors.

H.R. 2121 proposes that in the case of qualified health care properties, a health care provider should not be disqualified as an independent contractor for purposes of the foreclosure property rules solely because the REIT receives rental income from the provider with respect to one or more <u>other</u> properties. In addition, the proposal would provide that a REIT could make a foreclosure property election with respect to lease expirations of qualified health care properties.

NAREIT strongly supports this proposal, which would help ensure that important health care facilities are not forced to be closed because of a technical requirement in the Code. We note that as with any properties that are subject to a foreclosure election, non-rental income realized by the REIT under this proposal would be subject to the highest corporate tax rate.

SECTION 304: Payments Under Hedging Instruments

In 1988, Congress added section 856(c)(6)(G), which generally provides that income from an interest rate swap or cap agreement used to hedge a variable rate indebtedness is treated as qualifying income under section 856(c)(2). In addition, such agreement is treated as a security for purposes of section 856(c)(4)(A), which limits a REIT's gain on the sale of securities held for less than 1 year to 30% of gross income.

A swap agreement is a contractual arrangement between parties that permits them to convert existing variable rate interest payments or receipts into fixed rates, and vice versa. Thus, swaps may be used to hedge against potential increases in interest rates on debt exposures, as well as to capture higher rates on fixed income streams. Interest rate caps likewise may be used to hedge interest payments or receipts, but such hedge is effective only over a specified range.

There are a number of financial products available, in addition to swaps and caps, that may be important tools in a company's effort to hedge its exposure to increased liabilities and to protect current high returns. As the REIT industry has grown and become more knowledgeable in managing its investments, more and more REITs are using financial instruments of all kinds as a conservative method of managing their interest rate exposure.

A REIT should be permitted to use the wide variety of financial instruments that are available for managing its liability exposures, whether the interest rates are fixed or variable. Financial markets world-wide have undergone revolutionary changes over the past decade. These changes have brought about dramatic liquidity in interest rate and currency markets, which in turn have significantly increased the volatility in these markets.

H.R. 2121 would amend the REIT rules to include all hedges of REIT liabilities. This rule would not permit a REIT to speculate in hedging instruments, nor alter the REIT's primary mission to invest in real estate assets. NAREIT completely endorses this modernization of the REIT's interest protection rules.

SECTION 305: Excess Noncash Income

Generally, REITs are required to distribute 95% of their taxable income to shareholders each year. In 1986, Congress recognized the inequity of requiring a REIT to distribute "phantom income" items, in which the REIT recognizes income but receives no corresponding cash. Congress enacted section 857(a)(1)(B) to exclude certain excess noncash income from the distribution requirement.

A REIT has been compelled to return property to a seller rather than accept a cancellation and restructuring of a seller-financed mortgage, because of the REIT's inability to distribute the resulting noncash income. Moreover, REITs often accrue original issue discount ("OID") income resulting from their investments. In addition, REITs are precluded under the current rules from repurchasing bonds at a discount that were issued at rates that are now "above market." This inability to refinance adversely affects the capital requirements for REITs.

Under H.R. 2121, all forms of OID and REMIC excess inclusion income (to the extent not offset by distributions), and cancellation of indebtedness income would be treated as excess noncash income for purposes of the distribution requirement in section 857(a). As a matter of policy, these forms of noncash income are indistinguishable from the types that are excepted from the distribution requirement. The proposal also would extend the special rules for OID income and REMIC excess inclusion income to both accrual basis and cash basis REITs. The proposal would not alter the existing rule that imposes an excise tax on certain undistributed REIT income.

In addition, since the proposal would affect only a REIT's distribution requirements, a REIT would not receive a dividends paid deduction with respect to the phantom income. Thus, a REIT might be compelled to pay a corporate level tax to the extent its dividends paid deduction is less than its taxable income. NAREIT applauds these provisions as a logical extension of the 1986 changes.

SECTION 306: Prohibited Transaction Safe Harbor

A REIT may be subject to a 100% tax on net income from sales of property in the ordinary course of business ("prohibited transactions"). In 1986, Congress recognized the need for a bright line safe harbor for determining whether a REIT's property sale constituted a prohibited transaction. Congress further liberalized these rules in 1978 and 1986 to better comport with industry practice and to simplify a REIT's ability to sell long-term investment property without fear of being taxed at a 100% rate.

Because of certain limitations contained in the safe harbor, some of the industry's largest and most successful members cannot use the exception; thus, their ability to responsibly manage their property portfolio is impeded. The most restrictive limitation for these companies is the limitation on the number of sales per year.

The limitation relating to aggregate tax bases penalizes the companies that are the least likely to have engaged in dealer activity. The most successful REITs have typically held their properties the longest, resulting in low adjusted bases due to depreciation or amortization deductions. Thus, the aggregate bases of all the REIT's properties will be relatively much lower for purposes of the safe harbor exception than a REIT that routinely turns over its properties every 4 years. Accordingly, the REIT that holds its properties for the longer term is penalized.

Under H.R. 2121, any real property asset disposed of as a result of an involuntary conversion (e.g., its destruction, seizure, or condemnation) would not be considered for purposes of determining compliance with the 7 sales per year safe harbor. NAREIT supports this proposal, which would ensure that a diligent REIT is not removed from the safe harbor as a result of events beyond its control.

In addition, in order not to penalize companies that hold a large number of depreciated properties as long-term investments, H.R. 2121 would change the alternative aggregate bases exception to use the adjusted bases of properties *before* reduction for any allowed or allowable depreciation or amortization. NAREIT agrees that this proposal better carries out the intent of the safe harbor.

SECTION 307: Shared Appreciation Mortgages

Section 856(j) generally provides that income recognized by a REIT from a shorter holding period is substituted for that of the contract for the purposes of applying the 30% limitation in section 856(c)(4) and the prohibited transaction safe harbor rule of section 857(b)(6)(C)(i). The character of the underlying property as dealer property (i.e., section 1221(1) property) in its holder's hands also is substituted for the shared appreciation mortgage ("SAM") contract's character for purposes of imposing the prohibited transaction tax.

Congress enacted section 856(j) in 1986, partly in response to the REIT industry's request for statutory authority that a REIT may receive interest based on a borrower's sales profits under limited circumstances. As a practical matter, a REIT cannot control the holding period, character or disposition of property underlying a SAM contract that it does not own. Attempts to provide contractual controls on these items give little added assurance to a REIT and merely dilute its competitive position as a lender.

H.R. 2121 would create a safe harbor that would not penalize a REIT lender for events beyond its control, i.e., the borrower's bankruptcy. It also would clarify that shared appreciation mortgages can be based on appreciation in value as well as gain. NAREIT believes that both changes are useful steps in the right direction.

SECTION 308: Wholly Owned Subsidiaries

In 1986, Congress recognized that for purposes of limiting liability, investors commonly hold separate parcels of real estate in separate corporations. Congress therefore enacted section 856(i), under which a REIT "qualified subsidiary" that holds property as a separate corporation is ignored for federal tax purposes. To be a qualified subsidiary, the REIT must own 100% of a corporation's stock "at all times during the period such corporation was in existence."

The requirement in the phrase quoted above has presented some problems not envisioned in 1986. For example, several real estate operating companies operating as regular C corporations have elected REIT status since 1991. As is typical with corporations owning real estate, these electing companies had subsidiaries that owned various real estate properties. The IRS was asked whether the existing subsidiaries could be REIT qualifying subsidiaries because before the parent's REIT election, the subsidiaries were not held by a REIT. The IRS has issued several private letter rulings holding that they can so qualify. However, to reach this result, the IRS used the artificial construct of deeming the subsidiaries as being liquidated as of the REIT election and then reincorporated.[3] Similar issues arise if a REIT acquires all of the stock of a non-REIT corporation owning real estate, either in a taxable or tax-free transaction.

There is no sound policy reason why a non-REIT corporation may not become a qualified subsidiary once a REIT owns all of its stock. Under section 857(a)(3)(B), all pre-REIT E&P of the subsidiary should be distributed to the REIT's shareholders before the end of the REIT's taxable year. In addition, all of the subsidiary's pre-REIT built-in gain should be subject to tax under the normal rules of section 337(d).

H.R. 2121 provides that any corporation could be a qualified subsidiary if a REIT owns all of its shares, regardless of the prior ownership of its shares. NAREIT endorses this approach as a logical modification of the 1986 change that should remove an unnecessary barrier to REIT acquisitions.

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[3] See PLRs 9527020, 9421034, 9307018, 9205030, 9124041 and 9051043. See also PLR 9409035.

NMHC National Multi Housing Council

National Apartment Association

Statement of the National Multi Housing Council
and National Apartment Association

Before the Committee on Ways and Means
U.S. House of Representatives
Regarding the Hearings on Miscellaneous Tax Reforms
July 11-12, 1995

Submitted by
Richard L. Michaux
Chairman, National Multi Housing Council

The National Multi Housing Council and the National Apartment Association represent the preponderance of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of multifamily housing, including ownership, construction, finance, and management of rental properties.

As Chairman of the National Multi Housing Council, I urge you to support H.R. 2121, the Real Estate Investment Trust Simplification Act. H.R. 2121 would modernize and simplify the tax code provisions governing real estate investment trusts (REITs). At least 35 REITs are dedicated to the ownership and management of multifamily housing. These companies have a market capitalization of more than $11 billion and nearly $20 billion in market value of assets representing approximately 390,000 apartment homes as well as approximately 55,000 manufactured home sites.

A corporation or trust that qualifies as a REIT generally does not pay corporate income tax to the Internal Revenue Service. These rules are similar to the tax rules for mutual funds. To qualify as a REIT and receive this tax status, a corporation or trust must comply with a number of special requirements of the Internal Revenue Code including the distribution of at least 95 percent of its annual taxable income to shareholders each year.

H.R. 2121 would remove certain traps for the unwary, advance conformity of the REIT and regulated investment company (mutual fund) rules, and simplify the day-to-day operation of a REIT. More specifically, the benefits of the legislation would include the assurance that a REIT would not lose its tax status as the result of small omissions with respect to the REIT rules; have the freedom to make decisions based on the economic results for the company; and be able to retain gains from the sale of its properties for new investment. This legislation would also simplify operational rules. These minor modifications would enhance an industry that has played a significant role in the recapitalization of America's multi housing and other commercial real estate, while leaving unaltered the underlying asset, income and distribution requirements of REIT status.

We greatly appreciate the leadership of Congressmen E. Clay Shaw and Robert T. Matsui, as well as other cosponsors of H.R. 2121 in introducing this important legislation. We urge the Committee to include these proposals in any tax bill Congress passes in 1995.

TESTIMONY OF DAVID E. MANNING
COMMUNITY BANKERS ASSOCIATION OF ILLINOIS

On behalf of the 500 member banks of the Community Bankers Association of Illinois, I appreciate the opportunity to make a statement for the record regarding the proposal to allow the conversion of a common trust fund to one or more mutual funds without current tax consequences.

Before the advent of mutual funds, common trust funds were developed to more efficiently manage the assets of small trusts. They performed this task admirably until mutual funds created a new vehicle for investment. There are several intrinsic advantages of mutual funds over common trust funds including a greater degree of safety due to stronger oversight/regulation by the SEC and broader marketing potential allowing increased size which, in turn, allows more specialized management and more advantageous purchasing of large blocks of securities. For these reasons bank trust department have largely replaced common trust funds with mutual funds as they invest "new money" that is placed under their control. Due to their fiduciary responsibility under the law, however, they are prohibited from converting current common trust funds to mutual funds because such conversion would cause tax liability to the beneficiaries of the common trust funds upon conversion. Thus the beneficiaries of the more than 1,800 common trust funds are currently denied the advantages that mutual funds would bring to their trust investments.

As community bankers, we are particularly interested in the provision to allow the conversion of a single common trust fund to one or more mutual funds. Many of the smaller common trust funds are composed of a variety of investments that do not match those of existing mutual funds. Since virtually all of the assets of a common trust fund must be transferred to the mutual fund, the smaller common trust fund would be unable to convert unless it could place assets in more than one mutual fund. The creation of a new mutual fund is not a viable option because of the asset size necessary to economically manage a mutual fund.

In effect, the "one or more" feature creates a level playing field for the beneficiaries of all trust managed by banks, large and small, just as the overall provision creates a level playing field when measured against non-bank fiduciaries.

We thank you for your consideration of this proposal that will increase the efficiency of the trust system to the particular advantage of the multitude of trust beneficiaries - increasing both income and safety of their funds.

Statement for the Record
House Committee on Ways and Means
Hearings on Miscellaneous Tax Reform proposals
Representative Phil English

Mr. Chairman and Members of the Committee, I thank you for the opportunity to submit this statement for the record on one of the proposals before you that is of particular interest to me. I very strongly support the proposal to permit a bank common trust fund to convert into one or more mutual funds without incurring current tax to the common trust fund, or its participants.

The primary goal of this proposal is to aid common trust fund participants by facilitating the movement for their estates, trusts, and guardianships into more diversified and safer investment vehicles.

U.S. banks currently manage approximately 1800 common trust funds with total assets of about $137 billion. Common trust funds are quickly becoming obsolete vehicles for managing money, because they cannot offer the economic efficiencies, diversification and liquidity that are available with mutual funds. This harms beneficiaries of bank-managed trusts in limiting their access to most modern investment pooling vehicles and disadvantages these beneficiaries and banks as compared to non-bank trust management.

Currently, the conversion of common trust fund assets into one or more mutual funds would trigger tax to the participants of the common trust fund. Under state law, this event could be viewed as a breach of the bank's fiduciary responsibilities. Thus, banks generally cannot convert their common trust funds into mutual funds, which are more economically efficient than the common trust funds.

It is critically important that a common trust fund be permitted to transfer its assets to one or more mutual funds. Otherwise, a common trust fund will not be able to utilize this legislation unless it can find one mutual fund, willing to accept the common trust fund's portfolio, with similar enough investment parameters, an ability to accept appreciated securities, appropriate institutional distribution, and a satisfactory investment discipline that will meet fiduciary prudence standards. It is likely that a common trust fund will have to divide its assets across more than one mutual fund - large-capitalization stocks to a growth and income mutual fund, growth stocks to an equity growth fund, U.S. government securities to funds with similar types securities and similar duration and other characteristics, etc... .

This proposal enables both common trust fund participants and banks to benefit from the most current techniques in investment management. Common trust fund participants will benefit from moving to larger, more diversified investment pools, with greater resources and expertise being applied to analysis and selection of individual securities. The bank will be better able to separate security selection from asset allocation and focus greater resources on asset allocation decisions for each trust account, which ultimately are the biggest factor in producing higher returns at lower risk for trust beneficiaries.

Given the widespread and bipartisan support for this proposal as well as it's anticipated low revenue cost, I hope the committee will be able to act favorably on this legislation this year. Thank you for your consideration of this proposal.

Committee on Ways and Means
U.S. House of Representatives

Hearing on Miscellaneous Tax Reforms

Written Statement
of
Michael K. Keating, Senior Vice President
The Fifth Third Bank

I appreciate the opportunity to provide a statement for the record in support of the proposal to permit a bank common trust fund to transfer its assets to one or more mutual funds without current tax to the common trust fund participants. The proposal removes an artificial tax barrier and gives investors in bank common trust funds access to market efficiencies enjoyed by mutual funds.

Fifth Third Bank has 13 common trust funds and manages approximately $7.7 billion. Fifth Third is also the investment adviser to the Fountain Square family of mutual funds, consisting of 10 funds. Fifth Third's trust department uses both common trust funds and the Fountain Square Funds as an investment vehicle for fiduciary assets. Large trust account portfolios may be invested in various combinations of mutual funds and direct securities.

Bank Common Trust Funds

Bank common trust funds, historically have been established by banks in their capacities as trustees, executors, administrators, and guardians of certain customer accounts. Assets of different trusts are pooled together for investment purposes under these funds. Collective investment allows for greater diversification and administrative economies of scale than would be possible if investment decisions for the accounts were made separately. Many larger banks will have numerous common trust funds with different investment objectives. For example, a particular fund may be targeted towards asset classes such as corporate stocks, municipal bonds, or U.S. government securities, etc. More than $120 billion now resides in bank common trust funds, but banks are directing almost all new fiduciary accounts into mutual funds.

Mutual Funds

While investment in common trust funds has been declining, investment in mutual funds has surged in recent years, and for good reason. Mutual funds, like common trust funds, allow investors to pool their resources for investment. However, shares of mutual funds are registered securities that can be available to the public, and therefore mutual funds have a much larger field of potential investors.

Allowing conversions of common trust funds to mutual funds would benefit investors and banks alike. Investors would enjoy the benefit of greater diversification and greater administrative and custodial economies of scale, as well as greater management resources and expertise. Bank

trustees, on the other hand, would have a single investment pools to manage, and thus could concentrate on longer-term asset allocation strategies.

There is a potentially prohibitive tax impact. Current tax law can be interpreted to require that any movement of assets from a common trust fund to a mutual fund would be treated as a taxable event, triggering taxable gain (or loss) for participants. Moreover, state laws may treat any triggering of tax as a breach of the bank's fiduciary obligations.

Conversion proposal

The proposal would allow common trust funds to transfer assets into mutual funds on a tax-free basis without gain or loss being recognized by the fund or its participants. The common trust fund would transfer its assets solely in exchange for shares of the mutual funds, and the common trust fund then would distribute the mutual fund shares to its participants in exchange for the participants' interests in the common trust fund. The basis of any asset received by the mutual fund would be the basis of the asset in the hands of the common trust fund prior to the conversion.

Assets should be able to be transferred into multiple funds thus providing flexibility and workability. This is particularly important where the common trust fund investment portfolio is broadly defined and therefore may find it more difficult to find a "match" in a single mutual fund. Under these types of conversions, the basis in each mutual fund would be determined by allocating the basis in the common trust fund units among the mutual fund in proportion to the fair market value of the transferred assets.

The proposal to permit conversion of common trust funds to mutual funds is beneficial. It enables us to continually evaluate our common trust funds against available mutual fund alternatives, and, if appropriate, convert the common trust funds to mutual funds. This proposal also enables us to combine similar common trust funds and mutual fund portfolios, and through resulting efficiency, devote more time and attention to asset allocation decisions for individual trusts.

Fifth Third urges the enactment of this proposal, which is noncontroversial and has wide support. Thank you for your consideration of this proposal, and if you have any questions or need any additional information please contact the below Fred L. Darlington, Counsel at Fifth Third Bank, 38 Fountain Square Plaza, Cincinnati, Ohio 45263, (513) 579-4300.

STATEMENT FOR THE RECORD BY THE HONORABLE JIM NUSSLE
COMMITTEE ON WAYS AND MEANS
HEARING ON MISCELLANEOUS TAX REFORMS

July 11 & 12, 1995

Mr. Chairman, I wish to express my support for the proposal under consideration by the Committee that would allow banks to convert their common trust funds into mutual funds without triggering a taxable exchange for trust fund participants.

As you know, a provision allowing this conversion was included in H.R. 11 in the 102nd Congress. Additionally, H.R. 3419 which passed the House of Representatives in the 103rd Congress included a similar provision.

I hope that every consideration will be given to the inclusion of this proposal in any tax legislation considered by the Committee.

Jim Nussle
Member of Congress

Hearing Before the
Committee on Ways and Means
U. S. House of Representatives

on

Miscellaneous Tax Reforms - The Conversion of
a Bank Common Trust Fund to One or More Mutual Funds

July 11-13, 1995

Written Statement of

William F. Terry, Senior Vice President
Trustco Bank, National Association

We appreciate the opportunity to provide a statement for the record in support of the proposal to permit a bank common trust fund to transfer its assets to one or more mutual funds without current tax to the common trust fund participants.

Our bank's trust department has 9 common trust funds in which we manage approximately $200 million. These common trust funds have over 475 participants. The trust department uses various other mutual funds managed by other outside investment advisers. Large trust account portfolios may be invested in a combination of mutual funds and direct securities.

The investment of trust accounts is governed by stringent fiduciary standards. As a fiduciary, Trustco Bank, National Association, must invest as a "prudent investor" would, by considering all the circumstances of the trust and exercising reasonable care, skill and caution.

As our financial markets have grown so dramatically over the past 30 years, so has the base of research, analysis and theory as to investment practice. There is now a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory." Modern portfolio theory is influencing trustees to use, to a greater degree than in the past, pooled investment vehicles. Common trust funds and mutual funds are both pooling vehicles; but mutual funds, in many cases, offer additional benefits to their participants.

Modern portfolio theory and prudent investing are placing greater emphasis on diversification - both to reduce risk and to increase return at any given level of risk. Our mutual fund portfolios are not limited, as are our common trust fund portfolios, to our trust department fiduciary accounts. Therefore, we expect that our mutual funds can become larger and better diversfied portfolios.

Modern portfolio theory extends the notion of diversification to asset classes as well. An asset class is a particular type of security; e.g., stocks, bonds, real estate, and so on. To the extent asset classes, as well as different securities, are affected differently by economic events, each will have its own unique pattern of return. It is the ability of one asset class' pattern of returns to partially offset another asset class' pattern that enables diversification to reduce portfolio risk.

Mutual funds tend to be more highly defined in their investment objectives and policies than common trust funds, and, of course, there are hundreds of different funds available. There is a practical limit as to how many common trust funds a bank can manage. With mutual funds, we are better able to develop precise asset allocation strategies (meaning how much of a trust account is invested in particular asset classes), using a greater number of more highly defined asset classes. The mutual fund then becomes a

vehicle for access to management expertise in a particular market or security. Then, again, within each asset class portfolio, there is greater diversification as well.

The proposal to permit conversion of common trust funds to mutual funds is beneficial. It enables us to continually evaluate our common trust funds against available mutual fund alternatives, and, if appropriate, convert the common trust funds to mutual funds. This proposal also enables us to combine similar common trust fund and mutual fund portfolios, and through resulting efficiency, devote more time and attention to asset allocation decisions for individual trusts.

The feature of this proposal that permits conversion to one or more mutual funds is important in providing flexibility and workability. It is difficult to predict whether, if we convert a common trust fund, the recipient mutual fund will be able to accept "substantially all" the assets of the common trust fund as required by applicable tax law.

Thank you for your consideration of this proposal.

William F. Terry
Senior Vice President
Trustco Bank, National Association
192 Erie Boulevard
Schenectady, NY 12305
518-381-3611

July 7, 1995

Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515

TO: Members of Congress

We write in support of the U.S. Peace Tax Fund Bill (H.R. 1402).

Our deep concern regards an infraction of religious liberty visited on those citizens who for reasons of conscience cannot pay the military portion of their taxes. To do so would violate their deepest religious beliefs. The Peace Tax Fund Bill seeks to avoid violence to the consciences of the objectors, and at the same time to find a way in which they can fulfill their obligations to their fellow citizens through payments for nonmilitary measures.

At the present time, these citizens suffer penalties including the loss of automobiles and homes, and in rare instances, prison. Some have been forced to take their children out of college to satisfy IRS penalties. Others impoverish themselves and their families so as not to violate the law OR their beliefs.

If not allowed to follow one's conscience there can be no religious freedom. The Peace Tax Fund Bill will restore freedom of religion as protected in the First Amendment to taxpayers whose religious or moral convictions forbid participation in war, whether that participation is physical or financial. This "first of the freedoms" is the cornerstone of a democratic society.

We are anxious to work with you to find a way for these persons, who seek to live up to the highest good that they know, to pay 100% of their taxes without violating those deeply held beliefs about killing. Surely there must be some alternative for those persons of faith and conscience who are attempting to live according to their deepest beliefs.

Sincerely,

J. Brent Walker
General Counsel
Baptist Joint Committee on Public Affairs

Elenora Giddings Ivory
Washington Office
Presbyterian Church (USA)

Joe Volk
Executive Secretary
Friends Committee on National Legislation

Forest Montgomery
Counsel, Office of Public Affairs
National Association of Evangelicals

Robert Z. Alpern
Director, Washington Office
Unitarian Universalist Association

David R. Bassett, M.D.
1600 Brooklyn Avenue
Ann Arbor, Michigan 48104
July 9, 1995

Representative William Archer
Chairman, House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Ways & Means Committee hearing on U.S. Peace Tax Fund Bill (H.R. 1402) and other measures, scheduled for July 11, 12,1995.

Dear Representative Archer,

I am grateful that your committee has chosen to conduct hearings n the U.S. Peace Tax Fund Bill, and on other tax issues, and that you are willing to receive written testimony.

I write as the person who, with others in the Ann Arbor community, in 1971 developed the U.S. Peace Tax Fund Bill (originally introduced in April, 1972 as the World Peace Tax Fund Bill, H.R. 14414, and introduced in each Congress since then).

The U.S. Peace Tax Fund Bill seeks legal recognition of the right of conscientious objection to paying military taxes, while acknowledging our willingness to pay our full amount of taxes, if we can be assured that our tax moneys will not be used for military expenditures.

Our government has repeatedly recognized the right of the sincere conscientious objector not to engage in war (while requiring that the conscientious objector perform alternative service). We, that significant minority of citizens who are conscientious objectors to war, consider that paying for military systems is a form of participation in war.

We ask that Congress recognize the role of conscience in our lives. Our conscience derives from our religious and moral training, and makes demands on us which sometimes supercede the requirements of the state. The right of conscientious objection to war has been recognized by American presidents (e.g., George Washington, John Kennedy) and by outstanding American jurists. Justice Harlan Fiske Stone said, "It may well be questioned whether the state which preserves its life by a settled policy of violation of the conscience of the individual will not in fact ultimately lose it by the process."

The issue of conscientious objection to paying military taxes has drawn increasing national and world attention in recent years. The conduct of war increasingly relies on technology, and the dollars of citizens to support it. Modern weapons, especially nuclear weapons, threaten entire populations. We all know the risks resulting from weapons proliferation, and the risks of accidental use of weapons. Congress must recognize that those of us who are conscientious objectors to war care, to the depths of our being, for the welfare of all people. We cannot ourselves participate in war. We see so many evidences of the escalation of violence (small-scale and large-scale) around the world. And we insist that our determination to live non-violently, and to work to persuade others to live non-violently, must be granted legal recognition. At lest 20-25 nations have groups of citizens who are conscientious objectors to paying military taxes; a number of these nations have introduced in their parliaments legislation comparable to the U.S. Peace Tax Fund Bill. The issue will not go away. Some conscientious objectors to paying military taxes have suffered confiscation of their property; some have been imprisoned. We hope that the U.S. Congress is not going to require this demonstration of our conviction before it will know and feel the depth of that conviction and conscience in our lives.

The evidence of that conviction has been presented in testimony given to Congress in 1975 (House Ways and Means Committee hearing, 3/19/1976--record of Hearings, pp 1145-1173), and in 1992 (Subcommittee on Select Revenue Measures, House Ways and Means Committee hearings 5/21/1992--record of hearings pp. 4-5, 19-49, 58-81, 104-196 (verbal testimony), pp. 197-295 (written testimony)). Additional evidence, at a worldwide level, is contained in the evidence of the five international conferences on Peace Tax Funds and War Tax Resistance which have been held every 2 years since 1986 (in West Germany, the Netherlands, Italy, Belgium, and Spain).

Speaking at a personal level, I submit the evidence of my life and efforts as one who has tried to live with my conscience and in accord with my religious training and beliefs, throughout my life. I was born in 1928; during college and medical school years, I came to realize that I was conscientiously opposed to war. I informed my Draft Board of my conscientious objection to war in 1951 and am grateful to this country that I was <u>required</u> to make a firm decision on the issue of conscientious objection, and, further, that my legal right of conscientious objection to becoming a soldier was recognized. I was

recognized as a C.O. by the government in 1954. I am also grateful that the government recognized that the alternative service work which I found (working as a physician with the American Friends Service Committee project in Community Development, In Barpali, Orissa, India, between November, 1955 and November, 1957) was considered to meet the Selective Service criterion of being within the "national health, safety, or interest." A recent article on the Detroit Free Press (April, 1994--item 1) will summarize some of the key points of the witness made by myself and my wife during our lifetime.

The work which I and others have done in the intervening years (details of which can be found in my files which are not win the Bentley Historical Library, University of Michigan) has been directed to (1) expanding the recognition, by Congress, of the rights of conscientious objection to war, specifically with regard to our payment of income, estate, and gift taxes which go for military expenditures; and (2) my commitment as a physician to relieve suffering, specifically that huge amount of suffering which comes from war, from preparations for war, and from the damage to economies and environments as a result of war and preparation for war.

The enactment of the U.S. Peace Tax Fund Bill would represent a major advance in recognition of the religious and civil liberties of an important minority, an advance which will indicate to the world our government's recognition of the role which conscience-based decisions have in the lives of individuals, and the nation. And the enactment of the U.S. Peace Tax Fund Bill would be likely to improve federal revenue collection.

For the reasons stated, I urge you and the members of the Ways and Means Committee to give serious consideration to the U.S. Peace Tax Fund Bill.

Sincerely yours,

David R. Bassett

David R. Bassett, M.D.

1202

TAX OBJECTORS

Couple up in arms about helping IRS pay for military

BY STEPHEN JONES
Free Press Staff Writer

As millions of Americans grudgingly prepare to pay their taxes by tonight's midnight deadline, David and Miyoko Bassett will cheerfully refuse to pay part of theirs.

For the last 26 years the Ann Arbor physicians have objected — as a matter of conscience and religious principle — to paying the portion of their taxes that would go to support warfare and military programs.

Some might consider their effort tilting at windmills. The government ends up confiscating the money anyway, and over the years their resistance has cost them about $5,000 in added interest and penalties.

And that doesn't count the time and energy they spend every year responding to letters and visits from IRS officials. But hassle and inconvenience are not high on their list of concerns.

"We cannot, in conscience, pay for military spending," Dr. David Bassett said this week. "I believe violence begets violence. I don't think I should be part of that."

"We cannot, in conscience, pay for military spending. I believe violence begets violence. I don't think I should be part of that."
David Bassett

Dr. Miyoko Bassett added: "We need to carry out what we believe. If you feel so strongly, you do what you need to do."

For the Bassetts, war and military spending are contrary to their fundamental religious beliefs and the healing work to which they have devoted their lives — she as a pediatrician and he as a researcher and specialist in preventing hypertension and heart disease.

By the time they met during medical training in 1950 in Cambridge, Mass. — they married in 1953 — the Bassetts already were committed to nonviolence.

David was deeply influenced by his upbringing in the Congregational Church and his friendship with a Quaker family in his hometown outside Boston. Miyoko, who was born in California to Japanese immigrant parents, had spent World War II in an internment camp and had been taught nonviolence by her parents, who converted to Christianity.

David registered with his draft board as a conscientious objector and spent two years providing medical care in rural India as an alternative to military service. In 1955-57, David and Miyoko worked in India with the American Friends Service Committee and got to know many followers of Mahatma Gandhi, whose nonviolent movement led India to independence.

They joined the determinedly nonviolent Society of Friends in 1960 and by the end of the decade they had moved to Ann Arbor and decided to resist payment of taxes that would support the war in Vietnam. They also began working to change tax laws to recognize conscientious objec-

See OBJECTORS, Page 4B

OBJECTORS, from Page 1B

tor status.

So each year the Bassetts figure what portion of their federal taxes would go to military programs — it was 28 percent for 1993 — and deposit it in a bank account.

With their tax return they submit a letter explaining their resistance, telling the IRS where the money is and seeking IRS permission to spend that money in the interests of peace. In their letters they emphasize their belief that government confiscation of the money is a violation of our deep religious commitment to the way of nonviolence.

So far, that has not deterred the IRS. Each year, after a series of letters and notices, the money is confiscated; interest and penalties are assessed.

But the Bassetts do not consider their effort wasted. They have worked for 20 years with the National Campaign for a Peace Tax Fund to pass legislation to let conscientious objectors direct the part of their taxes that would otherwise go to the military into nonviolent programs like the Peace Corps and Head Start.

Support in Congress has been slight, but the Bassetts are not dismayed.

In the meantime, they say, they are standing up for what they believe.

"We may not affect the government," Miyoko said. "But I think through speaking out we might let others know how we feel and make others think what is right and what is wrong."

And though the tedious legislative path is frustrating, David said, it is not as bad as the frustration they felt before they began to resist.

"Now at least we're doing something," he said. "We're doing what we can do."

Item 1

LOCAL NEWS
INSIDE:
■ Friday, April 15, 1994 •
Detroit Free Press
Section B

JOHN COLLIER/Detroit Free Press

Drs. David and Miyoko Bassett of Ann Arbor continue their 26-year protest of paying taxes to support military spending. They figure what portion of their taxes would go to military programs and tell the IRS where it is placed in a bank account.

CENTER FOR LAW
AND RELIGIOUS
FREEDOM

4208 Evergreen Lane, Suite 222
Annandale, Virginia 22003-3264
(703) 642-1070
FAX (703) 642-1075

July 7, 1995

Dear Representative:

As the legal information arm of the Christian Legal Society, the Center For Law And Religious Freedom urges your serious consideration of the needs of those taxpayers who have sincere religious objections to paying the military portion of their federal taxes. The U.S. Peace Tax Fund Bill (H.R. 1402) would avoid infringement upon those conscientious objections without reducing revenue.

The beneficiaries of this bill would be the small number of citizens whose religious convictions forbid participation in war, whether that participation is physical or financial. As we understand the bill, these taxpayers would continue to pay their full tax obligation, but their military portion would be designated to agencies not involved in national defense. Simply put, the bill would create an accounting mechanism to re-route these citizens' taxes so that their portion does not directly fund the taking of human life.

No citizen should be forced to choose between violating the law or their conscience. Otherwise, we have compromised the promise of the First Freedom in the Bill of Rights -- religious liberty. The 103rd Congress reaffirmed this fundamental principle by passing the Religious Freedom Restoration Act of 1993 (P.L. 103-141). This Congress can demonstrate the same sensitivity to the sanctity of religious conviction.

We would be pleased to assist you in exploring how this bill or another might get our government out of the business of punishing persons of faith who seek to fulfill both their obligation to their conscience and to their fellow taxpayers.

Respectfully,

CENTER FOR LAW & RELIGIOUS FREEDOM

Steven T McFarland

Steven T. McFarland, Director

cc: Samuel B. Casey
Edward M. Gaffney

Church of the Brethren
Statement on H.R. 1402

The Church of the Brethren expresses support for H.R. 1402, the U.S. Peace Tax Fund bill, a means through which members of our church who are conscientiously opposed to war may pay their entire tax obligation.

The Church of the Brethren consistently through its history has stated its condemnation of warfare, military conscription and use of tax monies for military purposes. Our members do not agree with the government's present stewardship of resources. While Brethren generally support the traditional biblical interpretations that all taxes must be paid, church members and congregations have consistently been urged to continue to work for alternative legislation for the payment of taxes and specifically to support the United States Peace Tax Fund.

Annual Conference, the highest decision making body of our denomination, has consistently supported a Peace Tax Fund bill.

In 1961, in its STUDY OF THE PACIFIST MOVEMENT, Annual Conference directed the General Board of the Church of the Brethren to "...work out a proposal for an alternative tax arrangement so that the taxes of those who object to war on conscientious grounds may be used for peaceful and constructive goals of government."

In 1977, the Church of the Brethren Annual Conference passed a statement on JUSTICE AND NONVIOLENCE. This statement included advocacy for the U.S. Peace Tax Fund Bill. "The Church of the Brethren must be decisive in shaping its own programs and calling all Christians and other persons of good will to encourage the United States to...provide tax alternatives, such as the World Peace Tax Fund, to those conscientiously opposed to the current level of military spending (and to) transfer immediately the funds in the military budget to life-giving programs."

The General Board of the Church of the Brethren gave added impetus to the denomination's support of the U.S. Peace Tax Fund bill the following year (1978) when the following endorsement was passed and sent to each congregation: "The General Board of the Church of the Brethren endorses the World Peace Tax Fund and is called upon to communicate (this support) to the President of the United States and appropriate Congressional committees; Districts and congregations are encouraged to make statements of support and to notify their Representatives and Senators of this action either by letter or personal delegation; and that Staff continue to support actively the World Peace Tax Fund legislation and disseminate information concerning the progress and action needs of this legislation."

The 1980 Annual Conference called on Brethren to place a high priority on study and discussion of "war tax resistance, including Biblical examination of the Christian responsibility to civil authority, consideration of refusal to pay the portion of federal taxes used for militarism as a response to Christ's call to discipleship and obedience, and pledging by congregations and individuals of spiritual, emotional, legal, and material support to members who withhold war taxes."

Following this action, the 1981 Annual Conference of the church endorsed this action: "That Annual Conference approve the query that the Church of the Brethren reaffirm its 1978 support of the World Peace Tax Fund by: 1) contacting every senator and congressional representative by letter asking for their support, 2) encouraging each member of the Church of the Brethren to contact his/her own congregational representative; 3) informing other denominations of our action; and 4) distributing the slide presentation of the World Peace Tax Fund to all (Church of the Brethren) districts."

As the Annual Conference, in 1983, discussed its "World Mission Philosophy and Program," peacemaking in our world and financial support of the military again came to the fore, was discussed and debated by denominational members. "Peacemaking efforts should be increased on national and district levels. The Church of the Brethren has an urgent task to call the church of Jesus Christ back to the original vision gained from the Prince of Peace. We should also be supportive of those in government office who are working toward such peace

initiatives as a Peace Secretary on the President's Cabinet, the World Peace Tax Fund, and National Academy of Peace."

This 1983 Annual Conference further debated the war tax issue in its "War Tax Consultation" statement. "...the Church of the Brethren, through Annual Meeting has resolved that 'all war is sin,' and that 'we cannot...support the military machine in any capacity (1934);' we have advocated a separation of church and state, particularly at those points where the state would urge us to act contrary to the way of Jesus. Of import to this discussion are the legislative recommendations to Church of the Brethren congregations coming from this discussion. "The church should, in conjunction with Mennonites, Friends, and others, encourage legislation to allow institutions lawfully to refrain from collecting tax money from their employees where there is conscientious objection and to permit diversion of such tax money to worthy, non-military service. The 'World Peace Tax Fund' legislation would, if passed, allow employees to designate tax money for non-military uses, thus relieving employers of the need to withhold taxes for military use, at employees' request."

In 1985, all Church of the Brethren congregations received a War Tax Study Packet noting that the packet was prepared as a result of Annual Conference actions. One of the recommendations coming out of the responses to this packet was stated thusly: The denomination must "work harder at alternative legislation such as the United States Peace Tax Fund...including (the writing) of letters of protest against spending for war and working for passage of the United States Peace Tax Fund."

And, again, in 1987, the Annual Conference received a 'REPORT OF THE WAR TAX STUDY COMMITTEE.' This report states: "...Annual Conference has stated its opposition to the use of taxes by the government for war purposes and military expenditures, and specifically recognized those who are conscientiously opposed to paying taxes for these purposes..." This official policy statement of the church concludes by urging Church of the Brethren members and congregations to "work for alternative legislation for the payment of taxes, such as the United States Peace Tax Fund."

The Brethren, as a people of faith, hold to a higher power which we understand to be a God of peace. Our denomination has consistently and purposefully said "no" to any participation in war. For persons who hold, for religious reasons of conscience, that conscription of people and conscription of tax dollars for war are wrong, the United States Peace Tax Fund is an alternative which would permit legal participation in government while holding one's religious beliefs paramount.

Submitted By

(The Rev. Dr.) Donald E. Miler
General Secretary
Church of the Brethren General Board
1451 Dundee Avenue
Elgin, IL 60120
708-742-5100

Written Testimony submitted to
The Committee on Ways and Means, U.S. House of Representatives
by
The Rt. Rev. William Davidson, Retired Episcopal
Church Bishop
July 10, 1995

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Introduction

Mr. Chairman and members of the Committee on Ways and Means, I am William Davidson, a retired Bishop of the Episcopal Church, now living in the State of Colorado. I am submitting this testimony in regard to the U. S. Peace Tax Fund Bill (H.R. 1402). I am heartily in favor of this proposed legislation.

Personal

I appreciate the opportunity to join other witnesses who are responding to your willingness to receive such testimony. I am grateful that your Committee is holding hearings which allow me to express my feelings to you.

I am now, and have been for over 50 years (since 1939) religiously and conscientiously opposed to war and all of the efforts and preparations that go into the waging of war and the threats of war. At the time of World War II, I filed as a C.O. with my Draft Board and after some difficulty was granted "objector" status.

In my religious training over the years, I have learned and have tried to practice the Biblical concept of Peace. To me this means justice for all, respect for the dignity of every human being, and non-violent efforts to reconcile differences, and to renounce war.

I have found myself through most of my life to be in great conflict of mind, heart and conscience between my desire to be a loyal citizen of our great nation, and at the same time to live by my fundamental belief that war and violence are not acceptable means to achieve our desires as citizens and our goals as a nation. When I was of draft age according to Selective Service laws, I was greatly appreciative that those laws provided an alternative to military service which allowed me to fulfill the law, accepting its option for "conscientious objectors" and still not be seen as a law breaker and subject to fines, prison, etc. in the same category as those with criminal intent.

As I have continued to live my life these many years, I have found that I am in the dilemma of either supporting with some portion of my taxes, the military efforts of the United States, or of being subject to the same fate as tax-evaders and other criminals. I have been saddened and conflicted by this state of affairs. I have worked to change our federal laws to provide a suitable alternative. To date, however, I have not chosen to break the law by refusing to pay my total taxes, even though this violates my conscience. Perhaps I should explain further the source of my religious beliefs.

The Episcopal Peace Fellowship

I am a member and past President of the Episcopal Peace Fellowship and have, along with some 1500 other members of this voluntary organization of our Church, pledged "to pray, study and work for peace and to renounce so far as is possible, participation in war, militarism, and all other forms of violence" (EPF Commitment as stated in the membership brochure).

The EPF has a long history of efforts to eliminate war from the international scene, to establish non-violence as the basis for all human relationships, and to work for reconciliation, justice, and peace in the lives of individuals at all levels of society and especially within the Church. For many years the EPF has proposed and supported peace resolutions at Church conventions and has engaged in a ministry of intercessory prayer that such resolutions may be implemented and become effective. The EPF has supported young Episcopalians who are considering conscientious objection to military service, and has supported war tax resistance as a witness for peace.

The Episcopal Church

While the Episcopal Church, of which I am a member, is not known as an "Historic Peace Church", I am pleased to point to its record of being opposed to war. As far back as 1931, the Bishops of the Church adopted a resolution which affirms that "war as a method of settling international disputes is incompatible with the teaching and example of Our Lord Jesus Christ" (General Convention, 1931). This statement has been reaffirmed repeatedly by the Episcopal Church.

Continuing from the date of the above statement, the Episcopal Church has spoken similarly in official pronouncements on many matters which bear on the subject of this Hearing, and help to explain my reason for submitting this testimony. Let me list just a few of these subjects:

1. In 1934 our Church petitioned Congress to recognize non-combattant status for those who by conscience would refuse to serve in the armed forces.

2. In 1940 our Church established a register of Conscientious Objectors, which is maintained to this day at Church Headquarters to allow those who would refuse to serve, to declare their position even though current Selective Service law provides no opportunity for draft registrees to become "C.O.".

3. In 1962 our Church called its members to "the insistent duty of working with all their strength for the prevention and elimination of war", and further stated, "we recognize the validity of the calling of the conscientious objector and the pacifist, and the duty of the Church to minister to him". (House of Bishops' Pastoral).

4. In 1973, and in subsequent years, our Church has supported peace education programs, and the provision of pastoral counselling for young persons faced with draft registration.

5. In 1976 our Church called upon Congress to restrict arms sales to other nations, and also to check the proliferation of nuclear arms.

6. In 1982 our Church urged both the U.S.A. and the Soviet Union to adopt a policy of no first-use of nuclear weapons; and in 1985

spoke against the U.S. policy of "deterrence", and opposed the S.D.I. (Star Wars) effort, and supported efforts for a verifiable bilateral nuclear freeze.

7. In 1979 our Church established, as a part of its national structure, a Joint Commission on Peace, and in 1982 created the Office of Peace and Justice on the national staff; and more recently has developed Peace and Justice Officers in most Dioceses, and a National Network of Peace and Justice officers.

8. In 1988 and in 1991 our Church called for diplomatic and economic sanctions against South Africa. The Church has consistently supported efforts of the United Nations for non-violent settlements of international disputes, and for the reform of U.S. policy in Central America and in various other parts of the world.

9. In 1991 our Church again expressed concern over U.S. involvement in Arms sales world-wide, and it spoke against the promotion of "Low Intensity Conflict" as a national policy; and urged peaceful settlement of the Israel/Palestinian disputes.

10. In 1994 our Church deplored the sale and export of conventional arms of war, urging Congress to prohibit sale and export of such; and urged the President of the U.S., and our negotiators to take leadership in implementing a Test Ban Treaty in the interest of eliminating nuclear weapons design, testing, and manufacture throughout the world.

I believe this brief summary of statements and actions by The Episcopal Church covering the past 60 years gives evidence that we are a Church concerned with ethical and religious convictions in relation to peace and justice. We are a Church which expects its members to be active in working for peace, justice and reconciliation everywhere in life and in society. We are also a Church which is supportive of the conscientious actions of its members, particularly in relation to opposing laws which would require them to obey man-made laws which are in conflict with their understanding of the immutable divine law of God.

Conclusion

In view of all that I have written above, it must be clear that I am a member of a Church that could support and favor H.R. 1402 because of the provision it makes for an alternate opportunity for taxpayers conscientiously opposed to paying for military expenditures, to pay their full share of taxes as loyal U.S. citizens, yet without having their taxes go for war purposes. I would welcome this opportunity for myself, and for all other citizens with similar conscientious scruples. I urge you to give it your utmost attention and to consider reporting favorably to the House of Representatives regarding this legislation.

Thank you.

EASTERN MENNONITE UNIVERSITY

Office of the President

July 6, 1995

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Members of Congress;

This letter is to urge you to approve the U.S. Peace Tax Fund Bill. (H.R. 1402)

Eastern Mennonite University is an educational institution of the Mennonite Church. As part of the Mennonite Church we believe very deeply that the Christian Bible teaches a way of peace which does not allow for violence towards others in any form. To us this means we should not be forced by our government to support a military establishment which has no purpose other than to physically harm others. Our ancestors settled in this land centuries ago to find religious freedom.

The curriculum of Eastern Mennonite University promotes non-violence, instruction in conciliation, peace and service to all mankind. In addition to having a purpose of education, our Mission Statement states our intention to *challenge students to answer Christ's call to a life of service and peacemaking.*

We have just begun a masters program in Conflict Analysis and Transformation and an Institute for Conflict Studies and Peacebuilding. These are initiatives we have taken as an attempt to train more people in alternative means of solving conflicts in our world. We believe there are ways to resolve differences other than through violence, e.g. the use of the military.

As an educational institution we are preparing persons to be good world citizens. Preparing persons to be good world citizens means that we urge our students to find ways of healing conflict and to serve others, never engaging in acts of violence towards other citizens of the world.

Idealistic? Perhaps. Our nations history of violence in the form of war has never created lasting peace. In contrast, extending a hand of friendship and helping others in need has created relations of friendship which have lasted for generations.

As followers of the Christian scriptures and the Lord of all ages who is the subject of our scriptures, we urge you to approve the U.S. Peace Tax Fund Bill so that we do not have forced conscription of our dollars to support military activities.

Very truly yours,

Joseph L. Lapp

Harrisonburg
VA 22801-2462
(703) 432-4100

Statement by Alan Eccleston, Organizational Development Consultant
in Support of the Peace Tax Fund Bill, HR 1402
to be Submitted to the Ways and Means Committee
of the U.S. House of Representatives
for the Hearing on Tax Measures
July 11-13, 1995

FREEDOM OF RELIGION IS AT ISSUE

Thank you for this opportunity to submit testimony on behalf of the Peace Tax Fund Bill. In 1992, I appeared before the Subcommitte on Select Revenue Measures to speak in support of this Bill; I am glad to be able to submit an update and reiteration of that testimony. My statement is about Conscience, the Constitution, and Civil Rights.

I am a Quaker and I do not believe in war.

I want to tell you about my own spiritual beliefs, as a member of the Religious Society of Friends (Quakers), and how I am burdened by having to endure penalties, punishments, and the threat of confiscation of my home in order to be true to my conscience and to practice the faith of my Quaker forbears who in 1661 stated unequivocally to King Charles II that, "we utterly deny all outward wars and strife and fightings with outward weapons, for any end or under any pretense whatsoever. And this is our testimony to the whole world."

The origin of this witness did not start with a concern about war. Our peace witness developed from a deep faith in the essential unity of humankind and the sacredness of each individual because there is "that of God" or an "Inward Light" in every person. The "Inward Light" is in those on both sides of any conflict, and this aspect of holiness does not permit us to take a person's life, nor to assist others who would do so--not even under the mandate of temporal power.

Friends of Philadelphia Yearly Meeting have declared that, "every individual of every race and nation, is of supreme worth; that love is the highest law of life, and that evil is to be overcome, not by further evil, but by good. We affirm the supremacy of conscience. We recognize the privileges and obligations of citizenship, but we reject as false that philosophy which sets the state above the moral law. . . . we assert that every individual while owing loyalty to the state, owes a more binding loyalty to a higher authority--the authority of God and conscience." This brings us to the Constitutional question.

The Peace Witness Began in the Colonies and Has Continued to the Present.

Friends were especially prominent in two of the colonies, Rhode Island and Pennsylvania. William Penn refused to send money to England for war with Canada and during the French and Indian War Quakers petitioned the Pennsylvania Assembly not to require a militia tax of them since that would violate their "Liberty of Conscience, for the sake of which our Forefathers left their native country, and settled in this, then a Wilderness."

Issues of conscience came up during the Revolutionary War during which John Woolman, a well-known Quaker, wrote, "To refuse the active payment of a tax which our Society generally paid was exceedingly disagreeable, but to do a thing contrary to my conscience appeared yet more dreadful. . . Thus by small degrees, we might approach so near to fighting that the distincition would be little else but the name of a peaceable people."

James Mdison, author of the First Amendment, spoke on behalf of conscientious objection. There are recorded speeches from that era that elaborate the issue, such as Roger Sherman of Connecticut, who in 1789 told Congress, "It is well known that those who are religiously scrupulous about bearing arms are equally scrupulous of getting substitutes or paying an equivalent. Many of them would rather die than do either one or the other."

That issue, paying for others to bear arms when it is morally repugnant to do so oneself, is the one now addressed by the Peace Tax Fund. It has precedence in the amendment to the Selective Service Act passed by Congress and signed by President Roosevelt in 1940. That amendment acknowledged the Constitutional right of citizens not to be forced to bear arms contrary to their religious beliefs (or most deeply-held spiritual values). This amendment gave conscientious objectors the opportunity for alternative service, and the Supreme Court has upheld this.

The Peace Tax Fund Bill is the logical corollary to the constitutional rights already acknowledged. It is a tightly-drawn peice of legislation that was introduced in 1972. It is a clear piece of legislation that is workable, timely, and appropriate. It would put an end to IRS harassment and denial of a basic civil right to scrupulously hnert, peaceful, hard-working citizens of conscience (who generally owe relatively small amounts of taxes).

The Government Imposition of Civil or Ciminal Penalties for Being True to Our Religious Principles is a Denial of Civil Rights.

I have always filed my 1040; I gladly pay for the services of government that are life supporting and I am willing to pay for obligations incurred from past wars (debt and veterans' benefits)--these items do not threaten life. However, I cannot pay for the current military expenditures,--they do threaten life and that is their purpose. For the past 20 years I have informed the IRS and my Congressman of my act of conscience, and in return the IRS has garnished my income, closed my bank account, and taken money out of escrow, adding interest costs and penalties that frequestnly double the amount which I originally withheld.

The IRS has put a lien on my house four times. Automobiles have been taken from friends of mine and auctioned. Most recently in Colrain, Massachusetts, houses of two different families have been taken by the IRS.

Randy Kehler and Betsy Corner Forced from Their Home

In the case of Randy Kehler and Betsy Corner and their 12-year-old daughter, Lillian, the IRS auctioned the house for a minimum bid of $5400 against an alleged tax bill of $27,000. There were no takers. They subsequently charged Randy with criminal trespass on government property and sentenced him to an open-ended six-month sentence, renewable each succeeding six months without end, until he would swear that he would never trespass again by reentering the house he still considered belonged to his family.

I visited Randy two or three times a week while he was in jail from December 6, 1991 until February 12, 1992. On February 12 the IRS held another auction, this time moving its site to a different part of the state where moral suasion of friends and community would have less impact. The also removed the minimum--they would sell the house for just $1. This was not a house sale; this was the IRS dumping a problem which it had created by trying to coerce a family of high morals and deep conviction into renouncing their beliefs!

Who commissioned the IRS to police the religious values of the citizens of this country? They are ill-suited for this purpose, and I do not believe it is a good use of their limited resources. It is the responsibility of Congress to pass the Peace Tax Fund Bill and relieve the IRS of this inappropriate role.

Not only did the IRS make a sale for an absurdly low price ($5400--for a nice house!), it failed to acknolwdge that it never had title to the property. As strong as the IRS is, it does not have the power to take something from a taxpayer that the taxpayer never had. Randy and Betsy were lessees on a land trust. They did not own the land but had a long-term lease on the improvements. Their house did not have an independent water supply. Randy and Betsy were allowed to share in a limited water supply from a system built by two generous neighbors.

The IRS didn't ever concern itself that the house they took had no title and no water, nor did they advise the buyer of these facts. The whole issue went back to the courts. True, the IRS had gotten it off its hands, but at a severe cost to others, causing distress and unnecessary hardship to several families--Randy, Betsy and their daughter, the family that moved in (who also have a child), and other families in the land trust. The IRS can cause anxiety and hardship in any case, but when they act, as they have in this case, with seeming disregard for conscience, facts, legality, and human welfare, it is particularly distressing.

Conscience Is Not Incidental nor Expendable

Conscience must be taken into account. Spiritual values are real. They are not to be treated as incidental or expendable to fit the needs of the state. That is what the First Amendment is all about. That is our heritage as a nation taht was settled by colonists who came here seeking religious freedom. They wanted to escape persecution meted out to them by an intolerant state. And is this any different?

When the state forces Randy, Betsy and Lillian out of their home for following their spiritual beliefs, is that not persecution? When a parent is put in jail because of deeply held

spiritual convictions (Betsy and Randy deliberated about who should stay out of jail to care for Lillian), is that not persecution?

Randy and Betsy were paying their common share for the well-being of the country. They filled out their 1040, calculated their taxes and sent the form to the IRS, but their tax money was donated, to the dollar, to life-supporting charitable organizations in keeping with their spiritual beliefs.

It is not right for the government ot take a house to force people of conscience to pay for war. It is not right. It is not in the spirit of the founding of this country. It does not live up to the high ideals of a civilized democracy, and it must be changed. It can only be changed if you on this committee will take in in your heart and ask what it means to you to stand for truth? Ask what it means to sit in these chambers and make a decision that could move us toward the incredible vision of those who came to this country seeking religious freedom, of those who wrote the Declaration of Independence, of those who framed the U.S. Constitution, of those who approved the Bill of Rights. The Peace Tax Fund Bill rests firmly in these values. It acknowledges the right of the government to levy taxes and a citizen's obligation to pay them. It asks only that the government acknowledge the right of the citizen of conscience to make the payments in a manner that is consistent with our deeply held beliefs against war and preparation for war.

The values of the era in which we live have become materialistic and superficial. A very small percentage of the voting age population chose to go to the poles to elect you because there is such cynicism about a government that puts so much energy into caring for the elite, the vested interests, and the powerful.

The Peace Tax Fund Bill Is an Opportunity.

The Peace Tax Fund Bill is an opportunity to rise to the ideals and challenges posed to us by our contry's founders. When you support this Bill you support my religious freedom, and I will be indebted to you, and so will every Quaker, every Mennonite, every Brethren and every individual (of whatever religion) who abhors war, who believes that God intends for us to live in harmony with our most deeply-held beliefs.

As we acknowledge when we say the Pledge of Allegiance, we are citizens of this great nation--under God--and we who are conscientious objectors cannot deny the conscience within us short of renouncing the God that we believe in. I ask you to acknowledge the right of individual conscience as already defined by the conscientious objector section of the Military Service Act and move this Bill forward.

Thank you.

STATEMENT ON BEHALF OF THE EPISCOPAL PEACE FELLOWSHIP

House of Representatives Committee on Ways and Means
Hearing on Tax Measures, July 11-13
Statement in Favor of the U.S. Peace Tax Fund Bill, HR 1402
by Patricia A. Washburn

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Dear Chairman Archer and members of the Committee on Ways and Means:

I am Patricia Washburn of Estes Park and Denver, Colorado. I submit this written testimony in support of HR 1402, a Bill "to amend the Internal Revenue Code of 1986 to improve revenue collection and to provide that a taxpayer conscientiously opposed to participation in war may elect to have such taxpayer's income, estate, or gift tax payments spent for nonmilitary purposes." I appeared before the Subcommittee on Select Revenue Measures in May, 1992 in support of the Peace Tax Fund Bill, and this testimony is an updated version of what I said and submitted at that time. I have struggled and prayed in order to discern what I can say to you that is faithful and helpful to your understanding of my choice to be a Conscientious Objector to the payment of the military portion of my income tax. I am reminded in this process of something once said by Dorothy Day that "our job is not to look for results, but to be faithful to the truth." I will attempt as best I am able to be faithful in what I choose to share with you.

I am a religious educator by vocation and training, with a seminary degree in social ethics and moral development theory. In concrete terms that means that I have found myself involved over the last decade in the emerging field of Peace Studies. I spent four years teaching at a Quaker college and school of theology where I developed a faith-based program in Peace and Justice Studies. I also taught courses in nonviolence and conflict resolution. Currently I serve as adjunct faculty at the Iliff School of Theology in Denver, teaching in their Justice and Peace Studies program; I also serve as Director of Religious Education for a Unitarian congregation. My professional life has been devoted to teaching peace alternatives to military resolution of conflict.

I first became acquainted with the Peace Tax Fund when I spent four years working as public education staff for the National Peace Academy Campaign, the public interest lobby which ultimately succeeded in educating Congress about the necessity for the U.S. Institute of Peace. During the period when I served as public education staff person for the Campaign, I learned about the Peace Tax Fund Bill and was aware that if that legislation were enacted, one of the designated recipients of those tax funds would be the U.S. Institute of Peace. Thus I have always considered myself a supporter of such legislation even before I became an active war tax objector.

One of the lasting impressions of those four years working on the Hill was walking each morning into the Methodist Building where our offices were housed and meditating on the passage from Micah (Chapter 6, verse 8) which was embossed above the doorway. "For what does the Lord require of you; to Act Justly, to Love Constantly, and to Walk Humbly with your God." That passage has become a foundational part of my faith statement or creed.

Perhaps it would be helpful to share a bit of my personal story of my struggle to find a way to be ethical and faithful to my commitment to nonviolence as articulated in that passage from Micah. If you can envision for a moment a series of concentric circles, ripples in a pool perhaps, with the three ethical injunctions forming the content of each circle, it may help to understand my faith walk.

The center circle is the one in which I am called to <u>WALK HUMBLY</u> with God. From my experience with Quakers I understand that to mean "walking in the Light" and being mindful of "that of God" in myself and other persons. Much of my research has been in the area of psychological projection, what I call enemy making. I am aware that much of what we project onto other persons or nations has its genesis in our own psyche. Until we are spiritually grounded we will continue to think in terms of "them and us." One only has to remember the rhetoric of the "evil empire" to get a sense of the pervasiveness of that mindset. We are a culture permeated with violence, beginning with our own lives and moving out into our communities and ultimately our nation. Militarism is a systemic response to this culture of violence. To support this violence is to do spiritual and psychic harm.

The second ripple in our circle requires that we <u>LOVE CONSTANTLY</u>. As I look at family life and the deterioration of our educational system I want to weep. How

does one manifest an ethic of love of neighbor in a climate of mistrust and alienation? Much of my work has been in the area of racial reconciliation, and this becomes increasingly difficult when national priorities do not allow adequate funding for a minimum safety net for the poor. As an educator I am appalled at these skewed priorities. As the mother of four young adults I have spent over 30 years parenting in a society which does not seem to take loving constantly as a high priority. One has only to read statistics about unemployment among black youth or read Jonathan Kozol's book, Savage Inequalities: Children in America's Schools to become sick at heart at our misplaced priorities.

The final ripple in our circle requires that we ACT JUSTLY. I made my first public witness to this in 1968, when I stood in vigil with a group of Quakers in front of the Post Office in Colorado Springs protesting the escalating Viet Nam conflict. As a consequence I lost my teaching position in a public high school, and realized that being faithful would be costly to me. Shortly thereafter my husband and I began to withhold our federal telephone tax that had been added to pay the costs of the Viet Nam War and began to be active in our support of conscientious objectors by offering draft counselling in our parish church in Baltimore during the early 1970's. My public witness has continued, and the resistance has deepened as I have become more and more involved in working to change our priorities. To begin to accomplish this, it seems necessary to manifest a form of conscientious resistance to paying for war. I would like to elaborate on that with one personal vignette.

Although I have been deeply influenced by Quakers and the Peace Testimony of the Society of Friends, my primary religious affiliation and activity has been with the Episcopal Church. I have served as both staff and Vice Chair of the Episcopal Peace Fellowship, and am currently serving on the Peace Fellowship's National Executive Council. I am on the Steering Committee of the Episcopal Peace and Justice Network and editor of its newsletter. I have also served on the Standing Commission on Peace with Justice of the national Episcopal Church, and in that capacity I traveled with members of the Commission to Israel and Palestine in the summer of 1990, just prior to the outbreak of the Gulf War. We were asked to make a site visit in part to determine the extent to which U.S. military funds were being used to support Israeli efforts to maintain order in the Occupied Territories during the Intifada. We visited an Anglican hospital in Gaza City and were shown tear gas containers which had been lobbed into the delivery room of the maternity ward. I wrote in my letter to Fred Goldberg, Commissioner of Internal Revenue, shortly after my return, "We were told that the violence was increasing and that over one third of the victims were children. We were shown tear gas canisters made in Pennsylvania and rubber bullets purchased with U.S. aid money." I went on to add that "In a recent Save the Children report, it states that 50-60,000 children have been treated for Intifada-related injuries during the first two years of the uprising. We are complicit in those injuries since we help finance the Israeli military . . . . In addition to our support of Israel, we also provide $2.5 billion annually to Egypt. It is also noteworthy that the U.S. will spend $10 million daily to maintain its force in Saudi Arabia. All this arsenal of destruction/ Armageddon is paid for at least in part by my income taxes. This military buildup is too much for me to bear as a mother and as a person of Faith. I weep for the generation of children who will bear the burden of this war, and I weep for the mothers of these children." (Letter to IRS, August 15, 1990)

A few years ago I was deeply moved and disturbed by a book written by a team of research associates at the Erickson Institute in Chicago, a graduate school and research center for the advanced study of Child Development. No Place to Be a Child is subtitled Growing Up in a War Zone and tells of the trauma experienced by children in such diverse places as Cambodia and Chicago. Paul Simon has commented on reading the book, "I was struck by the role reversal--the child forced to respond as an adult because we as adults have walked away from our responsibility to provide a safe and peaceful environment for our children."

I have on the door of my office a poster from WAND (Women's Action for Nuclear Disarmament) of a mother holding on her lap a child who in turn is holding a globe. The logo reads CHILDREN ASK THE WORLD OF US. I cannot reconcile paying for weapons of destruction with this logo. And I am caught in a profound moral dilemma. I am not opposed to paying taxes, but I find no alternative form of tax payment that will support the quality of life to which I am committed rather than the destruction of life. Thus I see no current alternative to withholding the military portion of my taxes. In the previously mentioned letter to the IRS I concluded, "I pray for all the mothers and children as I make this witness. I pray that God will be merciful and allow those children to grow to maturity. I know that Mary will weep with us if we do not repent of this madness . . . Sister Theresa has written that "Goodness does not derive from our capacity to think but to love." I pray that my witness is done in love and that it will help to build a bridge across the chasm of violence and fear."

The witness to faithfulness is costly. By withholding the military portion of my tax monies, I have ultimately paid one third to one half again the amount owed in penalty and interest. In 1992 when I first testified for the Peace Tax Fund Bill, I was withholding the military portion of my 1989 taxes, having been levied in 1987 and 1988. In my letter to the IRS dated February 21, 1992, my attorney mentioned the then-upcoming hearings and stated that:

"That bill [HR1402] if passed would amend the IRS Code to provide that a taxpayer conscientiously opposed to any participation in war could have his or her income, estate and gift tax payments spent for non-military purposes only. Adoption of this bill is completely appropriate in light of international movement away from the arms race and the Cold War, and would put this country's tax code into greater harmony with that respect for free religious exercise embodied in the First Amendment to the U.S. Constitution. In light of the pending congressional consideration of the Peace Tax Fund Bill, Ms. Washburn and I respectfully request that you forego further action on this matter until the congressional hearing and action on the Peace Tax Fund Bill is completed."

By exercising my conscience, I have risked prosecution and perhaps prison. My wages have been, and are currently, levied. I have been forced to sell my house. Surely there must be some alternative for those persons of faith and conscience who are attempting to be faithful stewards of their resources. The Episcopal Church in its General Convention proceedings of 1988 went on record to say that conscientious objection is a faithful response and should have the respect, the support and the ministry of the Church. If my religious denomination believes my response is faithful, why then does my government not allow me to make this witness without living with the daily fear and anxiety that accompany this faith witness? Passage of HR 1402 would allow me to be faithful and remove this burden. To return to my credo, I believe that I am called by my Creator to live nonviolently, to ACT JUSTLY, TO LOVE CONSTANTLY AND TO WALK HUMBLY WITH MY GOD.

I respectfully request this Committee to hear my plea and provide me an ethical option that does not force me to violate the law of the land in order to honor the law of conscience. My colleague John Stoner has said, "We are War Tax Resisters because we have discovered some doubt as to what belongs to Caesar and what belongs to God, and have decided to give the benefit of the doubt to God." I make this plea for legislative change not only on my own behalf but on behalf of the thousands of others who struggle with this dilemma, and specifically on behalf of my children, Christopher, Peter, Polly and Cory and my grandchildren Paul, Sarah and Joshua.

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FRIENDS COMMITTEE ON NATIONAL LEGISLATION

**UNITED STATES HOUSE OF REPRESENTATIVES
WAYS AND MEANS COMMITTEE**

**Hearing on H.R. 1402,
the U.S. Peace Tax Fund**
July 11, 12, 13, 1995

Testimony Submitted by
Joe Volk, Executive Secretary
Friends Committee on National Legislation

We appreciate the committee's attention to the legislation that would establish a U.S. Peace Tax Fund. The Friends Committee on National Legislation, a religious lobbying organization representing Quakers in 26 yearly (regional) meetings and 7 national Friends' organizations, has followed the progress of the Peace Tax Fund since its first introduction in 1972, by Representative Ron Dellums. We are grateful to the principal sponsor of the legislation, Representative Andrew Jacobs, Jr. We thank the many co-sponsors who have given serious support to the religious freedom of the people addressed by this legislation.

The U.S. Peace Tax Fund bill is a request to Congress, seeking recognition and accommodation of a significant conflict between the requirements of tax law and the religious beliefs and practices of certain citizens.

Quakers are widely known for traditional teachings of pacifism. Even more central to our faith is the call to listen to the inner teacher -- the spirit continually present in our lives, and to conform our lives to the call of that spirit. Some Quakers, in faithfulness to that teaching, recognize that they *cannot* pay taxes that will support military activities, without doing violence to the religious beliefs that order their lives. Quakers, among many others, have approached Congress to find a legal way to resolve that dilemma.

Seeking other remedies. Knowing their small number, these conscientious taxpayers have tried, in several ways, to meet both the demands of conscience and the demands of government. Some have voluntarily reduced their incomes -- by donating their time and professional services -- to a level at which they owe no income taxes. Some reduce their taxable income by donating large portions of it to charity. Some have not found it possible to square the demands of government with the rule of conscience; they have illegally refused to pay the portion of their tax bills that would support military activities.

The situation of these taxpayers is analogous in many ways to the situation of those who can not, in conscience, fight as soldiers in a war. Before a mutually agreeable "conscientious objector" status was created for these individuals, many found that they had to violate the law in order to follow their religious beliefs. Some did join the armed services but would not fight. Some left the country. Some went to jail.

By the time the U.S. entered World War II, the concept of "alternative service" was invented. In creating this status, the Congress and the Administration recognized a diversity of religious beliefs in our society, and acknowledged that our country's commitment to the free exercise of religion requires that we honor and accommodate a wide spectrum of religious beliefs and practices. The "alternative service" concept further recognized that a country needs many kinds of service; participation in the military is not the only way to contribute to the common good.

Alternative Service for Tax Dollars. As this country's military history has evolved, it is now much more likely that an individual citizen will be called on to "serve" by paying military taxes, rather than by participating directly as a soldier. Under the military policies of recent administrations, the U.S. is more likely to invest in armaments and to support "low-intensity conflict" in other countries than to engage directly in large-scale combat. These military activities require U.S. tax dollars even more than they require U.S. soldiers.

This evolution of history has prompted many thoughtful religious individuals to examine more deeply their testimonies and beliefs against participation in war. Within the Society of Friends, some of the more recently written "disciplines" ask members to consider whether they participate in war "or preparations for war." As some search their consciences and their lives for "seeds of war," they stumble over the thousands of dollars that they pay each year into a federal budget which finances a major military force. For some, this "beam in the eye" cannot be ignored. They seek ways to divorce their lives from activities which they believe to be sinful.

We ask Congress now to create a legal alternative for these conscientious individuals, who care deeply about their society and who would support its life-sustaining efforts, but who cannot support war-making. The Peace Tax Fund would establish a channel for the tax payments of these individuals, to give some degree of assurance that their erstwhile military taxes would serve life-sustaining ends instead.

We seek this "alternative service" for tax dollars as one way of implementing a government policy that supports the free exercise of religion in this country. We appreciate your committee's assistance in developing the record of the need for this bill, and in discerning the questions that might surround its eventual implementation.

HOW WOULD THE PEACE TAX FUND WORK?

The bill creates a trust fund within the U.S. Treasury, which would receive the tax payments designated by eligible individuals for the Peace Tax Fund.

A portion of the trust fund, equivalent to the percentage of actual appropriations for "military purposes" (as defined in the bill), would be retained in the fund. The remaining portion -- the "non-military percentage" -- would revert immediately to the General Fund. The percentages would be calculated each year by the Comptroller General.

The monies remaining in the trust fund would then be disbursed to non-military programs. At this time, the bill names four: WIC, Head Start, the Peace Corps, and the U.S. Institute of Peace.

WHO WOULD PARTICIPATE IN THE PEACE TAX FUND?

Taxpayers who are conscientiously opposed, by reason of religious training and belief, to participation in war in any form would be eligible to participate in the Peace Tax Fund. Supporters of the Peace Tax Fund legislation recognize that the definition of "conscientious objection" has evolved, by Supreme Court decision, to a somewhat broader scope than that reflected in the statutory language. It has been the intention of this bill's supporters to track the

definition of "conscientious objection" found in the Military Selective Service Act, as interpreted by subsequent court decisions.

Such taxpayers would file a "questionnaire return," during a taxable year, stating their sincere conscientious objection to the payment of taxes for military purposes. Tax returns filed by Peace Tax Fund participants would be subject to routine (random, or other) audits, like any other tax returns. It is our hope that this process, or some variation of it, will:

* offer a solution for those who need a legal alternative in order to continue paying their federal taxes,

* discourage participation by individuals who are <u>not</u> compelled by conscience to divert their tax payments away from military purposes, but wish simply to make a statement about public policy, and

* encourage the use of this legal alternative, thereby relieving the IRS of the inevitable administrative expense that occurs when a taxpayer refuses on religious grounds to comply with tax laws.

DOESN'T THE RELIGIOUS FREEDOM RESTORATION ACT (RFRA) TAKE CARE OF THE ACCOMMODATION THAT THESE CONSCIENTIOUS OBJECTORS SEEK?

The Religious Freedom Restoration Act, adopted by Congress in 1993, instructs all levels of government to extend the religious freedom protections of the First and Fourteenth Amendments by accommodating individual religious beliefs and practices, except where the government entity has a compelling governmental interest, and no less intrusive alternative can be found. Thus, historical preservation councils may be required to allow internal alterations of churches as needed to respond to the changing faith needs of a congregation. Public buildings may need to be made available for religious uses on the same basis as other types of uses. In many cases, the accommodation that is required is in the administrative interpretation or application of an existing law or rule. In the case of tax payments however, no such simple "adjustment" would be possible without a change in the law itself. The Internal Revenue Service is not authorized to decline to collect a certain portion of taxes from any part of the population; nor is it authorized to handle collected revenues in any manner but the one carefully prescribed by Congress. If there is to be religious accommodation in this case, it will have to be permitted by Congress. And so we petition you to provide that accommodation, which is fully within the spirit of the Religious Freedom Restoration Act.

WILL THIS BILL ACTUALLY SERVE THE NEEDS OF CONSCIENTIOUS OBJECTOR TAXPAYERS?

Conscientious objectors to military service who were recognized as such by local boards during recent draft call-ups <u>knew</u> that their bodies were not being used in a war effort. Conscientious objector tax payers who direct their tax payments to the Peace Tax Fund will not have such a clear assurance. These are just two of several complexities:

A dollar directed to the Peace Tax Fund does not reduce the military budget by a dollar. The size of the military budget is determined by Congress and the President. This is not unlike the situation of C.O.s who request alternative service at the time of a draft call-up. The number of troops sent into action is not reduced by the number who request alternative service. Someone else goes in the place of the conscientious objector.

The dollars "covered in" to the General Fund for non-military purposes are deposited in a fungible account, out of which comes the Pentagon budget. Whose dollar goes to the Pentagon, and whose dollar will be used for non-military purposes? There is no reasonable answer to that question.

Because of these and other complexities, there will be some conscientious objector taxpayers who will not use the Peace Tax Fund, and will continue to seek ways to exclude themselves completely from the tax system.

For many conscientious people, however, the Peace Tax Fund offers a reasonable way to direct one's tax payments to non-military purposes. Supporters of the Peace Tax Fund are seeking "reasonable accommodation," not a perfect system in an admittedly imperfect world.

We thank the Committee for its time and attention to this matter. While we recognize that the issue is somewhat arcane in the larger scheme of things here in Congress, it is an issue that is central to the lives of many of us. It is in the nature of religious freedom issues that those who share a belief must try to communicate the subjective importance and centrality of that belief to some who may believe quite differently. It is difficult to be the listener in such an exercise. It is a credit to this Congress and to this Committee that you have set up this occasion to honor the exercise of religious beliefs in this country by listening -- officially -- to a group seeking religious accommodation.

FRIENDS JOURNAL

July 7, 1995

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Philip Moseley:

The Board of Managers of Friends Journal supports the passage of the Peace Tax Fund Bill (H.R. 1402) which is to be proposed at a hearing between July 11 and 13. Friends Journal is a Quaker magazine of national circulation, published monthly in Philadelphia, Pennsylvania. The Members of the Board of Managers are drawn from the Religious Society of Friends, an historic peace church. The Friends Peace Testimony, written in 1650 when Friends were pressured to join an uprising in England, states unequivocally: "We utterly deny all outward wars and strife, and fighting with outward weapons, for any end, or under any pretense whatsoever; this is our testimony to the whole world."

Our testimony is based on the belief that God resides in all persons, and to take life is to deny the Presence that dwells in each of us, and is superior in none. When we acknowledge there is that of God in other people, we enter into a relationship of equality of spirit with all the children of God. Abuse of others violates that relationship.

The Peace Tax Fund is a vehicle for those who wish to exercise their religious mandate of conscientious objection to wars of any kind. It allows us to participate as contributing members in the society which affords us that cherished freedom of religion, and assures that our tax dollars are used in ways that to us are deemed moral in the eyes of God. We supported in recent years an employee who could not as a matter of religious commitment pay taxes which he felt supported a war effort. A Peace Tax Fund would have allowed his full participation in a citizen's obligations to his country as well as his obligations to his faith.

The Peace Tax Fund is a vehicle that supports the principles of freedom on which our Constitution is based and provides a vehicle for those ~~of~~ the Peace Faith to reward that principle. We support the enactment into law of the Peace Tax Fund with the belief that the bill is our government's own protection of its citizenry.

Sincerely,

Richard Eldridge
Clerk, Board of Managers

1501 Cherry Street, Philadelphia, Pennsylvania 19102-1497
Phone (215) 241-7277 Fax (215) 568-1377

FRIENDS of the Earth

TESTIMONY OF FRIENDS OF THE EARTH

submitted to the
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C.

on H.R. 1402
A Bill to Establish a Peace Tax Fund

11 July 1995
Washington D.C.

Mr. Chairman, Friends of the Earth submits this testimony, for the hearing record of 11 July 1995, in support of H.R. 1402, a bill to establish a Peace Tax Fund on behalf of our 30,000 members and supporters. We are the U.S. affiliate of Friends of the Earth International, a worldwide environmental network with member organizations in 52 countries.

In 1992, the Subcommittee on Select Revenue Measures held an historic hearing on the U.S. Peace Tax Fund bill, the first since the bill was introduced nearly a quarter century ago. Citizens and organizations testified in strong support of the bill that would allow taxpayers conscientiously opposed to participation in war in any form to elect to have their Federal income, estate or gift tax payments spent only for nonmilitary purposes. The bill would create a special trust fund into which such tax payments would be deposited.

Friends of the Earth supports this bill for the following reasons:

1. Protection of the right of Americans who hold conscientious objections to military service is a long established tradition of the United States. However, the Federal Tax Code does not evidence that same respect for the rights of conscientious objectors.

Hugh Nash, in Friends of the Earth's book "Progress as if Survival Mattered", (1977) wrote:

"War is the ultimate destroyer. Preparations for war are economically ruinous and tend not to prevent wars but to cause them. In a condition of international anarchy, war is not merely possible but inevitable. . .The elimination of war is an environmental as well as a moral imperative."

Sadly, we saw this in the environmental destruction caused by the Gulf War. Friends of the Earth testified before Congress on several occasions on the environmental impacts from the Gulf War. However, one does not need to engage in war to destroy the environment. Virtually every U.S. military base, both in this country and abroad, has had an adverse environmental impact. It is ironic that many military bases reviewed for base closure had extremely high estimates for environmental cleanup costs.

2. Passage of H.R. 1402 would remove a burden on corporations and non-profit organizations such as Friends of the Earth. In the past, Friends of the Earth has been ordered to impose backup withholding on a Friends of the Earth staff member who had withheld income tax payment to the IRS because of conscientious objection reasons. Currently, the IRS has issued notices of intent to levy on an existing Friends of the Earth staff member. This staff member is not opposed to payment of taxes, rather this staff member was granted conscientious objector (CO) status by the Selective Service System and takes this status to include opposition to tax payments for military purposes.

The current IRS system puts organizations in the middle of a situation which should be resolved between the taxpayer and the IRS. As an example, in the early 1980's the commercial banks in this country fought vigorously against an IRS proposal to force banks, as well as savings and loan institutions, to impose a percentage withholding on interest bearing accounts. The banks were successful in arguing that they should not bear the burden of withholding taxes potentially owed the IRS by a depositor. As a result, this proposal was withdrawn.

We strongly support allowing Friends of the Earth staff and members who conscientiously object to contributing to military expenditures to pay their full share of taxes by the passage of H.R. 1402.

3. We support using the Fund revenues to fund significant peace activities, such as retraining American workers displaced by conversion from military production or other military activities to sustainable productivity, civilian production and civilian activities or services; research directed toward developing and evaluating nonmilitary solutions to international conflict; disarmament efforts; and improvement of International health, education, and welfare.

With the end of the Cold War, these alternatives have been accepted by the American people, yet Congress still intends to spend hundreds of billions of dollars on direct military accounts, and additional billions on interest and payments for past wars.

On 3 May 1990, then Friends of the Earth President, Michael S. Clark and George Frampton, Jr. President of the Wilderness Society, presented joint testimony to the Subcommittee on International Economic Policy, Trade, Oceans and Environment of the U.S. Senate Committee on Foreign Relations:

"An underlying issue in terms of being able to commit adequate resources to solving serious global problems is how much nations spend on arms. Obviously, with the waning of the Cold War, military realities ought to dictate very substantial reductions in military expenditures. In constant dollars, industrial countries have doubled their military expenditures since 1960, and developing countries have increased theirs sixfold. If a significant percentage of the more than $800 billion worldwide now being spent on weapons were instead invested in our futures, if we agreed to take actions based on our intelligence, then one could have more optimism about what may be available to future generations."

In summary, the Peace Tax Fund bill does not excuse taxpayers from paying taxes owed. Rather it provides an opportunity for citizens meeting the conscientious objector standards of the Military Selective Service Act a fair and equitable way of paying their taxes and ends the IRS practice of forcing organizations to go against the strong objections of their own employees.

Thank you for the opportunity to present this testimony. Please send us a copy of the hearing record when it becomes available.

July 10, 1995

TESTIMONY OF MR. JAYDEE HANSON, ASSISTANT GENERAL SECRETARY, GENERAL BOARD OF CHURCH AND SOCIETY OF THE UNITED METHODIST CHURCH FOR THE HOUSE WAYS AND MEANS COMMITTEE ON H.R. 1402, THE U.S. PEACE TAX FUND BILL

Dates of hearings are Tuesday, July 11 through Thursday, July 13, 1995.

The United Methodist Church, a Protestant denomination representing eight and a half million members in the United States, strongly supports those who conscientiously object to the payment of taxes for military purposes and has long supported legal recognition of this position. As the public policy agency of the United Methodist Church, The General Board of Church and Society welcomes the introduction of H.R. 1402, the U.S. Peace Tax Fund Bill, and hopes your committee will incorporate its provision into tax law. When enacted, this bill will finally grant religious rights to those people who, out of their faith in God, cannot conscientiously contribute to the military budget.

Loyal U.S. taxpayers who are also faithful believers in God, earnestly desire to contribute to our nation's financial and moral strength by paying income tax. The Peace Tax Fund Bill will provide the way for them to pay their taxes with the assurance that they are not acting in opposition to their strong religious beliefs.

These people do not wish to opt out of tax payment. They deeply desire to participate in the U.S. system. H.R. 1402 provides for full payment of taxes, a portion of which would go to the U.S. Peace Tax Fund to be used to support economic conversion from military production and other peace-related efforts.

The General Conference of the United Methodist Church, which is a democratically elected policy-making body of our church, has said, "We . . . support all those who conscientiously object to . . . the payment of taxes for military purposes; and we ask that they be granted legal recognition." (The Book of Resolutions of the United Methodist Church, 1992; page 622) At our 1992 General Conference in Louisville, Kentucky, the United Methodist Bishops stated prophetically that a common enemy to all humanity is militarism.

The General Board of Church and Society of the United Methodist Church, in keeping with this policy, supports its employees who choose to contribute a portion of their income tax to peace-making activities, equivalent to that percentage which would fund the military budget.

I urge you to speak strongly in support of this bill with your colleagues and to enact H.R. 1402 to bring about full rights for faithful U.S. citizens and residents who desire to live their faith as they believe God commands them to do. Our country has a unique and powerful tradition of religious liberty. Please continue that example and witness by creating the U.S. Peace Tax Fund. Thank you.

Jaydee R. Hanson
Assistant General Secretary
General Board of Church and Society
of the United Methodist Church
100 Maryland Avenue NE
Washington, DC 20002

Statement of Peter Goldberger, Attorney
July 10, 1995 - H.R. 1402, the U.S. Peace Tax Fund Act

As a lawyer and former law professor who has counseled and represented dozens of individuals and religious and other organizations whose conscientious beliefs about personal participation in war have brought them into conflict with the tax system, I appreciate this opportunity to express my concerns and to share my experience with the committee about the need to amend the Internal Revenue Code by adding a provision such as the U.S. Peace Tax Fund Act.

Many conscientious objectors to participation in war find that their religious beliefs require them to resist not only the forced conscription of themselves or their sons, but also the conscription of their dollars toward the one third or more of federal expenditures which today directly fund a variety of military activities. They are not "tax protesters," although the IRS mistakenly labels them as such. Unlike the so-called "tax protesters," these individuals and groups generally do not have political or economic objections to the concept of federal taxation; their concerns are religious in origin and focus upon their deep feeling of personal responsibility for the uses to which their taxes are put. Needless to say, the tax system at present does not accommodate their convictions, but I believe that it can and that it should. It is from this legal counseling experience that I offer my testimony.

Because the courts have refused to accommodate them, those who are called by conscience to a witness of military tax resistance have been prepared to suffer the consequences of their beliefs, out of respect for the legal order and for the freedoms this country does afford to religious minorities. In my practice, I am called upon almost daily to attempt to maneuver through the current system so as to minimize its impact on my clients' lives and consciences. Small victories, such as the elimination of improper penalties or the termination of particular unlawful collection efforts, are sometimes possible. But more often I see my clients or advisees forced to compromise their most deeply held beliefs in the face of IRS pressure, or to suffer cruel financial hardship. This bill would eliminate much of this needless suffering, while producing more revenue for the Treasury through increased voluntary compliance.

There are certainly many thousands of persons who have scruples concerning military spending arising from deeply held moral beliefs about war in any form, or at least about war in all its contemporary forms. No doubt, under the law as it is now written and interpreted, most such persons -- among whom I count myself -- pay the taxes which are due from them, despite considerable personal anguish over contributing to, and thus participating in, what they know is fundamentally wrong. Others deliberately adopt low income lifestyles which incur little or no tax obligation in order to avoid personal financial support for war or military activities. Many other such persons, however, simply cannot bring themselves to participate with their dollars any more than they could with their bodies. They therefore refuse to pay some or all of the income taxes which are due under the law. Some file honest and candid returns, but openly refuse to pay, having avoided withholding through self-employment or other means. Others do not file at all, becoming part of the burgeoning "underground" economy. (In my experience, however, very few engage in fraudulent evasion schemes. deep-seated personal honesty that extends fully to their dealings with their government seems to be characteristic of these conscientious objectors.) Whether through reduced taxes paid by the deliberately underemployed or as a result of outright refusal to pay, the Treasury is unnecessarily deprived of needed receipts.

Forced collection of delinquent taxes from these persons is often tedious, expensive and relatively unproductive. It can also be downright heartless. A number of years ago I repre-

sented a young man in Philadelphia who worked as a hospital nurse. He was recently married to another nurse, and they had a new baby. Several years earlier he had been a conscientious military tax refuser. At that time, he had sent checks directly to various nonmilitary departments and agencies of the U.S. government at the same time that he filed his tax return with a letter to the IRS explaining why his moral and ethical principles prevented him from paying through the General Fund of the Treasury. Those agencies -- such as the Postal Service, the Department of the Interior, and the Department of Transportation -- cashed the checks. In other words, the government received the amount of his taxes, but not in the manner required by law. When he came to me, the IRS had levied his bank account and attached his wages. Nothing the government was doing in the case was unlawful. A letter to the District Director with copies of the canceled checks to the other agencies, with a request to exercise forbearance and discretion, went unanswered. Even the embarrassing publicity we generated about the case had no effect. Eventually, he was able to discharge these tax debts through bankruptcy, but of course the family then had to endure years of a bad credit rating. The option of a Peace Tax Fund would have made that unhappy tale unnecessary.

As you will learn from others' testimony, in addition to levies on bank accounts and wages, which are common, IRS seizures of personal property, including automobiles, and even of homes are also permitted under the law. Such seizures have occurred in many parts of the country.

Military tax objectors are frequently subjected to civil tax penalties when they attempt to carry out their beliefs, and occasionally to criminal prosecution. In addition to interest charges, delinquency penalties can reach 25 percent (at five percent per month) for failure to file, and another 25 percent (at one half to one percent per month) for failure to pay. 26 U.S.C. ("IRC") § 6651. Additional 20 percent add-ons for willful disregard of rules and regulations (raised from five percent in 1990) are not uncommon. IRC § 6662. Fraud penalties, now at 75%, IRC § 6663, while rarely applicable under the law and facts, see Muste v. CIR, 35 T.C. 913 (1961), are occasionally asserted and must be challenged by administrative appeals or in court to get them removed. In the mid-1980's many suffered imposition and collection of the $500 "frivolous return" penalty, IRC § 6702, before concerned counselors could spread the word that claiming a "war tax deduction" on one's Form 1040 so as to produce a zero balance due -- once a popular tactic -- was counterproductive.

The Justice Department has generally shown a commendable restraint and sound discretion in not bringing criminal prosecutions. But a few "war tax resisters" who claimed excessive numbers of allowances on their W-4 forms, or fictitious dependents on their tax returns, have been prosecuted for filing false documents, e.g., United States v. Snider, 502 F.2d 645 (4th Cir. 1974); United States v. Malinowski, 472 F.2d 850 (3d Cir. 1973); and one elderly midwestern activist was prosecuted, convicted, and imprisoned not so many years ago for willful refusal to pay. See United States v. Catlett, 584 F.2d 864 (8th Cir. 1978). Others have gone to jail for contempt of court after refusing on grounds of principle to provide information in response to IRS administrative summonses. Most of the individuals who were subjected to these prosecutions would have been able to comply with the tax law, and would willingly have paid in full, if the Peace Tax Fund had been in place.

Because of their strong beliefs about peace and justice, the centrality of these beliefs to their lives, and their personal commitment to action based on these beliefs, many conscientious military tax objectors chose to work for their churches or for other religious employers, or for nonprofit social service organizations. These employers are often placed in the unfair position of being required to comply with legally binding third party collection efforts by the IRS, knowing that they are thereby defeating the deeply held beliefs of their

cherished employees. The employee may ask the employer not to withhold tax from wages. To honor such an employee's request is a felony, IRC § 7202, and even though there is seldom if ever a prosecution, the civil penalty for complying with a request not to withhold tax from wages, or not to pay over tax which has been withheld, is up to 15% of the amount not paid over. IRC § 6656. In addition, responsible employees and officers of the employer can be held personally responsible for 100% of the unpaid amount. IRC § 6672.

Similarly, the current wages of the scrupled employee may be levied on a continuing basis for past due amounts, IRC § 6331(e), leaving the employee with only the non-taxable level of income to live on. IRC § 6334(d). The employer -- which may be a church, for example -- is then faced with the dilemma of acting as collection agent in the government's effort to defeat what the sympathetic employer knows to be the employee's witness to his or her fundamental beliefs. An employer that refuses a levy against wages becomes legally liable for the amount that should have been paid, and risks the possibility of an additional 50% penalty, which can be applied against responsible officers and employees as well. IRC § 6332(d). (The IRS even claims the power to use these "continuing levies" against fees charged by regular contractors, despite Congress's limitation of that authority to "salary or wages." IRC § 6331(e).) Only the sound discretion and well-placed outrage of a courageous federal judge in Philadelphia kept the IRS and Justice Department from imposing such a penalty in 1990 on the Philadelphia Yearly Meeting of the Religious Society of Friends -- a 300-year-old church, founded by William Penn, and consisting of over 100 Quaker congregations located from New Jersey to Maryland -- for abiding by its formally-adopted policy of refusing to be an accomplice to such coercion of a member-employee's religious conscience. See <u>United States v. Philadelphia Yearly Meeting</u>, 753 F.Supp. 1300 (E.D.Pa. 1990).

If the Peace Tax Fund Bill were enacted, it would not be the first time that Congress has moved to accommodate a religious objection to the operation of the tax system. For many years, upon approval of a proper application, full-time ministers have been able to exempt themselves from the Federal Insurance Contributions Act (Social Security). <u>See</u> IRC § 1402(e). And even more to the point, based solely on their absolute theological objection, certain minority religious adherents, notably the Amish, have been permitted to opt out of Social Security as well. <u>Id.</u> § 1402(g). The Peace Tax Fund provision is just as practical, and far less Constitutionally problematic under the Establishment Clause, than these existing and unchallenged provisions. First, it reaches a far broader and less sectarian spectrum of religious objections. Second, it creates a mechanism under which the full amount of funds are available for appropriated purposes; the Bill would not create an exemption from paying the level of tax otherwise due.

Such arrangements as this are plainly constitutional. The reasoning behind that conclusion is set forth in Georgetown University Law Professor Mark Tushnet's testimony, and the statement of Chicago University Law Professor Michael W. McConnell, both published in Serial 102-98 (the record of a hearing before this Committee's Subcommittee on Select Revenue Measures, held May 21, 1992). In addition, the Supreme Court's decisions in <u>Gillette v. United States</u>, 401 U.S. 437 (1971), and <u>Arver v. United States</u>, 245 U.S. 366, 389-90 (1918), confirm that Congress may properly grant exemptions or accommodations to conscientious objectors, and may set the limits of those accommodations.

In fact, if Congress does not act on this Bill, the courts will soon be faced with claims that the Religious Freedom Restoration Act ("RFRA"), 42 U.S.C. § 2000bb, mandates a tax exemption for conscientious objectors if accommodation is possible but not offered. The RFRA, enacted November 16, 1993, requires all branches of federal, state and local government to accommodate religious objections to legal requirements whenever

possible. Under RFRA, "Government" -- defined very broadly -- may "substantially burden a person's exercise of religion only if it demonstrates that application of the burden to the person" serves to further "a compelling governmental interest" and "is the least restrictive means of furthering that compelling governmental interest." Id. § 2000bb-1(b). The statute states that its purpose is "to restore the compelling interest test as set forth in Sherbert v. Verner, 374 U.S. 398 (1963), and Wisconsin v. Yoder, 406 U.S. 205 (1972), and to guarantee its application in all cases where free exercise of religion is substantially burdened." Id. § 2000bb(b)(1). The RFRA contains no exceptions, and undoubtedly applies fully to the IRS and to the Internal Revenue Code. Id. § 2000bb-3(a).

Under RFRA, it is highly unlikely the courts will feel bound by the dictum in United States v. Lee, 455 U.S. 252 (1982) (which upheld the extent to which Congress had limited the exemption granted to members of certain religious groups, such as the Amish, who object to participation in the Social Security system), which had repeated the Court's comment -- originally made in Hamilton v. Board of Regents, 293 U.S. 245, 262 (1934) (upholding compulsory military study at a state university) -- that the Free Exercise Clause would not support a religious pacifist's claim to an exemption from paying taxes that support warmaking or military preparations. The Sherbert and Yoder decisions, which RFRA endorses, are far more sympathetic to religious objectors' claims; indeed, they are the Court's most sympathetic decisions of all time, and it cannot be accidental that it is those decisions which Congress chose to mention in the RFRA statement of purpose.

This Committee should lend a highly skeptical ear to any argument advanced by the administration's lawyers that any accommodation, or that this particular accommodation, is unworkable and would threaten the either tax administration or the budgeting and appropriations process. In United States v. Lee, the government advanced the same kind of argument, which was accepted by the Supreme Court: that no further Social Security exemption for the Amish could be allowed without risking the soundness of the system. But this alarmist testimony proved false in fact. In the 1988 Tax Bill, Congress enacted the precise expansion of the Amish exemption that the Lee Court had held impossible. Pub.L. 100-647, § 8007 (Oct. 22, 1988), adding new IRC § 3127. The Social Security system has not collapsed, or even suffered, as a result. The Committee should treat this history, as will the courts, as a cautionary tale against accepting mere argument in lieu of proof of government claims of inability to accommodate.

If the Selective Service System and the military branches can administer their provisions for recognition of conscientious objectors, even in wartime -- see 50 U.S.C.Appx. § 456(j); 32 C.F.R., pt. 75 -- then surely the Treasury and the Comptroller General can manage the far less cumbersome provisions established by this Bill. Indeed, the Peace Tax Fund would not even be the first provision of the Internal Revenue Code allowing individuals to choose how their tax money is to be spent. The Presidential Election Campaign Fund works this way, with the familiar check-off on the front of the Form 1040. See 26 U.S.C. §§ 6096 (taxpayer choice), 9006(a) (transfers to Fund). The Peace Tax Fund would not be significantly more difficult to administer than the Presidential Election Campaign Fund check-off system. In its own very different way, the Peace Tax Fund would serve the cause of democracy just as well as public financing of elections.

Legislative enactment of H.R. 1402, the United States Peace Tax Fund Act, would alleviate a persistent burden on the IRS while permitting these few but undeterrable citizens to pay their full share of tax without violation of religious conscience. Legislation of this kind has a noble history in our country, from the earliest years of our history up to the enactment of RFRA. In a 1790 letter to Philadelphia Yearly Meeting of the Religious Society of Friends (Quakers), President George Washington wrote:

> Government being, among other purposes, instituted to protect the Persons and Consciences of men from oppression, it certainly is the duty of Rulers, not only to abstain from it themselves, but according to their stations, to prevent it in others. ...
>
> Your principles & conduct are well known to me. ... I assure you very explicitly that in my opinion the Conscientious scruples of all men should be treated with great delicacy & tenderness, and it is my wish and desire that the Laws may always be as extensively accomodated to them, as a due regard to the Protection and essential Interests of the Nation may Justify, and permit.[1]

During World War II, the Treasury Department created an alternative "Civilian Public Service Bond" for those who wished to support the National effort but could not buy "War Bonds." As already noted, provisions for conscientious objection to the draft and direct military service have slowly but steadily become more available.[2] The whole history of our Nation's laws in this regard is one of gradual Congressional broadening of accommodations to religiously-scrupled conscientious objectors to participation in war. Two hundred years after President Washington sent his letter to the Philadelphia Quakers, the time for a United States Peace Tax Fund has come.

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[1]. Spelling, capitalization and punctuation as in the signed original of this letter in the Quaker Collection at the Haverford College Library, Haverford, Pennsylvania.

[2] In addition to enactment of the U.S. Peace Tax Fund Act, the appropriate next step in this regard would be the codification of provisions for in-service military conscientious objectors (which now exist only as administrative regulations).

GRACE PLACE

July 6, 1995

Mr. Phillip D. Moseley, Chief of Staff
The Committee on Ways and Means Committee
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Friends,

This is another retelling of my written testimony of May 7, 1992 in favor of passage of the Peace Tax Fund. I write, as a private citizen and pastor of a congregation, of my conviction that based on a person's religious beliefs he or she should not be coerced, in the name of citizenship, to participate in killing another human being.

I have come on a long spiritual pilgrimage in my 41 years of life. I have come from a "military dynasty" background and thirteen years in the Army Reserve (seven active duty) to the point where I now believe, and try to live out in my life, that true peace is fostered not by force or violence, but through the religious principles of love, justice and forgiveness. While I have never withheld any of my taxes in protest, or have become a tax resister, I am in full support of the constitutional principles behind this legislation.

The Episcopal Diocese of Chicago, in Convention October 22-23, 1993, passed a resolution supporting the Peace Tax Fund Bill then in consideration by the House. After lively debate the delegates supported allowing persons to be citizens AND to not violate their consciences of this matter.

A Peace Tax option would allow duly recognized conscientious objectors to better live with their beliefs and allow pride in participation in a democracy secure enough to make such provisions for some of her citizens. This is a noble, compassionate and *informed* Bill.

Sincerely,

Edward W. Curtis (The Rev.)
Rector

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July 7, 1995

The Hon. William Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: H.R. 1402

Dear Congressman Archer and Members of the Committee:

I have been asked by supporters of H.R. 1402, the Peace Tax Fund Bill, to review the proposal and provide an opinion as to its conformity to the Religion Clauses of the First Amendment. In so doing, I do not purport to address any of the issues of tax policy raised by the bill. I also offer no comment on the use of the monies paid into the trust fund, other than to assume they will be used for lawful governmental purposes of a nonmilitary nature, pursuant to appropriations duly passed by Congress.

This letter reflects solely my opinion as a scholar in the field of the constitutional law of church and state. I do not represent or speak for the University of Chicago Law School, the supporters of the legislation, or anyone else. My qualifications to opine on the constitutionality of this bill are based on my position as Professor of Law at the University of Chicago Law School, where I teach (among other courses) the course on Religion and the First Amendment. I have written a number of scholarly articles in the field, and have the honor of being described by the leading constitutional law casebook "probably the leading contemporary scholar on issues of free exercise." Gerald Gunther, Constitutional Law 1584 (12th ed. 1991). My curriculum vitae is attached.

I do not share the moral and religious convictions of the supporters of this legislation. I consider the responsibility of the federal government to "provide for the common defense" and protect the lives and liberties of the people its most fundamental duty. I have no hesitation in paying my share of taxes toward that end, and have no intention of availing myself of the accommodation this legislation offers. In my judgment, neither the holy scriptures nor the historical teachings of the church to which I adhere supports the proposition that war as an instrument of justice and self-defense is is contrary to the will of God, except in the sense that the causes of war are rooted in the sinful nature of man. Notwithstanding my deep disagreement with the supporters of this legislation as to the merits of their moral and religious stance, however, I respect and understand the conscientiousness of their position and believe that the nation should take this reasonable step toward enabling them to reconcile the demands of conscience and the obligations of citizenship.

It was at the height of this fledgling nation's greatest peril that our national councils first confronted the question of what stance to take toward those citizens

who could not, by reason of religious conviction, participate in or support the war for independence against King George III. The Continental Congress passed the following resolution:

> As there are some people, who, from religious principles, cannot bear arms in any case, this Congress intend no violence to their consciences, but earnestly recommend it to them, to contribute liberally in this time of universal calamity, to the relief of their distressed brethren in the several colonies, and to do all other services to their oppressed County, which they can consistently with their religious principles.

Resolution of July 18, 1775, in 2 Journals of the Continental Congress 187, 189 (W. Ford ed. 1905 & photo reprint 1968) In each and every conflict since that time, Congress has made special accommodation to religious conscientious objectors, and these measures have consistently been upheld by the courts. The proposed bill stands on a similar footing. Like the Continental Congress resolution, the bill seeks to avoid violence to the consciences of the objectors, and at the same time to find a way in which they can fulfil their obligations to their fellow citizens through payments for nonmilitary measures.

While (at least under current interpretations) this form of accommodation is not constitutionally mandated under the Free Exercise Clause, it falls within the scope of legislative discretion to further the purposes of the Free Exercise Clause through religious accommodation. The bill plainly does not violate the Establishment Clause. The prevailing interpretation of the Establishment Clause in the past 20 years has been the three-part test of Lemon v. Kurtzman, 403 U.S. 612-13 (1971). Under this test, legislation is constitutional if (1) it has a secular purpose, (2) it neither advances nor inhibits religion, and (3) it does not foster an excessive entanglement between government and religion.

1. *Purpose.* The proposed bill has the secular purpose of avoiding injuries to sincere religious conscience. See Corporation of Presiding Bishop v. Amos, 483 U.S. 327 (1987); Texas Monthly, Inc. v. Bullock, 489 U.S. 1, 18 n.8 (1989) (approving laws "designed to alleviate government intrusions that might significantly deter adherents of a particular faith from conduct protected by the Free Exercise Clause," even where the Free Exercise Clause does not mandate the accommodation by its own force); Employment Division v. Smith, 494 U.S. 872, 890 (1990) (calling legislative accommodations of religion "desirable"). Indeed, in this respect the proposed bill is identical to draft exemption laws upheld in such cases as Gillette v. United States, 401 U.S. 437 (1971).

2. *Advancement of religion.* The bill does not "advance" religion: it provides no benefits or advantages to religion over nonreligion. The objecting taxpayers are not relieved of their tax burden, and the law thus provides no inducement to adopt or feign the religious belief. See Thomas v. Review Board, 450 U.S. 707, 727 (1981) (Rehnquist, J., dissenting) ("governmental assistance which does not have the effect of 'inducing' religious belief, but instead merely 'accommodates' or implements an independent religious choice does not impermissibly involve the government in religious choices and therefore does not violate the Establishment Clause"). Rather, the bill seeks to reduce the "inhibiting effect" of current law on the practice of religion.

It is probable that some nonreligious moral objections will be deemed to be protected by the bill. But even if they are not, the First Amendment permits the government to extend special protections to the exercise of "religion." As the Court stated recently, "Where, as here, government acts with the proper purpose of lifting a regulation that burdens the exercise of religion, we see no reason to require that the exemption come packaged with benefits to secular entities" Corporation of Presiding Bishop v. Amos, supra, 483 U.S. at 338. See also Wisconsin v. Yoder, 406 U.S. 205, 215-16 (1972) ("A way of life, however virtuous and admirable, may not be interposed as a barrier to reasonable state regulation . . . if it is based on purely

secular considerations; to have the protection of the Religion Clauses, the claims must be rooted in religious belief.").

3. *Entanglement.* The bill envisions no communication or connection between the institutions of church and state. The only conceivable "entanglement" is that entailed by determination of the sincerity and eligibility of objecting taxpayers. In light of the administrative difficulty of applying for the accommodation, and the lack of any incentive to feign eligibility, this process should not be difficult. Indeed, it will be far less difficult than administration of the draft exemption, which has been upheld by the Court. If the involvement of the government in determining whether a person asserting a religious accommodation were, without more, an excessive entanglement, this would imply that all accommodations are unconstitutional, which is manifestly contrary to precedent.

In recent years, the Lemon test has been much criticized, and it appears that the Court may well abandon it, if it has not implicitly done so already. Recent cases involving religious accommodation strongly support the legitimacy of the proposed bill. For a detailed analysis of those cases, see my recent article, "Accommodation of Religion: An Update and a Response to the Critics," 60 Geo. Wash. L. Rev. 685, 695-712 (1992). In Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989), the most restrictive of the recent cases, the Court struck down a sales tax exemption targeted exclusively to religious periodicals. In a plurality opinion written by Justice Brennan and joined by Justices Marshall and Stevens, the Court held that the sales tax exemption did not "remove a demonstrated and possibly grave imposition on religious activity sheltered by the Free Exercise Clause," but "burden[ed] nonbeneficiaries by increasing their tax bills by whatever amount is needed to offset the benefit bestowed on subscribers to religious publications." Id. at 18-19 n.8. The other Justices advocated a less restrictive approach, three of them (Chief Justice Rehnquist and Justices Scalia and Kennedy) voting to uphold the exemption. Even under the approach taken by the plurality, the present legislation is constitutional. It unquestionably is designed to alleviate an imposition on protected religious activity, and it imposes no burden on nonbeneficiaries (other than mere administrative cost, which is insufficient to rise to a constitutional level). Indeed, since the bill will enable many citizens who now resist compliance with the tax laws to do so voluntarily, it could reduce administrative cost and provide benefits to all.

Some Justices in recent years have advocated a so-called "endorsement test" for interpreting the Establishment Clause. See, e.g., Edwards v. Aguillard, 482 U.S. 578, 587 (1987). For a detailed analysis, see my recent article, "Religious Freedom At A Crossroads," 59 U. Chi. L. Rev. 115, 147-57 (1992). While the principal difficulty with this test is its subjective and unpredictable character, it seems unlikely that the proposed bill would be viewed as an endorsement of the religious tenet of opposition to war. In light of this country's multi-billion dollar commitment to national defense, it would be nothing short of bizarre to conclude that this modest act of toleration is an endorsement of religious pacifism. Certainly, this is no more an "endorsement" than the draft exemption, which the Court has repeatedly upheld.

I conclude that under all of the prominent tests for violations of the Establishment Clause, the proposed bill is permissible. Moreover, in light of the fact that under current Supreme Court doctrine, only the political branches will be permitted to make accommodations to sincere religious objections to generally applicable laws (see Employment Division v. Smith, supra), it is especially appropriate for Congress to address this issue. This nation has a long and admirable history of solicitude for religious minorities whose sincere beliefs come into conflict with the state, especially with regard to the questions of war and peace. Where accommodation of religious differences is possible without injury to the legitimate interests of the public and without imposing burdens on nonbeneficiaries, it is both consistent with the First Amendment and good public policy.

Very truly yours,

Michael W. McConnell
Professor of Law

**Written Statement of the Mennonite Central Committee
Submitted to the Committee on Ways and Means
in Support of the United States Peabe Tax Fund Bill
H.R. 1402**

Mennonites are one of the Historic Peace Churches who have conscientiously opposed war and participation in war since before the founding of the American colonies in the 17th century. Today, our statement for peace is to support H.R. 1402 which calls for the establishment of a Peace Tax Fund enabling people who conscientiously oppose participation in war to also express their conscience by not having to pay for war.

In 1991, the three Historic Peace Churches (Mennonites, Quakers and Church of the Brethren) published *A Declaration of Peace* which begins by asking whether "loyalty to Jesus Christ (is) compatible with participation in war?" The immediate answer: "We believe it is not." This same document adds:

> We deny that the body of Christ (the church) must lend its members to the enterprise of defending and preparing to defend the nation-state against its real or merely putative enemies by means of organized military force and violence.

It is this affirmation that is at the heart of our testimony as Mennonites. From the beginning of our tradition, the commitment to follow the patterns of the loving God meant that we could not participate in war or the things that made for war. This was an unpopular position which led to considerable persecution and suffering in Switzerland, Holland, Germany, and later in the American colonies. But this point of view was not easily squelched. Conscientious objection to participation in the military was gradually accepted, first in England and Russia, then the United States and now it is widely accepted on all continents.

This concern for non-participation in the military quickly raised questions about the sale of goods to the military and the payment of taxes making militarism possible. Already in 1560, a representative of the Mennonite tradition noted:

> When however the government requires of us what is contrary to our faith and conscience -- as swearing oaths and paying hangman's dues or taxes for war -- then we do not obey its command. This we do not do out of obstinacy or pride, but only out of the pure fear of God.

So for our tradition, the concern about the payment of war taxes is not new. While the majority of us have in the final recourse paid these levies, we have done so with an uneasy conscience. There are individuals in the Mennonite tradition who have refused to pay taxes for conscience sake. During World War I some of our church leaders were imprisoned for encouraging their members not to purchase war bonds. In more recent years, members of the Historic Peace Churches have had their property and bank accounts confiscated for protesting the use of their tax monies. Others have reduced their income or increased their charitable contributions to avoid paying for war. Many of us have paid our taxes for military purposes under protest.

Mennonites have specifically acted to support the establishment of the Peace Tax Fund. One of many church statements declared in 1983:

> We accept our subordination to government and our obligation to pay taxes. However, we must witness to governments our conviction that war and preparation for war do wrong to our neighbors and are contrary to the will of God as revealed in the teachings of Jesus Christ and his death, resurrection, and ascension to Lordship. Thus we urge our governments (U.S. and Canada) to sharply reduce military spending and use our resources for life-affirming purposes. Furthermore, just as conscientious objectors have received exemption from military service, we also seek legislation exempting conscientious objectors from paying taxes for military purposes. Thus we continue to work in the U.S. for the passage of the (U.S.) Peace Tax Fund Act and in Canada for the Peace Tax Fund, which would allow individuals to designate all of their federal taxes for peaceful purposes. (*General Conference Mennonite Church Triennial Sessions, Bethlehem, PA August, 1983*).

It is clear from this statement that our concern about paying military taxes is rooted in our history of believing that participation in war and violence is incompatible with true Christian faith. This concern has been heightened in more recent years because the nature of warfare has changed, along

with our national war policies. There is greater reliance on expensive, highly technical weaponry as well as more emphasis on funding and supplying weapons for low-intensity conflicts in Third World settings. In both cases, the focus has shifted from the use of U.S. military personnel, to money and military hardware, so that the income tax has become even more essential than the draft as a primary means of maintaining our nation's military establishment and war efforts.

Mennonite institutions have also felt the pain of serving as tax collectors of money for war-making. Faced with an intolerable conflict between religious duty and civil law, some of our church institutions have passed actions honoring the conscience of employees who do not want their tax monies used for military purposes. For some institutions (such as the General Conference of the Mennonite Church), this has meant a willingness to not withhold income taxes from employee salaries. Other institutions have refused to comply with IRS levies on employee salaries.

We believe the time is here to extend the cause of religious freedom by recognizing the legitimacy of conscientious objection to the payment of war taxes. It took centuries to earn the legal recognition of conscientious objection to participation in the military. Now it is time to recognize the same expression of conscience with regard to the payment of military taxes.

The establishment of a Peace Tax Fund would be an appropriate way to have taxes designated for non-military purposes. We press this cause not only in the United States, but also in Canada where key government officials have recently expressed new openness to a proposal that would allow conscientious objectors to redirect their tax dollars for nonmilitary use.

During this historic juncture in world affairs -- with the demise of the Cold War and its military threats -- we believe it would be especially appropriate to respond to this citizen based concern of conscience. One of the most important symbols of the demilitarization of American society would be to extend the boundaries of freedom to enable people of conscience to redirect their taxes from military use to peaceful purposes. We would hope that the Peace Tax Fund would point toward a new order where national defense would be rooted in the practices of a just society and a high regard for all the peoples who make up the human family.

Mennonites have never been satisfied with simply a statement of conscientious objection -- whether to military participation or military taxes. We have active service programs which are our way of pointing to a different kind of social order based on respect for all human lives and a commitment to life based on principles of nonviolence. In 1994, Mennonite and Brethren in Christ churches in North America contributed some $25.2 million in financial and material aid through Mennonite Central Committee (MCC) for the cause of human well-being. During 1994, some 919 workers served through MCC locally and globally (in 57 countries) to respond to the needs of suffering and poor people.

Indeed, it is through this commitment to service that we have lived and walked with people who suffer the wounds of war in their lives and societies. We have watched with deep sorrow as wars have harmed and taken the lives of those we love and claim as family in the Kingdom of God. Our link to this suffering through the payment of taxes for war causes us great spiritual anguish.

The establishment of the Peace Tax Fund will tap a deep concern for the well-being of this country and the entire world. This issue is not the payment of taxes for the general good. Mennonites readily accept the notion of the necessity of such taxes. Rather, the issue is the payment of taxes for that which violates our deepest religious commitments. This concern for an alternative to military taxes is not only the conscience of the Historic Peace Churches. It is a growing concern found in all religious communities.

I encourage this committee and the Congress to take the bold and courageous step of recognizing religious freedom and conscience, and establishing a new vehicle for the peaceful uses of governmental monies.

John A. Lapp
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Testimony for Hearing on U.S. Peace Tax Fund Bill
National Campaign for a Peace Tax Fund
2121 Decatur Place, N.W., Washington, DC 20008
202-483-3751
Marian Franz, Executive Director
July 1995

I. THE NATIONAL CAMPAIGN FOR A PEACE TAX FUND

My name is Marian Franz. I am executive director of the National Campaign for a Peace Tax Fund. The campaign is organized solely to pass legislation which would provide a way for persons to participate in the tax system without violating their conscientiously held beliefs. The proposed legislation would amend the Internal Revenue Code to provide that a taxpayer conscientiously opposed to any participation in war could have his or her income, estate, and gift tax payments spent for non-military purposes only. As a registered lobbyist, I have spoken on behalf of citizens who are petitioning the government for the right to pay 100% of their taxes without violating deeply held moral/ethical beliefs. As present law now stands, they cannot.

Our central affirmation is that each individual has the right not to be coerced into participation in killing other human beings-whether that participation is physical or financial. Ultimately this right is based in the freedom to exercise religion according to the dictates of conscience.

The National Campaign for a Peace Tax Fund was founded in 1971 to address this basic issue of conscientious objection to war as it involves the payment of taxes. Voluntary contributions from some 2,000 individuals and from organizations support all of our activities. Basic support is from corporate religious bodies The annual budget is $97,000.

Organizations that endorse the U. S Peace Tax Fund Bill include, at the national level: American Arab Anti-Discrimination Committee, American Friends Service Committee, Baptist Peace Fellowship of North America, Buddhist Peace Fellowship, Catholic Committee of Appalachia, Cental Committee for Conscientious Objectors, Church of the Brethren, Consortium on Peace Research Education and Development , Episcopal Peace Fellowship, Evangelicals for Social Action, Fellowship of Reconciliation, Franciscan Federation of Brothers and Sisters, Franciscans Sisters of the Poor, Friends Committee on National Legislation, Friends United Meeting, Fund For Peace, General Conference of the Mennonite Church, Grandmothers for Peace, Jewish Peace Fellowship, Leadership Conference of Women Religious-Peace/Disarmament Task Force, Lutheran Campus Ministry, Lutheran Peace Fellowship, Mennonite Central Committee, Mennonite Chruch General Board, Mercian Orthodox Catholic Church, National Assembly of Religious Women , National Council of Churches Ecumenical Witness Conference, National Federation of Priests' Councils, National Interreligious Service Board for Conscientious Objectors, National Jobs with Peace Campaign, NETWORK - A National Catholic Social Justice Lobby, New Call to Peacemaking , Nonviolence International, Nuclear Free America, Pax Christi USA, Presbyterian Church USA, Presbyterian Peace Fellowship, Project for Conversion of Johns Hopkins Applied Physics Laboratory, School Sisters of St. Francis, Society of the Sacred Heart-US Province Provincial Team, Sojourners, Unitarian Universalist Association, United Church of Christ, United Methodist Church , US Province Office of the US Provincials, Veterans for Peace, War Resisters' League, Women Strike for Peace, Women's International League for Peace and Freedom and World Peacemakers.

A dramatic increase of support for the idea of a peace tax fund has been realized in recent years. This has been in the context of a widespread interest in the protections for conscientious objectors to war. Among recent endorsers for the U.S. Peace Tax Fund are the Presbyterian Church (U.S.A.), a denomination constituting nearly three million members, and the General Board of Church and Society of the nine million member United Methodist Church.

The international interest in conscientious objection has included new provisions instituted in Poland, Russia, Hungary, and Brazil, together with adoption of this right by the United Nations Commission on Human Rights in 1989 "as a legitimate exercise of freedom of thought, conscience and religion." Also the Steering Committee on Human Rights of the Council of Europe, as well as many church-based groups in Latin America, Asia and Eastern Europe are taking positions in support of conscientious objection. In March, 1995, the Human Rights Commission of the United Nations affirmed the right of conscientious objection as the legitimate exercise of freedom of thought conscience and religion.

Canada - Finance Ministry officials in Canada have recently notified religious bodies that the government "is receptive" to the idea of finding a means to accommodate conscientious objectors to military spending within the current tax code. The goverment indicated that it is interested in accommodating the request within the current tax code.

Other nations which have active Peace Tax Fund campaigns include: Australia, Belgium, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

II. THE U.S. PEACE TAX FUND BILL - HISTORY

Since 1972 efforts have been underway in Congress to establish a right of conscientious objection for taxpayers who, on religious grounds, cannot participate in the funding of war or preparation for war. Dr. David Bassett, a Quaker physician on the medical faculty of the University of Michigan, with help from the legal faculty, brought the first Peace Tax Fund Bill to Congress in 1972. Representatives Ron Dellums, Charles Rangel, (current chair of the Ways & Means Subcommittee on Select Revenue Measures) and eight other members of the House introduced the World Peace Tax Fund Bill in 1972, and in 1975 Senator Mark Hatfield introduced a companion bill in the Senate. The bill has been introduced in every Congress since then.

In 1985 the bill's name was changed to the "United States Peace Tax Fund Act." At that time several important changes were introduced in response to concerns about the technical viability of the Bill. The campaign has been, and remains, open to making improvements in this legislative vehicle.

Sen. Mark Hatfield (R-OR) and Rep. Andrew Jacobs, Jr. (D-IN) introduced legislation in the 102nd Congress that would amend the Internal Revenue Code to recognize conscientious objector status with regard to the payment of taxes for military purposes.

III. EXECUTIVE SUMMARY OF U.S. PEACE TAX FUND BILL

1. Purposes of the Bill

The Bill establishes the United States Peace Tax Fund as a special trust fund within the U.S. Treasury. Eligible taxpayers may designate payment of their federal taxes into this fund. There is no financial benefit to those who contribute their taxes to the Fund. The full tax amount is paid and the bill actually generates a modest increase in federal revenue. What the bill achieves is protection of conscience in the context of the free exercise of religion.

Recognizing that for a significant minority of U.S. citizens, sincere conscientious objection to participation in war in any form means that they cannot, in conscience, pay the portion of their taxes that would support military expenditures, the Bill has as its purposes:

(a) to protect conscience by allowing conscientious objectors to pay their full tax liability without violating their moral, ethical, and religious beliefs;
(b) to reduce the present administrative and judicial burden created by conscientious objectors who violate the tax laws rather than violate their consciences;
(c) to recognize conscientious objector status with regard to the payment of taxes for military purposes; and
(d) to provide a mechanism for congressional appropriation of such funds for nonmilitary purposes.

2. Eligibility

An eligible individual is a person who is conscientiously opposed to participation in war in any form, and who either (1) has been exempted or discharged from combatant service and training in the armed forces as a conscientious objector under military or Selective Service System law and regulations or (2) certifies to the IRS that he or she is a conscientious objector (C.O.) within the meaning of the Military Selective Service Act and its case law. "Conscientious objection" is a precisely defined category: "anyone who by reason of religious training and belief is opposed to participation in war in any form," or whose opposition is based on moral and ethical beliefs held with the strength of the traditional religious convictions.

An individual qualifies under (2) above by filing during each taxable year, with the IRS, a form claiming C.O. status for that taxable year. The form will contain three questions designed to certify the individual's beliefs about participation in war, the source or genesis of such beliefs, and how the beliefs affect the taxpayer's life. These are the same three questions C.O. claimants must answer under section 6(j) of the Military Selective Service Act. The IRS sends a receipt in return to verify such filing, and the receipt is then attached to the individual's income tax return. The IRS will include, in its publications of income tax instructions, information about the existence of the Fund and criteria for eligibility, as well as an explanation of the claim-filing process.

The Secretary of the Treasury may require the taxpayer to further justify his or her C.O. claim. If the Secretary then rejects the claim, the burden of proof (including initiating court action, if that is to follow) falls upon the taxpayer.

3. Payments into the Fund

An eligible taxpayer may designate that his or her income tax payment for that year will be paid into the U.S. Peace Tax Fund. A joint tax return would qualify for payments into the Fund if one of the couple has qualified for such status.

The sums of all the amounts designated by eligible taxpayers will be transferred at least monthly into the U.S. Peace Tax Fund from the Treasury's general fund. The Secretary of the Treasury will report to Congress, each year, the total amount transferred into the Fund during the preceding fiscal year, with such information to be printed in the Congressional Record.

Soon after the end of each fiscal year, the Comptroller General will determine the percentage of federal funds actually appropriated in that fiscal year for current military purposes and report that figure to Congress for printing in the *Congressional Record.* The nonmilitary percentage is then returned to the General Fund to be used for nonmilitary purposes.

An eligible individual may also elect that any estate or gift taxes for which he or she is responsible likewise are to go into the Fund.

Eligible Activities: Fund appropriated pursuant to authorization in the U.S. Peace Tax Fund Bill are Special Supplemental Food Prgram for Women, Infants and Children (WIC), Head Start, the U.S. Institute of Peace and the Peace Corps.

4. Definitions Appearing in the Bill

"Military purpose" means any activity or program conducted, administered, or sponsored by an agency of the government which affects an augmentation of military forces, defensive and offensive intelligence activities or enhances the capability of any person or nation to wage war. This includes funding for the Central Intelligence Agency, the National Security Council, the Selective Service System, and military expenditures of the Department of Energy and of the National Aeronautics and Space Administration, and foreign military aid.

5. Handling of Penalties for Past Failure to Pay Tax

If an individual has had a civil or criminal penalty imposed on him or her for unpaid income tax for any year prior to the effective date of the USPTF Act, that penalty will be vacated if the individual (a) pays the tax due, with interest and (b) establishes satisfactorily that his or her failure to pay was based on the criteria for conscientious objection as defined in the Bill. An amount equal to the taxes due will then be transferred by the Treasury to the Fund.

IV. QUESTIONS AND ANSWERS ABOUT THE PEACE TAX FUND BILL

1) Question: Does the Bill delegate congressional authority to make appropriations?

Answer: The Congressional Research Service of the Library of Congress in 1983 concluded that the bill does not delegate congressional authority to appropriate funds, since the appropriations under the bill are authorized by Congress, not by the Peace Tax Fund Board. The principle of a specialized exemption for conscientious objectors is well established under case law connected with the Military Selective Service Act. The legal counsel in Congress which drafted the 1985 revision of the bill has been very mindful of the need to meet constitutionality challenges. At that time we clarified the role of the appropriations committee in two ways:

a) We added a provision requiring the Board to make recommendations to the appropriations committee each year regarding the dispersal of funds and stated
b) that the appropriations committee be required to appropriate the "set-aside" funds on projects recommended by the Board (i.e., not on projects of its own choosing.)

2) Question: Is this approach legally similar to the ear-marking of funds into special trust funds?

Answer: A Congressional Research Service report says: "Yes. Section 2(b)(1) provides that all amounts designated by eligible taxpayers go into the Fund by way of transfers from the general fund of an amount equal to the sum of these amounts. The actual amount that goes out of the fund to be used by the Board, however, is dependent upon the amount that is appropriated annually."

3) __Question__: How would the appropriations process actually work?

__Answer__: The Congressional Research Service commented on the financial scheme of the Peace Tax Fund Bill proposal. (Sections have been renumbered to correspond with current bill, HR 1402).

> (The Bill) establishes a special trust fund known as the (World) Peace Tax Fund. The Fund consists of an amount transferred from the general fund that is equivalent to all amounts designated to it by eligible payers of income, estate, and gift taxes and is available only for the nonmilitary purposes specified in section [9(c)] including research directed toward developing and evaluating nonmilitary and nonviolent solutions to international conflict, disarmament, and improvement of international health, education and welfare.
>
> While the amount from these taxpayers goes into the Fund and cannot be used for purposes other than those listed in section 9(c), a separate annual appropriation is required to transfer money from the Fund to the World Peace Tax Fund Board of Trustees. Section 9(a) provides that the Board may make payments as authorized by appropriation acts under such conditions and terms as it considers necessary. Section 7(b) authorizes the appropriation each year of a certain portion of the Fund but nothing in the proposal actually appropriates any money. Section 7(b) is a permanent authorization but not a permanent appropriation. Congress in the future may choose not to appropriate any amount in any given year to the Board.
>
> The maximum amount that section 7(b) authorizes to be appropriated is the percentage of actual appropriations made by the United States from the Federal Funds Budget during the preceding fiscal year which were made for a military purpose applied to the total of tax payments transferred to the Fund plus all moneys in the Fund previously authorized to be appropriated to the Board but not yet appropriated.
>
> Section 7(c) authorizes to be appropriated to the general fund of the Treasury any portion of the Fund not appropriated to the Board. No part of the money transferred to the general fund may be appropriated for any expenditure, or otherwise obligated for military purposes.
>
> In these trust funds the authorization is permanent as in section 7(b). These funds differ from the World Peace Tax Fund in that they have permanent appropriations in their basic underlying authorizing legislation. These appropriations become available without current action by Congress; the receipts of these funds are automatically appropriated for the purposes of the funds. As noted above, funds must be appropriated from the World Peace Tax Fund to the Board.

4) __Question__: What protection is provided against capricious and spurious claims?

__Answer__: We recognize that the various malcontents and others who simply disagree with current administration policy may try to take advantage of this opportunity and misuse the provision. In 1985 the Bill was changed to protect against such claims. Earlier proposals had included a simple C.O. check-off box on Form 1040 To minimize the likelihood of capricious claims, the bill now requires an essay answer to establish that one is a C.O. under the current legal definition. The extra Form would provide a measure of self enforcement, not provided by the check-off box on the form 1040. The series of short essay statements in response to questions parallels the SSS form for C.O.s to military service. We believe there is less likelihood of capricious C.O. claims than under a military draft because in this case there is no incentive to be dishonest. Unlike a draft, there is no escape from physical danger. The full tax bill is still due and payable. The act would be private – no public acclaim ensues from filing the C.O. Form.

5) __Question__: Will screening C.O. claims put an undue administrative burden on the IRS?

__Answer__. We assume that screening will occur only as part of any routine audit. A statement which expresses simple disagreement with current policy, or conscientious objection to nuclear weapons only, would be rejected. The taxpayer could, if he/she wished, appeal to the tax court or to a federal district court for a declaratory judgement. We do not want to overburden either the IRS or the judicial system. We are reluctant to suggest any pre-screening because of the tremendous bureaucratic burden that suggests. We believe that the lack of financial incentives for false claims and the structure of the filing process are sufficient, and will not cause an undue burden on the IRS. There will certainly be a savings from the current need to enforce collections from C.O.s who are war tax resisters.

6) Question: Could other bills providing for similar special arrangements for other causes be initiated in Congress?

Answer: There are no restrictions on the introduction of bills in the Congress, but the U.S. Peace Tax Fund Bill does not, itself, set a precedent. Congress exists to accede to a number of citizens' concerns based on some sound principles. What is distinctive about the U.S. Peace Tax Fund Bill is that it extends to taxpayers a long and honored tradition of respect for conscience as it relates to killing in war.

Statutory exemptions designed to accommodate religious scruples which already exist in other areas of government compelled activity are generally far less pervasive or involve less significant societal or governmental values. Most notable of these other forms of statutory exemptions include exemptions for religious objectors from taking oaths, for Christian Science healers from requirements in certain medical practice acts, and from restrictions on the use of alcoholic beverages for sacramental purposes.

7) Question: Does the Bill open the door to a "flood" of special exemptions?

Answer: We know that for members of Congress this could potentially be a problem. However, historically and legally, objection to war has held a unique place in our nation. Most of the American colonial governments made special provision for conscientious objectors beginning with Rhode Island in 1662. The first Continental Congress resolved in 1775 that it would recognize the rights of those who would not bear arms because of religious scruples [2 Journals of the Continental Congress 189 (1905)]. By the time of the Civil War numerous states exempted C.O.s from conscription on religious grounds from their militias. In the Federal Militia Act of 1862, the control of conscription was left primarily to the States but the Federal Conscription Act of 1863 contained commutation and substitution provisions, and the Draft Act of 1864 extended exemptions to conscientious objectors who were members of certain religious denominations. In the latter year, the Confederacy also exempted certain pacifist sects from military duty.

During World War I, the Draft Act of 1917 (40 Stat, 76, 78), afforded exemptions to certain religious C.O s Yet hundreds of conscientious objectors suffered and a few died in American prisons for their beliefs during that war. It was not until 1933 that President Roosevelt issued a full pardon, and the last World War I C.O. was released from prison.

In World War II, the Selective Training and Service Act of 1940 broadened the earlier exemption by making it unnecessary that the objector belong to a pacifist religious sect (54 Stat. 889). Following that war, the 1948 Universal Military Training and Service Act (62 Stat. 604), renamed the Military Selective Service Act of 1967, and still later, the Military Selective Service Act, continued the 1940 exemptions. The statutory policy of exempting religious conscientious objectors from military service has been characterized as a "long standing tradition in this country" and one with roots "deeply embedded in history." [*Welsh v. United States*, 198 U.S. 333 91970), Mr. Justice Harlan's concurrence at 365,366]

8) Questions: "Are there legal precedents which recognize conscientious objection to war as unique and superior when compared to other forms of objection? Are there legal distinctions made between conscientious objection to war and other forms of objection?"

Answers: Shortly after the Bill's introduction, the Congressional Research Service issued a report addressing these two questions: We quote from: "Special Status of Conscientious Objection to War and Legal Distinctions between Conscientious Objection to War and Other Forms of Objection":

> No legal precedents have been found which hold that conscientious objection to war is superior to or of more compelling character, as an aspect of the right to freedom in the exercise of religion as guaranteed by the First Amendment or otherwise, than other forms of objection.
>
> Objection to war does, however, possess certain unique characteristics. First, exemption from combatant service on the basis of conscientious objection has been accorded by statute extensively and since the early days of this nation. Such exemption was extended by several of the colonies and has been incorporated in the constitutions of many of the states. *[See Hamilton v. Regents of the University of California, 293 U.S. 245, 267 (1934)].*

... Second, in evaluating the weight of the restrictions on religious freedom, the sincerity of the claim for religious exemption must be assessed, not necessarily to be rejected simply because of a lack of historical pedigree but at the same time not to be automatically accepted. Related to the question of sincerity is the element of how central or essential to the religion is the practice affected by the prohibition or requirement. A conflict that threatens the very survival of the religion or the core values of the faith poses clearly more serious free exercise problems than does a conflict which merely inconveniences the faithful.

Finally, an assessment must be made of the relative extent to which the challenged government regulation interferes with practices or commands. In this respect, both direct and indirect interference must be considered, and the probable duration of the effects may be relevant. *Regulations which compel actions contrary to conscience are arguably more serious interferences than those which merely subject more or less passive religious dissenters to government action.*

Recognition of the special moral dilemma faced by those who must pay taxes in support of military activities to which they are opposed will not open a Pandora's box to claims by other persons. The plight of individuals who will be benefitted under H.R. 7053 is worthy of special consideration in view of the fundamental moral basis of their claims and the historically recognized unique status of conscientious objectors.

V. CONSCIENTIOUS OBJECTION DEFINED

This Bill is designed to address issues related to conscientious objection rather than concerns about specific national policies or spending priorities. The Bill uses the same legal definition of conscientious objection to war as the Military Selective Service Act. Conscientious objectors say that it is the ultimate right of the conscience not to participate in the killing of another human being – whether that participation be physical or financial. Although the belief of conscientious objectors necessarily implies criticism of the existing order, we are not subversive of social aims and values. Rather, our belief encompasses our whole life and the search for justice and peace for all is a goal of our active existence. We have nothing to gain financially or in terms of self-interest except preservation of our religious and conscientious integrity.

1. The Problem for Individuals in their Own Words: Quotes from Testimony of PTF Proponents & War Tax Resisters

The impelling character of conscience in relation to conscientious objection to military taxation is revealed by these voices:

FROM MEMBERS OF RELIGIOUS DENOMINATIONS

"As a Christian, I believe that those who take the sword will die by the sword, and I see evidence of that as first the Soviet Union and now the United States fall to ruin because of our obsession with military might over the past 50 years. I follow the principles of my denomination (**Presbyterian**) one of which is that "God alone is Lord of the conscience." This applies to matters of spiritual belief, and I believe that how one spends one's money is ultimately a spiritual question, especially when the wrong spending of it (for more weapons) directly contributes to wounding and killing other people, all of whom are created in the image of God." Daniel R. Erdman, Lancaster, PA

"Our convictions grew out of early religious training. Biblical teachings about the 'Prince of Peace' seemed totally discordant with the slaughter of Christians of one nation by Christians of another. By the time World War II erupted, we were ready to declare all war contrary to the God we worship and the Scripture we were taught. Our conscientious objection to all war is now officially recognized by our denomination [**Presbyterian Church** (U.S.A.)], and nuclear war is condemned as unjust and immoral by our denominational policy."
Jean Edwards/George Edwards, Louisville, TN

"I am a **Roman Catholic**, and I believe very strongly in the Gospel of Jesus Christ. Jesus instructed us to love our enemies, and He reinforced the commandment 'thou shalt not kill' with messages of peace and love, forgiveness and reconciliation. ... So too, as a follower of this Jesus, I find it morally repugnant to pay taxes which I know support these evil weapons and the war machine which creates them ... I cannot in conscience fully contribute my share when I know that a large percentage of my taxes pay for war. I must follow my conscience in this aspect of my citizenship just as I try to let it guide me in my relationships and all other aspects of my life."
Dawn Green, Omaha, NE

"As a young mother during the Vietnam War years, I remember sitting in my **Catholic** church one Sunday knowing intuitively and without a doubt that war was wrong, not just the Vietnam War, but any war... My religious beliefs and conscience were gradually awakened in many areas... I came to realize that spending large amounts on defense was waging war on our own people by depriving them of decent nutrition, education and housing... Knowing that my tax dollars were killing and injuring men, women and children in Central America was incredibly painful... While my husband didn't want our taxes used for war and killing, he was not willing to break the law...**When one cannot follow one's conscience, there is tremendous inner conflict and psychological cost.** One represses one's feelings and becomes numb... When a nation loses its conscience, it loses its soul. I feel I am in danger of losing my soul. Please give people whose religious and moral beliefs are violated at tax time, a legal alternative by passing the Peace Tax Fund Bill."

Ann Marie Judson (mother of 5), Lemoyne, PA

"The Social Principles of the **United Methodist** Church states: 'Though coercion, violence, and war are presently the ultimate sanctions in international relations, we reject them as incompatible with the gospel and spirit of Christ.' 1988, paragraph 74G."

Marion Tappan, Chairman, Board of Church & Society, E. Ohio Conference United Methodist Church, Cleveland Heights, OH

"The night before Jesus was crucified... the apostle Peter took up a sword and tried to prevent Jesus' arrest.... Jesus, however, was against arms – healed the wounded soldier and told Peter to put the sword away. 'He who lives by the sword will perish by the sword!" Jesus said. Thus, let those of our people who feel that they cannot support a war machine have a way of paying their taxes knowing they will go to other national expenses."

Earl Cunningham Pastor Tod Avenue United Methodist Church, Warren, OH

"My roots as a **Baptist** stretch back to the 16th century when a spontaneous and scattered revolt against religious oppression broke out in Europe. A key affirmation of that revolt — named by its enemies as "Anabaptist" — was the refusal on theological grounds to wield the sword ... The basis of this affirmation was not political theory but biblical fidelity. My conscientious objection to taxes for war rests on that foundation."

Ken Sehested, Baptist Peace Fellowship Memphis, TN

"As a committed Christian, I believe that I cannot in conscience kill another person because of my commitment to Jesus Christ. As an American I believe strongly in religious freedom and separation of church and state; I believe that the state should have a way for people like myself to contribute to many, many important things that the country does so well without contributing to what in conscience we feel is wrong."

Ronald J. Sider, Professor of Theology & Culture, Eastern Baptist Theological Seminary, Wynnewood, PA

"The Jewish Peace Fellowship has recently celebrated its 50th anniversary of dedication to nonviolence in the **Jewish** tradition. Our members sign a statement committing themselves to conscientious objection to war. We believe that this conviction follows to the support of any spending for the military. Our faith leads us to support the Peace Tax Fund."

Joyce Bressler, Jewish Peace Fellowship, Nyack, NY

"I think it is the responsibility of Congresspersons to recognize that not only persons of draft age are persons of conscience in matters of war. Some of us have held this position for many years, even after serving our country as I did in world War II. It has been a deepening conviction of mine through the last thirty years that war is morally wrong.

Bishop L. David Brown, Northeastern Iowa Synod, Evangelical Lutheran Church in America, Waverly, IA

"As **Lutherans** we believe that God holds us all responsible for our actions. God has entrusted this planet and the creatures on it to our care. Humanity has practiced slaughter and destruction for millennia. This must stop.... We call for the option offered in the Peace Tax Fund Bill. The most sane alternative without it is to refuse to pay taxes at all."

Bill Braham and Judy Braham, Madison WI

"During the 16th, 17th and 18th centuries, my ancestors, European Anabaptists, were persecuted, tortured and slaughtered by the thousands because they refused to take up the sword. Many of their descendents who survived, **Mennonites** like myself, moved to America for the express purpose of religious freedom. For them that included nonparticipation in any war or violence. Today the methods of war have changed. Rather than putting so many bodies on the line, we can push buttons that wreak untold destruction on the lives and environment of our 'enemies.' **Today it is our tax money that kills** far more effectively than soldiers... So how can I, who am conscientiously opposed to war, pay taxes to support these modern weapons which destroy so effectively?"

Loreta Finger Chicago, IL

"The **Quaker** faith posits that there is something of God in every human being. Believing this, I cannot kill, or strike, or intentionally hurt or insult, or even ignore another human being without doing the same to the God that is within him or her. Thus the position against killing is absolute: I cannot kill or pay for the killing of a human being without killing that portion of God that is within."

William Hayden, Dearborn, MI

"My conscience burns within when I learn of deaths and injuries caused by weapons my tax money helped to create. I am a Quaker from a family with many Christian ministers and have had the Ten Commandments, including 'Thou shalt not kill,' taught to me from infancy."

Mary A. Glover, M.D., Nanakuli, HA

"As a member of the **Mennonite** Church, which has emphasized a peace witness for more than **450 years**, I am a conscientious objector to war. As a follower of Jesus Christ, I am called to love my enemies and to do good to all. This not only forbids participation in war, it also raises ethical questions about my payment through taxes for weapons of war...**it is not our bodies which are required...but our tax dollars. I do not object to taxation as such. I am glad to pay** taxes for services which help needy people and which establish a more just society. However, my conscience is deeply violated when I am required to pay taxes for the support of a military machine and military actions which are contrary to my faith in Jesus Christ."

Janet Jennings, Sterling IL

"For a long time I have been seeking a way to be a loyal and law-abiding citizen without doing violence to my conscience, and I have found none. The Peace Tax Fund Bill will provide for such a way. I believe in taxation as i believe in community service. By enabling me to pay taxes toward building up the community of nations – rather than destroying other nations – you make it possible for me to be a better citizen."
Alfred Kross, Pastor, United Christian Church (UCC), Levittown, PA

"I am an ordained minister in the **United Church of Christ and the Church of the Brethren...** Within the pages of the New Testament we find Jesus counseling forgiveness, understanding, reconciliation, harmonious relationships, and never violence. ...I have wanted to support my government as is counseled in Scripture but have not wanted to pay for weapons and wars that simply do more harm than good in the long run. Now there seems to be a way for me to both support the state and honor my beliefs." Steven Jones, Kettering, OH

"We are Christian pacifists and members of the **Church of the Brethren**, ... For every year since 1969 that we've earned enough to be taxed we have refused to pay the military portion of the tax, most of those years redirecting those funds to organizations dedicated to peacemaking by peaceful means. Both our religious convictions and our moral scruples forbid our bodily participation in war, ... For this conscientious war tax refusal, we have been harassed by IRS agents, had funds seized from our bank account, wages garnished, and on one occasion had four Revenue agents seize our 3 year old van (...used for family...and variety of church activities) and put it up for public auction. Such retribution makes a mockery of "freedom of religion," Please understand we we would go to jail before we would willingly pay taxes for war." Philip W & Louise B. Rieman, Grundy Center, IA

"In over 450 years as a peace church, no member of the **Hutterian Brethren** has ever taken part in war or military service of any kind Thousands of Hutterian Brethren have been tortured and killed rather than violate their consciences by acting against the teachings of Jesus to love and pray for one's enemies (Matt 5:38-48)." ... "Indeed, two of our brothers died in a prison camp in the United States during World War I because they refused to participate in any way in the military organization. In earlier centuries members suffered deprivation, loss of property and homeland, and endured persecution rather than pay taxes levied for supporting the military."
George & Dorly Albertz., Norfolk, CT and Richard and Carolyn Kurtz, Farmington, PA

"My ancestors of the **Hopi Tribe** from the southwest part of this country lived, and taught my people to live, in peace and harmony with all peoples through the practice of peaceful non-resistance and sharing, providing for the entire community and the stranger as one's brother. For over **1,000 years** or more my tribe has up until this day sought to live out these values and beliefs as a way of life! ... When the General Conference Mennonite Church was given approval by our Hopi Chief Loloma back in 1893, it was because they also believed and practiced this way of life and belief as from the teachings from the Holy Scriptures..." Elmer & Nadinie Myron, Phoenix, AZ

"For many years I have been a **Zen Buddhist** and the killing of sentient beings is to me a very serious mistake. Recruiting and training other people to kill is the same moral error, as is paying for the whole process. It is a great grief to me, a great moral problem, that my federal taxes are used for war and preparation for war, for weapons and for public relations attempts to make war activities acceptable to us all. ...The Peace Tax Fund Bill would enable me to support my government in all but its war-related activities, without violating my conscience."
Edith Chadenedes, Friday Harbor, WA

GENERAL RELIGIOUS OBJECTION

"This is a fundamental religious position that has to be respected, and the government will not be one cent poorer as a result. Thank God that there are citizens who act our of conviction, as opposed to following the herd blindly." Helen Homans, Santa Fe, NM

"We don't believe that any member of The House Ways and Means Committee could stand up in Congress and state that the basic tenets of the Christian, Jewish and other religions are wrong, unjust and absurd. Yet that is just what is being said by the way our tax law requires conscientious objectors to pay for military expenditures. We can't explain why all people of these same religions are not conscientious objectors, too. We only know that some of us are. ...Not recognizing us as conscientious objectors does not change the fact that we are.
Diane Post and Irwin Post, Ph.D., Bethel, VT

"I am unable to consider the possibility of taking someone else's life ... I must give myself both personally and materially to help meet the many complex needs of persons in this world. ... As a professional working with school age children and parents it is immediately obvious that for a secure future we need to teach and build resources of peace and conflict resolution ... I would ask that my tax dollars support such efforts". Hilbert Penner, Indianapolis, IN

OBJECTION BASED ON CONSCIENCE & THE CONSTITUTION

"The decision to challenge federal law is a weighty matter, and tax resistance has, for each of us, been undertaken only after serious consideration... If we are striving, in all our different professions, to preserve and uphold human life, it poses a significant dilemma to be asked to use part of the income from our work to pay for weapons and military forces which are unquestionably destructive of human life... The framers of the Constitution felt its [conscience's] force so strongly that the principle of freedom of conscience became the very foundation upon which our government was based." Signed by nine C.O.s to military taxation, Austin, TX

"I am writing to support the Peace Tax Fund and Rep. Ron Dellums 'Military Conscientious Objector Act of 1992... these cover long overdue protection against courts' recent weakening of constitutional freedom of religion and conscience."

Maisie Jones, Haines, AK

"I have spent more than 10 years resisting federal taxes which use money to build nuclear weapons, and a lifetime as a physician in support of human services. I shouldn't be considered a criminal. Please closely consider the morality of this bill." Robert Mastroianni, M.D., Lakeport, CA

HARDSHIP OF LIVING BELOW TAXABLE INCOME LEVEL / LOSS TO SOCIETY

"For the last two years I have finally begun to withhold as much as possible of the proportion of my taxes that would be spent on killing people. **I am finally at one with my conscience, but at the cost of becoming a lawbreaker...** Last year the IRS collected my withheld war taxes from my salary, making me again an unwilling contributor to killing. To prevent this from happening again, this year I will drop out of a career in which I am very productive... My contributions as a good technical writer will be lost as well as the taxes and contribuuons I would pay toward human needs." Lenore Luscher, Watsonville, CA

"**It is not easy to raise a family, living below the taxable level.** We continually struggle with making ends meet and providing for our family needs, but for us it would be impossible and unacceptable to raise our level of income if it meant supporting the military with our taxes. We will continue to see simple living as a challenge and a vehicle for our expressions of faith. The Peace Tax Fund would allow us to earn more and channel more money into the rebuilding and nurturing of our society. To grant a nation the freedom of religious and then bind its member's creative abilities by forcing its very life blood into planning for war is not freedom of religion at all. We love our country and its people and want desperately to find avenues that will allow our involvement in the healing of our nation. We believe it is only a matter of time for a nation build on principles of truth and justice to recognize this and allow its members with a conscience towards peace to fulfill their convictions and participation as tax paying citizens."

Laurie Wilson Hesed & Larry Mann Hesed, Pawnee Rock, KS

"In the late 1940s I began keeping my income below the IRS taxable level -- then $600/year -- because I was conscientiously opposed to paying any money to be used for military purposes. Over many years since then I was able to live on such a small income, deliberately holding my earnings down, owning no car, and giving much income away for charitable deductions. ... When my income went over the taxable limits I then refused to pay that portion of my income tax owed which went for 'current military expenditures,' explaining to IRS that I had religious convictions against supporting military expenditures. Eventually IRS would levy the unpaid amount from my bank account. ... The last such levy occurred last November. Of the total of $620.83, only $395.47 was originally owed. The difference $225.36 was for IRS 'statuary additions' over the years the tax was unpaid. ... A good Peace Tax Fund bill would relive me of being forced to pay such a heavy dollar price for practicing my religion."

Franklin Zahn (age 84), Los Angeles, CA

EXPERIENCE WITH LEVIES/ LIENS & FINES / IRS COST OF COLLECTION

"I have filed with the IRS every year even though I have refused to pay; I have been up front about my intentions, and as a consequence I am facing both stiff fines and a lien on my bank account and property. Starting with my first letter to the IRS, I have continued to state that I will pay my taxes – even the fines – if I know they will not go to military purposes. Frankly I don't make very much money, and I am sure that my case is similar to many others: The government is spending more than I owe in trying to get me to pay." Lisa Kiser, Washington, DC

"In the past, on four different occasions, we have expressed the depth of our convictions on this matter by publicly attempting to refuse to pay a portion of our income taxes. In each case we were fined. In two cases, we were refused a trial to argue our case... on our second attempt we were harassed with a $1,000 fine for attempted fraud, which was dropped without apology on our challenge thereof. Secondly, on traveling nearly 400 miles to Washington, D.C. for a hearing before a judge as to whether or not we could have a trial our request was declared frivolous and we were fined $2,000." Donald and Marion Lathrop, Canaan, NY

TAX RESISTANCE, NOT AVOIDANCE

"My tax payment is held in escrow, to be released to the government when the government, in acknowledgment of the right to free exercise of religion will agree to use the money for nonmilitary purposes and not for war or preparations for war. Passage of a bill such as the Peace Tax Fund Bill would give an administrative way to do this. The rights of conscience are inalienable rights, not privileges." Rose Covington Packard, Greenwich, CT

"I would be willing to increase my income substantially and pay the resulting tax happily, if I knew I was not supporting war and preparation for war. Legally or illegally, thousands of C.O.s are avoiding tax payments. Let them contribute in good conscience." Gary Duell, Portland, OR

"I recently protested, in an open and honest manner, the spending on my federal taxes for military purposes; the IRS responded by taking $500 more, telling me I had filed a 'frivolous' return. Representatives, this is not a frivolous matter, but a question of deep religious conviction. I am not trying to find a way to pay less taxes. For religious reasons I give my entire earnings to the Catholic community to which I belong."

Anne-Marie Boucher, Little Sisters of Jesus, Lumberton, NC

GULF WAR

"The voices of the victims of war keep rising up... A year ago Americans watched their tax dollars at work in Iraq. They killed between one and two hundred thousand people in a month's time... Today malnutrition, disease, and destitution are the continuing results of this man-made plague of death and despair. Taxes paid for all this... I cannot willingly consent to the conscription of my taxes for the destruction of God's creation... I accept Jesus' way of love and peace and justice and reject coercion and violence in all human relations." Helen Loewen, Minneapolis, MN

NUREMBURG PRINCIPLES/ HIGHER LAW

"...I believe it is illegal for me to pay taxes for immoral purposes, as it is illegal for IRS to require those taxes... I believe that the decisions of the Nuremberg Tribunal give strong support for this view. But even were it not for this support, I state unequivocally that I would not commit murder even if ordered to do so by any agency of the government. ...To pay taxes for war is to participate in murder." Roger Lorenz, Oroville, WA

CONSCIENCE AND MILITARY TAX: AN AGE-OLD DILEMMA

"Therefore we are gladly and willingly subject to the government for the Lord's sake, and in all just matters we will in no way oppose it. When, however, the government requires of what what is contrary to our faith and conscience – as swearing oaths and paying hangman's dues and taxes for war – then we do not obey its command. This we do not out of obstinacy or pride, but only out of pure fear of God. For 'it is our duty to obey God rather than men'?" Claus Felbinger (a 16th century martyr), 1560

2. The Problem for Religious Bodies

Because many of their members have become conscientious war tax resisters, religious institutions and communities cannot avoid examining their own involvement. Most affirm conscientious war tax resistance as an authentic Christian witness. A collection of these statements is available in our publication, *Communities of Conscience.* Church bodies are now supporting conscientious objection to military taxation on three levels:

1) Many offer financial support through "conscience support funds" which provide money to help pay interest and penalties of war tax resisters. Churches also provide moral support through prayers and active support by accompanying individuals at court hearings, at meetings with revenue collection agents, or at auctions and seizure of personal property. Some maintain provisional peace tax funds into which war tax resisters contribute the military percentage of their federal taxes.

2) Employers face involvement as collection agents for the IRS through the system of employer tax withholding. The tax withholding system has to a large extent made every taxpayer a supporter of war efforts even before he or she receives the paycheck. Therefore, some employees are asking their church employers not to violate their consciences by not withholding, or not sending to the government, the military portion of the federal tax from their paychecks. This places the burden of conscience squarely on the employers who must respond to conscientious objectors on their staffs.

Because employers are directly and involuntarily involved in the withholding system, many religious employers are caught in a difficult place. They stand between the conscientiously held beliefs of their faith tradition and the requirements of the tax system. How can they teach their people to follow conscience – no matter what the cost – and then violate that conscience by giving to Caesar what the employee believes belongs to God?

3) In response, a number religious organizations have adopted personnel policies which support staff members who are conscientious objectors to military tax by not withholding or not turning over the military portion of the income tax. Several religious organizations have adopted policies not to comply with IRS levies on salaries of staff members of conscientious objectors to military tax. Some have suffered severe monetary loss attempting to defend their right not to violate the deeply held religious convictions of their own staff.

VI. CONCLUSION

The National Campaign for a Peace Tax Fund believes that this legislation is a workable mechanism to resolve the dilemma faced by these individual conscientious objectors and by these religious institutions. Attorney Peter Goldberger's testimony addresses the legal precedents and constitutional issues which both permit and require us to seek this legislation.

We will be happy to work with you to enshrine this fundamental freedom into law.We are also willing to admit that a portion of the conscientious objector community will not use the bill for a variety of principled reasons. We see the appropriation of the military portion to the stated purposes allowed in the bill as a form of economic conversion from military defense to peaceful non-military defense strategies. Perhaps we can emphasize here that conscientious objectors believe in the defense of the nation and are willing to pay for it, but not through military means. That indeed is the whole point of the list of alternative appropriations – to defend the nation, not to provide extraneous exceptions or busy work. These alternatives are seen as developing and researching a new type of very strong and effective defense.

Our central affirmation is that each individual has the right not to be coerced into participation in killing other human beings–whether that participation is physical or financial. Ultimately this right is based in the freedom to exercise religion according to the dictates of conscience.

TESTIMONY OF

DAVID E. ORTMAN
ANN E. MARCHAND
7043 22nd Ave N.W.
Seattle, WA 98117

on H.R. 1402
U.S. Peace Tax Fund Bill

Ways and Means Committee
U.S. House of Representatives

11 July 1995
Washington D.C.

Mr. Chairman, we are David E. Ortman and Ann E. Marchand, 7043 22nd Ave N.W., Seattle, WA 98117. Please include this statement in the hearing record on H.R. 1402, the U.S. Peace Tax Fund Bill, to be held on 11 July. We would also ask that the enclosed material, including our letter of 13 April 1995 to the IRS, their 3 July Notice of Intent to Levy and our 9 July response also be included in the hearing record.

To summarize, we are conscientious objectors to all war in any form as defined by the Selective Service. We have always properly and completely filled out our 1040 forms each year. However, we have withheld varying amounts because we could not, in good conscience, pay for military budgets. The Selective Service System accepts conscientious objection to war as a legitimate position of conscience. However, the IRS has steadfastly refused to acknowledge such a position of conscience, preferring, as in our case, to levy bank accounts, place liens on property and instruct employers to freeze withholding levels.

In 1992, a House Ways and Means Subcomittee held a hearing in which citizens from all over the United States submitted testimony in support of the U.S. Peace Tax Fund. We greatly appreciate the decision of the full Ways and Means Committee to allow additional input on the importance of a U.S. Peace Tax Fund to people of conscience.

As stated in our letter to the IRS, David was granted CO status by the Selective Service System in 1971. Although he was not required to perform alternative system due to the termination of the draft, he entered Mennonite Voluntary Service from 1975-1980 and for five years received room, board and a small monthly allowance. In part, his motivation included keeping his income below taxable limits. Since our marriage in 1983, we have withheld the federal tax on our phone bill, sending a letter each month explaining to the phone company that we were withholding the federal tax as a protest against the military uses of this money.

In addition, we have withheld a varying percentage of our federal income tax with the predictable results of escalating penalties. We estimate that the IRS has collected approximately $400 in penalties and interest. With the passage of the U.S. Peace Tax Fund bill, the IRS would no longer have to devote staff and time to trying to collect from people of conscience and we could pay our full share of taxes.

Thank you for the opportunity to explain our views. Please send us a copy of the hearing record when it becomes available.

9 July 1995

Internal Revenue Service Center
Ogden, UT
84201 Ref: CP-504, 1040, 12-31-94

Dear IRS:

We have received a copy of your Notice of Intent to Levy dated 3 July 1995. As we wrote to you in our 13 April 1995 letter, as conscientious objectors to all war in any form we find ourselves called on to protest the military uses of our tax money. For example, Congress is currently proposing to appropriate additional funds for the B-2 bomber, despite the Clinton Administration's opposition to acquiring any more bombers of this type.

David was granted CO status by the Selective Service System in 1971. Although he was not required to perform alternative system, due to the termination of the draft, he entered Mennonite Voluntary Service from 1975-1980 and for five years received room, board and a small monthly allowance.

We continue to support passage of the U.S. Peace Tax Fund bill, H.R. 1402. We are providing a copy of your Notice of Intent to Levy and this letter for the 11 July 1995 U.S. House Ways and Means Committee Hearing on H.R. 1402. We would strongly urge the IRS to support this bill so that citizens of conscience could pay their full share of taxes.

Thank you for an additional opportunity to explain our views.

Sincerely,

David E. Ortman
Ann E. Marchand
7043 22nd Ave N.W.
Seattle, WA 98117

cc: Senator Slade Gorton
Senator Patty Murray
Rep. Jim McDermott

007472

P 904 001 017

Department of the Treasury
Internal Revenue Service
OGDEN, UT 84201

** IF YOU HAVE ANY QUESTIONS, **
** REFER TO THIS INFORMATION: **
NUMBER OF THIS NOTICE: CP-504
DATE OF THIS NOTICE: 07-03-95
TAXPAYER IDENT. NUM: 503-82-0142
TAX FORM: 1040
TAX PERIOD: 12-31-94

DAVID E ORTMAN & ANN E MARCHAND
7043 22ND AVE NW
SEATTLE WA 98117-5626438

FOR ASSISTANCE CALL: 442-1040 LOCAL SEATTLE
1-800-829-1040 OTHER WA
CALLER ID: 686676

WE INTEND TO LEVY - RESPOND NOW
* * * THE AMOUNT YOU OWE IS $167.96. * * *
- (AVOID ADDITIONAL INTEREST: PAY THIS AMOUNT IN FULL IN 10 DAYS.)

THIS IS A FORMAL NOTICE OF OUR INTENT TO LEVY (SEIZE) YOUR PROPERTY, OR THE RIGHTS TO IT, TO PAY THE TAX YOU OWE. WE PREVIOUSLY SENT YOU NOTICES REQUESTING THE FULL AMOUNT YOU OWE FOR THIS OVERDUE TAX, BUT HAVE YET TO RECEIVE IT.

The $167.96 you owe includes penalty and interest computed to the date of this notice. If we receive your full payment by 07-13-95, we will stop penalty and interest charges. Otherwise, we will continue to charge additional penalties and interest until the amount you owe is completely paid.

Send your full payment to us today. Make your check or money order for the amount you owe payable to the Internal Revenue Service. Write your social security number or employer identification number on your payment. Tear off the payment voucher stub from the end of this notice and send it with your payment in the enclosed envelope.

If we don't receive your full payment by 08-02-95, we may levy your property without further notice to you. This means the law allows us to take your property or rights to property such as real estate and personal property (for example, automobiles and business assets) to collect the amount you will owe on your tax account shown on the front page of this letter. We may also take your wages, bank accounts, commissions and other income. We have enclosed Publication 594, Understanding the Collection Process, which gives you additional information.

We may file a Notice of Federal Tax Lien at any time to protect the government's interest. A lien is a public notice to your creditors that the government has the right to the interest in your property, including property you acquire after we file the lien. When there is a lien on your property, it may be difficult for you to obtain credit in the future or sell your property.

007472

Department of the Treasury
Internal Revenue Service

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TAX PERIOD: 12-31-94

DAVID E ORTMAN & ANN E MARCHAND
7043 22ND AVE NW
SEATTLE WA 98117-5626438

We don't want to take the actions described above. In fact, we prefer that you call us at the telephone number(s) that are shown on the front page of this notice to make arrangements to pay your taxes voluntarily. By working with us to resolve your tax problem, you can help us avoid the lien and levy actions outlined in this notice. However, if we don't hear from you, we will have no choice but to take these collection actions.

If you can't pay the amount you owe now, CALL US IMMEDIATELY at the number(s) shown on the first page of this notice. We want to help you resolve this bill -- don't delay!

If you think this bill is incorrect, or you want to know how we arrived at the amount you owe, CALL US at the number(s) on the first page of this notice and we can tell you.

If you believe that we didn't apply a payment you made to your account for this tax period, CALL US at the phone number(s) on the first page of this notice. When you call, have the following payment information available:

(1) IF YOU DEPOSITED THE PAYMENT DIRECTLY WITH THE IRS -
- a copy of the front and back of your canceled check;
- your money order receipt, the name and address of the issuing station with the amount and date of purchase; or
- the cash amount, date, and number on the cashier's receipt.

-- OR --

(2) IF YOU DEPOSITED THE PAYMENT WITH A BANK -
- the deposit amount, the date of the deposit, and the name and address of the bank where you made the deposit.

THE AMOUNT YOU OWE IS $167.96.
We figured this amount by adding:

Amount unpaid from prior notices	$166.21
Late payment penalty	$0.81
Interest	$0.94

The amount unpaid from prior notices may include tax, penalties, and interest you still owe IRS. It also should reflect any credits and payments we received from you since the last notice we sent you.

As of the date of this notice, the late payment penalty increases to 1% of the unpaid tax for each month or part of a month the payment

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Department of the Treasury
Internal Revenue Service

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7043 22ND AVE NW
SEATTLE WA 98117-5626438

is late up to a maximum of 25% of the unpaid tax.

The federal income tax is a "pay-as-you-go" tax. You must pay the tax as you earn or receive income during the year. There are two easy ways to do this:

1. WITHHOLDING: If you are an employee, your employer will withhold income tax from your pay. Tax is also withheld from other types of income -- including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service in your name.

If too little tax is being withheld from your wages to pay the taxes you will owe at the end of the year, you should file a new Form W-4, Employee's Withholding Allowance Certificate, with your employer to change the amount of withholding.

2. ESTIMATED TAX PAYMENTS: If you don't pay your tax through withholding, or don't pay enough tax through withholding, you have to estimate the tax you will owe and make payments during the year directly to the IRS.

If you need more information about changing your Form W-4 or making estimated tax payments, please call us today. Publication 505 explains both methods in detail. You may request forms and Publication 505 by calling 1-800-829-FORM.

If you write to us or send additional information (including Form 9465, Installment Agreement Request), use the IRS address on the first page of this notice. Be sure to include your telephone number, the best time for us to call, and any necessary changes to our record of your name and address.

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Department of the Treasury
Internal Revenue Service

NUMBER OF THIS NOTICE: CP-504
DATE OF THIS NOTICE: 07-03-95
TAXPAYER IDENT. NUM: 503-82-0142
TAX FORM: 1040
TAX PERIOD: 12-31-94

DAVID E ORTMAN & ANN E MARCHAND
7043 22ND AVE NW
SEATTLE WA 98117-5626438

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Send this PAYMENT VOUCHER with your payment in the enclosed envelope.

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929 9101 Date of this notice: 07-03-95 9531
Taxpayer Identifying Number: 503-82-0142
Form 1040 30 Tax Period 12-31-94

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AMOUNT YOU OWE.. $167.96
Subtract any payments you believe we haven't received
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PAY THIS AMOUNT..

DAVID E ORTMAN & ANN E MARCHAND

7043 22ND AVE NW
SEATTLE WA 98117-5626438

13 April 1995

Internal Revenue Service Center
Ogden, UT
84201

Dear IRS:

As conscientious objectors to all war in any form we find ourselves called on to refuse income tax payment due to the military uses of our tax money. Please note that we are not opposed to paying taxes. Instead, we support passage of the U.S. Peace Tax Fund bill, H.R. 1402, which has been introduced in Congress and on which hearings were held in the House Ways and Means Committee in 1992.

This bill would allow those conscientiously oppposed to participation in war to pay their full tax liability. The U.S. Peace Tax Fund bill is a consistent extension of long-standing Congressional recognition of conscientious objection and a willingness to provide constructive alternatives for those who profess these beliefs.

We are also concerned that the material presented on the U.S. budget in the 1040 Form is extremely misleading. For example, a large percentage of the Department of Energy is devoted to nuclear warhead production. In addition, at least half the interest on the national debt can be attributed to past military spending. We request that next year the IRS present a realistic accounting of budget outlays.

At this time, we regret that the amount we owe and are withholding is only $162.00. This money will be deposited in the N.W. Peace Fund, interest on which will go for peace and social concern projects in the Northwest.

We appreciate this opportunity to explain our views.

Sincerely,

David E. Ortman 503-82-0142
Ann E. Marchand 509-62-9941
7043 22nd Ave N.W.
Seattle, WA 98117

cc: Senator Slade Gorton
Senator Patty Murray
Rep. Jim McDermott

philadelphia yearly meeting

Religious Society of Friends

1515 Cherry Street, Philadelphia, PA 19102 (215) 241-

TESTIMONY FOR WAYS AND MEANS COMMITTEE, July 11-13, 1995

U. S. HOUSE OF REPRESNENTATIVES in support of H.R.1402

This statement of testimony is on behalf of the approximately 10,000 members of Philadelphia Yearly Meeting, Religious Society of Friends, an association of over 100 local congregations in the greater Delaware Valley known to the larger community as Quakers. You very likely know that we have been known since a letter to England's King Charles II in 1661 as a "peaceable people". This reputation emerges from our abiding faith in God's presence within each individual.

We believe that religious experience must be personal and that religious understanding is hollow until it affects how we live. Our Quaker witness in the matter of participation in armed conflict or paying for the military actions of others is not a matter of doctrine or discipline, but rather a matter of obedience to conscience. A small minority of contemporary members of the Religious Society of Friends are moved to civil disobedience and resistance to the voluntary payment of federal taxes in support of armed conflict. Although those members so moved are a small minority, as a corporate body the Yearly Meeting upholds their witness as fully consistent with our understanding of the message of the New Testament.

Indeed, many Quakers came to this land in pursuit of religious freedom and the right not to be conscripted. George Washington, in exempting Friends from military service wrote to Philadelphia Yearly Meeting in 1790:

> *Government being, among other purposes, instituted to protect the persons and consciences of men from oppression, it certainly is the duty of the rulers, not only to abstain from it [oppression] themselves, but according to their stations, to prevent it in others. ... Your principles and conduct are well known to me. I assure you very explicitly that in my opinion the conscientious scruples of all men should be treated with great delicacy and tenderness, and it is my wish and desire that the laws may always be as extensively accommodated to them as a due regard to the protection and essential interests of the nation may justify and permit."*

As a religious body we have suffered administrative difficulties over the war tax resistance of some of our member-employees for at least 25 years. Before the 1993 passage of the Religious Freedom Restoration Act, the Federal District Court in Philadelphia found it could not rule on the merits of our defense against a government suit alleging we violated tax laws "without reasonable cause." The Peace Tax Fund Bill would grant relief not only to the individuals whose conscientious objection to participation in killing extends to the payment of federal taxes to support the military, but it would also grant relief to us as a religious organization. In general, both individual Quakers and Quaker organizations seek maximum cooperation with government agencies in pursuit of the general welfare of our society.

The Peace Tax Fund Bill - H. R. 1402 - is simple in design. It is modeled on the Selective Service accommodation of Conscientious Objectors to war. The Joint Committee on Taxation informs Congress that passage of this bill would be revenue positive. It would permit the voluntary compliance with tax laws by persons now compelled by religious conviction either to earn less than they are capable of earning or to resist the voluntary compliance upon which our system of collection depends. The analysis of revenue effect by the Joint Committee on Taxation did not even calculate the savings which would be realized by reducing the costs now incurred by the Internal Revenue Service in collecting from war tax resistors.

I appreciate the fact that the House Ways and Means Committee must sort out deserving petitions for accommodation from those of little importance to the common good. Please understand that there are precedents for government protection in this profoundly significant matter of relief from enforced participation in military action. H.R..1402 does not alter Congress's right to control the budget. It does grant relief to that minority of religious people, some of whom are members of Philadelphia Yearly Meeting, whose opportunity for free exercise of religion is currently severely thwarted by tax laws which fail to distinguish between conscientious objection to paying for violent death and destruction and tax evasion. Please help good citizens to be fully law-abiding citizens by establishing the orderly, legal process of the Peace Tax Fund.

As George Washington put it in 1790, government should protect persons from oppression and the laws treat conscience with delicacy and tenderness, accommodating to the extent that the essential interests of the nation permit. The Peace Tax Fund would afford such protection.

7/ 7/ 1995

Nancy Middleton
Acting General Secretary
Philadelphia Yearly Meeting, Religious Society of Friends
1515 Cherry Street, Philadelphia PA 19102

Attachment to testimony of Philadelphia Yearly Meeting, Religious Society of Friends, 1515 Cherry St., Philadelphia PA 19102

Historic Commitment to Our Peace Testimony

"We base our peace testimony on a fundamental conviction that war is wrong in the sight of God. In explaining his unwillingness to serve in the army, George Fox [founder of Quakerism] records that 'I told them . . . that I lived in the virtue of that life and power that took away the occasion of all wars.'" (Faith and Practice: A Book of Christian Discipline, Philadelphia Yearly Meeting, 1972 ed., pp. 34-5.)

"The Society of Friends has consistently held that war is contrary to the spirit of Christ and stated its position clearly in the Declaration to Charles II in 1660: 'We utterly deny all outward wars and strife, and fightings with outward weapons, for any end, or under any pretense whatsoever; this is our testimony to the whole world. . . . The Spirit of Christ, by which we are guided, is not changeable, so as once to command us from a thing as evil, and again to move unto it; and we certainly know, and testify to the world, that the spirit of Christ, which leads into all truth, will never move us to fight and war against any man with outward weapons, neither for the Kingdom of Christ nor for the kingdoms of this world. . . . Therefore, we cannot learn war any more.'" (Faith and Practice, p. 34)

". . . In Philadelphia Yearly Meeting a statement was approved in 1776 which said, 'It is the sense of this Meeting, that a Tax levied for the purchasing of Drums, Colours, and other warlike uses, cannot be paid consistent with our Christian Testimony.'" (Edwin Bronner, "A Quaker History," in Handbook on Military Taxes & Conscience, 1988, p. 46.)

"The Friends General Conference met at Cape May, New Jersey, in early July [1940]. . . . A highlight of the conference was a report by Clarence Pickett on recent developments. . . . Pickett's comments set the stage for two intensive days of Quaker dialogue. . . . The findings committee report summarized the result: opposition to all forms of conscription; concern that all Friends engage in meaningful peace and humanitarian work, regardless of the international situation; the special responsibility of Friends to help reduce war hysteria and defend civil rights in their local communities; and the need to discover opportunities for special assistance to war sufferers in the conflicts then raging in Europe and Asia." (Keim and Stoltzfus, The Politics of Conscience: The Historic Peace Churches and America at War, 1917-1955, 1988, pp. 81-3.)

In recent decades the religious exercise over the payment of taxes for military purposes continues in our meetings for worship for business; minutes were recorded in our annual sessions of 1968, 1970, 1975, 1978, 1979, 1983, 1984, and 1988. For example, from 1970: "We gladly pay the civilian part of our taxes, but many have reached a point in their conscience which prevents or makes difficult the payment of the military portion... We warmly approve of people following their conscience, and openly approve civil disobedience in this matter under Divine compulsion. We ask all to consider carefully the implications of paying taxes that relate to war-making." (Declaration of Samuel D. Caldwell, in U.S. District Court, Eastern District of PA, Civil Action No. 88-6368 (NLS) and 88-6390, pp. D-8-10.)

WASHINGTON OFFICE
NATIONAL MINISTRIES DIVISION

PRESBYTERIAN CHURCH (USA)

Testimony from Presbyterian Church (USA)
on Behalf of U.S. Peace Tax Fund Bill, H.R. 1402
to the Ways and Means Committee
of the U.S. House of Representatives

Hearing Dates: July 11-13, 1995
Date submitted:July 10, 1995

This testimony in support of H.R. 1402 is submitted by Rev. Elenora Giddings Ivory, Director of the Washington Office, Presbyterian Church (USA). The Washington Office represents the policies of the Presbyterian Church (USA) General Assembly to Members of Congress and the Administration. The General Assembly is the highest policy-setting body of the church. As a representative body, the General Assembly reflects the authentic, deliberative judgement of the denomination. It does not speak for each individual member.

The Presbyterian Church (USA) General Assembly urges the United States Congress to pass H.R. 1402. The bill would create a legal mechanism for citizens who are conscientious objectors to military force and, therefore, in conscience are unable to pay that portion of their income tax which goes to support the military. On May 21, 1992 the Presbyterian Church (USA) submitted extensive testimony to the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in support of this bill.

The Presbyterian Church (USA) has a long history of advocacy for religious liberty which provides fundamental support for the Peace Tax Fund Bill. While many Presbyterians would not necessarily share the beliefs of conscientious objectors, we strongly support their religious liberty to practice those beliefs.

A small group of Presbyterians have contemplated civil disobedience in refusing to pay those taxes that would pay others to do the killing that they personally cannot do, from conscience. Some have changed their life-style to live below taxable income. A very few have actually refused to pay taxes for war as conscientious objectors, and have had their assets confiscated. One has been imprisoned for his beliefs.

In 1991 the Presbyterian General Assembly gave explicit endorsement to the proposal for a U.S. Peace Tax Fund to create a legal alternative for conscientious objectors, on the grounds that the Peace Tax Fund would allow U.S. citizens to share the burden of government without paying for war.

We respectfully urge that these hearings lead the committee to pass H.R. 1402, the U.S. Peace Tax Fund Bill.

110 Maryland Avenue, N.E. • Washington, DC • 20002 • (202) 543-1126

Peace Tax Fund Testimony for the House Ways and Means Committee

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Friday July 7, 1995

Abstract

I have known I was a conscientious objector since I turned 18 in 1957. My convictions came simply from taking to heart, the teaching that I got both in school and at home, that I should not fight. Furthermore, as I watched others who broke this simple rule or as I failed to follow it myself in disputes with playmates, I observed that conflicts were invariably settled in the end, not by the fighting, but by reason and agreement. My training came in school, in Sunday school and at home and was based in the Quaker foundation of all three. During the Viet Nam War, after earning my PhD in physics, I began to refuse to pay the federal taxes on my telephone service. Later, as my income taxes rose, I began to pay what I sill owed on April 15 to humanitarian and peace organizations instead of to the IRS. IRS Collection processes involved garnishment of my salary and attachments of my bank accounts. All of this takes many letters and, I expect, much research on the part of IRS collections people. Enactment of the Peace Tax Fund legislation would assure me that my taxes would go for humanitarian and peaceful purposes. It would accommodate my deeply held religious beliefs that killing and destruction are wrong for whatever propose, and would at the same time raise a bit more in taxes. It seems a simple step to take - a parallel to the provisions to accommodate me when I turned 18 and faced service in the military.

Foundations of my Religious Beliefs

I was born into a quaker family in 1939. My grandfather had been active in the American Friends Service Committee and in 1948 was appointed to be the interim mayor of Jerusalem as the state if Israel was being formed. (Violence prevented his ever assuming this position.) In school, I was taught that it was wrong to fight and as I grew up, I saw how destructive and inefficient fighting was as a way to settle differences. As long as one had enemies, one was in danger of being attacked. Only when one constantly tried to communicate with those nearby could one work out conflicts amicably and securely. Fighting invariable set things back and destroyed confidence and trust. Peaceful interactions built confidence and trust.

At the age of 18, in 1957, I registered for the draft as a conscientious objector. Deferments for my education and my family prevented my being called, but I continued to believe deeply in the wrongness and ineffectiveness of killing and destruction to force compliance with a particular government or set of rules. I remember filling out the conscientious objector forms wondering what would come of them. My brother was called to do alternative service following his graduation from college, but I was never called. I now read

reports from the Christian Peacemaker Teams in Hebron on the West Bank, in Haiti, in Washington DC and in Chiapas, Mexico. I feel that they are carrying out an effective mission.

How much more effective could they be if they had the resources of the world's military behind them. How much more secure the world would be if we made clear the distinction between **Police and Military**.

The Police are charged with saving lives and preserving property.

The Military are charged with killing the "enemy" and destroying their property.

My Tax Protest

As I graduated with my PhD in physics in 1966, the year my first child was born, I felt strongly that the world needed to develop non-military forms of international governance. I participated in protests of our involvement in the Viet Nam War. When the war continued, I began to refuse to pay the federal tax on my telephone bill since that tax had been scheduled to be phased out, but instead was maintained to pay for the military effort. Later in the 1970s, as my income taxes also increased, I began to realize that I was paying for the military with my taxes and I stopped voluntarily paying that portion which was not withheld by my employer. I filed my income tax forms and submitted them to the IRS along with a letter explaining my protest and the reason why a check was not enclosed. Instead, I contributed these withheld taxes to the American Friends Service Committee (headquartered in Philadelphia, PA) and to the Mercer Street Friends Center (in Trenton NJ) for their humanitarian work and to the Friends Committee for National Legislation for their anti-military lobbying efforts. I don't know what the IRS does with the letters I send. The computer correspondence I get from the IRS shows little evidence that my letters have been read. The return receipts for our submissions to the IRS do prove that they have been received. I also send letters explaining my actions and my deeply held religious beliefs that lead me to these actions to my congressional representatives and to the President. These letters are usually acknowledged.

These refusals to pay my taxes to the IRS (though I did file my returns) led over the years to various collection methods. One of the most benign was in a year in the 1970s, when I was owed a refund. The treasury check was held up for months and finally arrived in late fall minus about \$25, roughly the amount of my withheld telephone taxes at that time. Later an attempt to garnish my wages led, after multiple attempts, to reduced paychecks for a few months. More recently my bank accounts have been levied, again only after multiple attempts. Somehow, though I have not changed my accounts, it has always been a different account. Most recently, we found we were being billed for the same taxes more than once. Our investigation revealed that though last year's levy amount had been deducted from our bank account along with the bank's levy fee, the bank had not forwarded the check to the IRS. This situation is still not resolved. This collection effort must be costly for the IRS and, in the end, all of us as taxpayers.

When the amount of my taxes withheld has been large, I have deposited the tax amount withheld in the Conscience and Military Tax Fund (initially on Long Island, but more recently in Seattle, WA) or in the Philadelphia War Tax Alternatives Fund. These funds invest in programs that meet human needs. The IRS collection efforts for all these years surely must cost taxpayers more than necessary.

Peace Tax Fund

If the Peace Tax fund were enacted, I would happily pay my taxes for Head Start, the Women Infants \& Children program and the National Peace Institute. The proposed process seems simple and effective. It seems that both the government's need to collect taxes and my need to feel secure that my taxes are not being used for killing and destruction.

I don't know how many other taxpayers are, like me, not willingly contributing to the huge military maintained by our government. I know the numbers are larger than the numbers actually protesting as I have

been. Some decide that dealing with the IRS over the unpaid taxes is ineffective and costly both in time and in penalties and interest. They are right, but I feel I am also right, and my conscience is a little easier because I pay this price.

In summary, I have done the following because my religious training and beliefs do not permit me to willingly pay for the killing and destruction which is the purpose of the military.

- Demonstrate and lobby for deep reductions in the US military spending. 1\% of GDP should be plenty and I would argue that this be for a purely defensive, police force to protect life and property.

- Enclose letters of protest with my income tax returns and inform my Congressional representatives of my protest and action.

- Refuse to pay the federal tax on my telephone service because that tax was originally levied specifically to pay for the Viet Nam war and continues now as a tax to offset huge military spending.

- Refuse to pay the portion of my federal income taxes which is not withheld by my employer. I would do this only for the portion up to the roughly 33\% which goes for current military spending.

- Simplify my lifestyle and not seek income beyond that necessary for living comfortably in order to reduce my tax liability so as to reduce the amount I ultimately pay for the military.

I know that other people have similar conscientious objections to paying for the killing and destruction which is the purpose of the military. As I am, these people are taking similar actions and violating their religious training and beliefs to various degrees. I would be a more productive member of our society if I could fill out a form (like I did in 1957 when I was seeking Conscientious Objector (CO) status with the military draft) to gain CO status for the payment of my taxes. I believe that enactment of the Peace Tax Fund legislation would both raise more tax income for the federal government from me and would raise my productivity by eliminating one diversion, that of fighting the payment of taxes for the military. I assume that this would apply to others in my situation. Please enact this simple legislation as soon as possible.

AMERICAN ACADEMY *of* ACTUARIES

July 27, 1995

The Honorable Bill Archer
House of Representatives
Ways & Means Committee
Washington, DC 20515

Re: Miscellaneous Tax Proposals Scheduled for Hearings on July 11 - 13
Before the House Ways and Means Committee

Dear Chairman Archer:

The American Academy of Actuaries, on behalf of the Pension Committee, commends you on seeking simplification of pension plan administration through the miscellaneous tax proposals which are before the House Ways and Means Committee. Pension rules have become so complex that many employers have decided not to provide pension plans for their employees. Your proposals open up the dialogue for, among other things, the need for a retirement income policy.

The Academy Pension Committee provides technical actuarial expertise to public policy makers through expert testimony, comments on proposed legislation, and meetings with legislators and their staff. While the Pension Committee agrees with many of the proposals included in the list, we have three main concerns for your consideration.

1. Pension legislation should be developed in the context of a **national retirement income policy**, and not be driven by short-term revenue considerations. In addition, changes in pension law should be made as infrequently as possible. Not withstanding the above, we do welcome many of your proposals which truly **simplify** the complex world of employee benefit taxation, such as streamlining the definition of highly compensated employee, repealing top-heavy rules, eliminating Section 415(e), and family aggregation rules.

2. The current legislative and regulatory environment favors defined contribution plans over defined benefit plans. Through increased regulation and burdensome administration, defined benefit plans have been placed at a disadvantage. **We believe that all private pension plans should be treated equally**, and much of the hardship should be removed from the administration of defined benefit plans. Along the same lines, not only should pension plans be treated similarly, but treatment of those participating in both types of plans should be comparable. For example, we believe that group medical practices should not have deferred compensation limits different from those of similar business groups.

3. Finally, our greatest concern with the miscellaneous tax proposals is the proposed alternative to the current limitation on pension funding based on 150 percent of the plan's current liability. **We not only oppose the proposal to tinker with the 150 percent full-funding limitation, but would further suggest that this limitation be eliminated altogether** for the following reasons:

> Section 412(c)(7)(D) of the current IRS Code gives the Department of Treasury explicit authority to issue the same rules that are suggested in the legislative proposal. The Department has chosen not to issue such rules, and we believe that Congress should not legislate such a change.
>
> The current 150 percent full-funding limitation, along with limits on currently recognizable earnings for pension purposes, only delays adequate funding of known future benefit obligations and exacerbates cashflow difficulties for corporations by increasing pension plan funding requirements in times of economic downturns.
>
> The current 150 percent full-funding limitation was adopted primarily for the purpose of increasing tax revenue by limiting current deductions for pension funding. The 150 percent limit is both inconsistent with ERISA's intent and contrary to a national retirement income policy.

Therefore, for reasons of pension simplification and national retirement income policy (not tax-driven policy), we recommend that the 150 percent full-funding limitation be repealed in favor of the full-funding limitation as prescribed by the original 1974 Employee Retirement Income Security Act.

The Pension Committee of the American Academy of Actuaries believes that the formulation and growth of retirement plans should be encouraged. Consideration of the above comments will help create a favorable environment for the establishment and growth of qualified pension plans. In the attachment to this letter, we have also provided specific comments on the miscellaneous tax proposals.

We hope that the enclosed comments are useful to you and the Ways & Means Committee. Please contact Christine Cassidy or me (212/345-3517) if you or your staff have questions or would like additional information or assistance from the American Academy of Actuaries.

Sincerely,

Ron Gebhardtsbauer

Ron Gebhardtsbauer
Chairperson, Pension Committee

cc: House Ways & Means Committee

AMERICAN ACADEMY *of* ACTUARIES

Comments on Miscellaneous Tax Proposals Based on the Description by the Joint Committee on Taxation for the House Ways & Means Hearing July 11 - 13, 1995

Section BB. Pensions and Employee Benefits

A. PENSIONS AND EMPLOYEE BENEFITS

1. Nondiscrimination Rules

a. Repeal special nondiscrimination tests for qualified cash or deferred arrangements

Comment. The special nondiscrimination rules encourage participation of non-highly compensated employees in 401(k) plans. We do not recommend a repeal of the special nondiscrimination rules, but recommend simplifying them. The two percent limit and two times rules and the multiple use test should be eliminated, both for simplification purposes and for achieving the correct results. This change alone would lower contributions of highly compensated employees (HCEs). Thus, there should be a concurrent liberalization in the basic limit. The limit is currently 1.25. If the limit were increased to 1.50, the result would be a smaller contribution for HCEs in the pure salary reduction plan where the non-HCEs defer less than four percent, and a larger contribution for HCEs in any situation where the non-HCEs defer more than four percent. We do not see the logic in the current rules that allow a greater deferral (200 percent) for HCEs when non-HCEs contribute very little. Under our suggested simplified rules, employers would encourage more participation from non-HCEs. This would also greatly simplify the calculations when matching funds are contributed.

b. Modify definition of highly compensated employee to eliminate 1-officer rule

Comment. This is a worthwhile simplification. We prefer President Clinton's proposal because it is more of a simplification and eliminates the officer category altogether.

c. Repeal top-heavy rules (Section 416)

Comment. This is a worthwhile simplification and an important change. In view of current law regarding salary limits, permitted disparity nondiscrimination and vesting, top-heavy rules impose a large administrative burden and are redundant.

d. Modify safe harbor rule for leased employees

Comment. There are numerous issues involving not only leased employees, but also affiliated service groups, management service groups, and shared employees. The complex rules governing these groups should be replaced by a "facts and circumstances" test.

e. Exempt state judicial retirement plans from non-discrimination requirements

Comment. We disagree with this provision. Laws and regulations governing public and private pension plans should not show preference for one type of pension plan over another. Pension plans, whether private or public, defined benefit or defined contribution, should be treated comparably.

f. Repeal OBRA 1993 provision limiting compensation taken into account to $150,000

Comment. We agree with this provision.

g. Repeal for pilots OBRA 1993 provision limiting compensation taken into account to $150,000

Comment. If the proposal described in A.1.f. is enacted, this provision becomes unnecessary. We believe that all pension plan participants should be treated equally, and that special treatment should not be extended to pilots. For example, if bargained plans get a three year delay, then non-bargained plans should also get a three year delay in the effective date.

h. Repeal minimum participation rule (Section 401(a)(26))

Comment. While many committee members support elimination of Section 401(a)(26), some committee members would rather reduce the fifty participant minimum in Section 401(a)(26) to five participants as long as the plan passed seventy percent coverage rules. This should apply to both defined benefit and defined contribution plans. We object to more liberal rules for defined contribution plans as compared to defined benefit plans and therefore would not support eliminating, or easing, 401(a)(26) for defined contribution plans only.

2. Distribution rules

a. Repeal 15-percent excise tax on excess distributions

Comment. We believe that the excise tax should be repealed because it penalizes retirement savings at many income levels. However, if the repeal of Section 415(e) in item 3.b. is contingent on this rule still being in force, we would prefer a repeal of Section 415 (e).

b. Provide that pension distributions are taxed as capital gains

Comment. We do not agree with this provision. There are other revenue decreasing items in these proposals that we prefer.

c. Reinstate 10-year forward averaging

Comment: We are not in favor of this provision. Pension plans are intended to provide retirement income, and legislation should not favor options that are counterproductive to saving for retirement. Further, we do not think that the tax code should favor any particular method of distribution of pension plan assets. This is not a simplification.

d. Permit penalty-free withdrawals for unemployed individuals

Comment: We disagree with this provision. The United States already has a problem with inadequate retirement savings, in addition to an unemployment problem. Unemployment problems need to be addressed separately in the proper context, not at the expense of adequate retirement savings.

3. Limits on contributions and benefits (Section 415)

a. Modification of interest and mortality rate provisions of the Retirement Protection Act

Comment: We do not agree with this proposal. If a change occurs now, it will cause an upheaval for those plans currently using these rates.

b. Eliminate combined plan limit for participants in both a defined contribution plan and a defined benefit plan

Comment. We agree with this provision and believe that elimination of the combined limits in Section 415(e) are a worthwhile simplification.

4. Employee stock ownership plans (ESOPs)

Comment. It is not clear to us that ESOPs serve national retirement income policy. Any social justification should be based on the notion of employee empowerment, not retirement income security.

5. Permit permanently disabled persons to contribute to Section 401(k) plans

Comment: We agree with this provision. Many of these individuals are collecting money under disability insurance programs and should be permitted to set aside funds for their retirement as others are able to do.

6. Modify sanctions for failure to comply with qualification requirements

Comment: We agree with this provision. The alternative, Closing Agreement Program, provides regulators with too much latitude in their authority. In addition, we are concerned with legislating sanctions. Therefore, we recommend that the Internal Revenue Service create and oversee a committee consisting of private and public representatives to design penalties in advance.

7. Allow prenuptial waiver of spousal annuity benefits

Comment: We have significant concerns with allowing prenuptial waivers for spousal annuity benefits unless they provide notifications of the amounts waived. We believe that this approach warrants further examination before making any changes.

8. Deny Federal tax information to States imposing a pension source tax

Comment. While we agree with the outcome of this provision, we would recommend taking it further. We recommend that pension source taxes be prohibited. Pension source taxes do not encourage retirement income security, can cause double taxation, and create many complex problems for plan administrators.

9. Underfunded deferred compensation plans of tax-exempt and government organizations (Section 457)

a. Exempt deferred compensation plans for volunteer fire fighters

Comment. We do not agree with this provision, and are concerned with the treatment of other volunteer organizations. One rule should apply to similar groups. We believe that this is part of a larger problem that should be resolved in the proper context.

b. Increase deferred compensation limit for group medical practices

Comment. We do not agree with this provision because it creates a special limit/windfall for a highly paid group.

c. Require individual ownership of plan assets

Comment. We do not agree with this provision. We believe that plan participants for all pension plans should be treated similarly. In addition, treatment of tax-exempt organizations should be more comparable to taxable entities. An alternative would be to insulate plan assets from business creditors.

10. Provisions relating to individual retirement arrangements (IRAs)

a. Permit tax-free rollover of certain severance payments

Comment. We agree with this provision if a small limit is placed on the amount of the roll-over. Another option is to establish a safe harbor formula with no test on utilization. The payments would only be offered to a group that meets effective availability testing.

b. H R 682 (the "Savings and Investment Incentive Act of 1995")

Comment. We are opposed to the provisions in H.R. 682 for the following reasons: (1) tax-free nondeductible IRAs may negatively affect retirement savings; (2) expanding spousal deduction limits may not be effective, and it may be preferable to relax the rules for 401(k) plans; (3) tax-free distributions from tax-sheltered retirement income accounts are counterproductive to saving for retirement. In general, we oppose arrangements that could be harmful to society by giving individuals the perception that their retirement savings can be used for anything other than retirement income.

11. Treatment of Indian tribal governments under Section 403(b)

Comment. We agree that Section 403(b) needs to be addressed. On the basis of simplification and clarity, we recommend a repeal of Section 403(b), with appropriate transition rules, and an extension of 401(k) privileges. We support permitting tax-exempt organizations to maintain 401(k) plans, along with appropriate rules to transfer 403(b) contributions to a 401(k) plan.

12. Special rules for church pension plans
Comment. While we generally believe that all pension plans should be treated uniformly, our committee could not achieve consensus regarding church plans. However, if vesting requirements for church plans are changed we suggest using current vesting requirements, rather than the original ERISA vesting requirements.

B. EMPLOYEE BENEFITS

1. Tax treatment of certain disability benefits for police and fire fighters

Comment. We believe that employee benefits should have uniform rules. Therefore, we do not agree with these provisions unless they apply to all similarly situated participants.

2. Exclude from income retirement benefits that an employee elects to use to purchase employer-provided accident or health care

Comment. We do not agree with this provision. Allowing retirees to purchase accident or health care on a pre-tax basis adds another tax preference to health care spending These types of provisions distort health care pricing and increase the disadvantages of retirees whose employers do not sponsor post-retirement health care.

3. Modify restrictions on golden parachute payments

Comment. We do not have specific comments on this provision but recommend that any changes in the law be made either for pure simplification purposes or in the context of retirement income policy.

4. Employee housing for certain medical research institutions

Comment. We do not have specific comments on this provision but recommend that any changes in the law be made either for pure simplification purposes or in the context of retirement income policy.

II. Possible Modifications to Simplification Provisions Contained in H.R. 3419 (103rd Congress)

2. Pension Simplification

a. Tax-exempt organizations eligible under Section 401(k)

Comment:. We believe that tax-exempt organizations should be eligible for 401(k) plans. In addition, we believe that if a tax-exempt organization has a 401(k) plan, it should not be allowed to have a 403(b) plan (and vice versa). We do not support the proposal to eliminate Section 457 for tax-exempt organizations, unless they have the same ability to set up non-qualified deferred compensation excess benefit plans for their top-hat employees as taxable organizations.

b. Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions

Comment:. We are in favor of this provision, and recommend that it go a step further by eliminating simplified employee pensions (SEPs). We have witnessed excessive abuse in SEPs. If SEPs are created because qualified plan administration is too complex, then rules regarding plan administration should be simplified for all plans.

c. Full-funding limitation of multiemployer plans

Comment. We believe that the 150% full-funding limit should be eliminated for all plans and not merely for one class of plans. See cover letter for further comments on this provision.

d. Alternative full-funding limitations

Comment. We believe that the 150% full-funding limit should be eliminated for all plans and not for only one class of plans. See cover letter for further comments on this provision.

e. Special rules for plans covering pilots

Comment. While we do not agree with the exact provision (because there should not be special rules for pilots), we agree with the concept that there should not however, be a distinction between collectively bargained groups or those that are not collectively bargained groups.

f. Treatment of employer reversions required by contract to be paid to the United States

Comment. We agree that there should be no excise tax (or income tax) on the reversion that goes to the Federal government and not to the sponsoring employer.

g. Continuation of health coverage for employees of failed financial institutions

Comment. If the Resolution Trust Corporation does not provide any health coverage to continuing active employees of a bank during its wind-up activities, then we agree that coverage, even under COBRA rules, should not be required. However, if the RTC does provide extended coverage to any active employees, then the RTC should be subject to the same COBRA continuation rules as any other employer.

h. Clarify relationship between community property rights and retirement benefits

Comment. Clarification is generally good, but we would like to know more about the specifics of this provision, since we have not observed a need to further "clarify" these requirements. Furthermore, we suggest consideration of eliminating the complex QJSA, QPSA, and QDRO rules in favor of providing one-half of each years accrual to the spouse, as long as it does not become too complex as well.

ERIC

STATEMENT OF THE ERISA INDUSTRY COMMITTEE

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

OF THE U.S. HOUSE OF REPRESENTATIVES

AT ITS HEARINGS ON

MISCELLANEOUS TAX REFORMS

JULY 11 and 12, 1995

The ERISA Industry Committee (ERIC), is pleased to present this statement regarding certain of the employee benefit provisions that are included in the tax simplification measures now under consideration by the Committee.

We applaud the Committee for again considering simplification of the Internal Revenue Code's employee benefit provisions, and we are pleased that Congressmen Portman and Cardin have introduced H.R. 2037, the "Pension Simplification Act of 1995." We look forward to working with the Committee and its members on simplification of the law governing employee benefit plans.

Although much of the discussion regarding simplification of the Code's employee benefit provisions has focused on the burdens these rules impose on small businesses, the burdens on large employers are no less onerous. While economies of scale sometimes allow large employers to achieve lower *per capita costs* than small firms, major employers' *total costs* are staggering and are mounting rapidly, largely as a result of the costs of complying with layer upon layer of complex and restrictive legislation and regulation. A recent study commissioned by the Pension Benefit Guaranty Corporation showed that, adjusted for inflation, annual pension administration costs for very large plans (10,000 or more participants) increased by a breathtaking *176%* in constant dollars over the 10-year period from 1981 to 1991.

This statement addresses only certain of the employee benefit simplification measures now under consideration. We may address other proposals in supplemental submissions to the Committee.

THE ERISA INDUSTRY COMMITTEE

The ERISA Industry Committee is an association of more than 125 of thetion's largest employers concerned with national retirement and welfare benefit issues. As the sponsors of pension, savings, health, disability, life insurance, and other welfare benefit plans covering millions of participants and beneficiaries, ERIC's members share with this Committee a strong interest in the success and expansion of the employee benefit system in the private sector.

VOLUNTARY EMPLOYEE BENEFIT PLANS

Major employers provide pension, savings, health, disability, life insurance, and other important benefits to their employees through voluntary employee benefit plans. Although employers are not required to provide benefits to their employees, voluntary employee benefit plans have been remarkably successful in delivering needed pension and welfare benefits to millions of employees and their families and dependents. For example, in 1993, employer-sponsored retirement plans paid $319 billion in benefits, and payments from such plans have for the past several years exceeded annual payments from the Social Security Old Age and Survivors fund.[1]

OVERREGULATION OF VOLUNTARY EMPLOYEE BENEFIT PLANS

Today employee benefit plans are subject to layer upon layer of legislation and regulation. From 1982 through 1994 Congress enacted statutes in almost every year to change the laws affecting pension, savings, and other employee benefit plans. The legislation was motivated primarily by a desire to raise revenue and to eliminate any conceivable potential abuse, with little consideration being given to the adverse effects that the mounting regulatory burden would have on voluntary employee benefit plans, including those that operate on an entirely equitable and responsible basis.

The result has been that plans have become more and more entangled in a regulatory jungle, and less and less able to provide benefits to employees efficiently and effectively. Many employers have terminated existing plans, while others have elected not to establish new plans. The percentage of civilian workers at establishments offering a pension plan grew steadily from less than 20% in 1940 to 56% in 1979, but has remained stagnant at 57% from 1988 through 1993.[2] The employers that continue to maintain plans must invest increasing amounts of time and resources in regulatory compliance, and less and less in benefits that employees and their families actually receive. Dollars that otherwise would be devoted to benefits have been diverted to compliance with the mounting regulatory burden.

If voluntary employee benefit plans are to continue to have a major role in providing critical benefits to employees and their dependents, this Committee must take a hard look at the most burdensome laws and regulations and ask the key questions: What do these rules accomplish? What are the costs imposed by these rules? Do they follow sound policy objectives that can be achieved in simpler, less burdensome ways? Are these rules really necessary?

COMMENTS ON SELECTED SIMPLIFICATION PROPOSALS

We present below our comments on certain of the employee benefit simplification measures now under consideration. We may address other proposals in supplemental submissions to the Committee.

1. **Repeal of the § 415(e) combined limit.**

   This proposal would repeal the benefit and annual addition limits that apply to employees who participate in both defined benefit and defined contribution plans maintained by the same employer.

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[1] *EBRI Databook on Employee Benefits, Third Edition*, Employee Benefits Research Institute, pp. 14 and 206-7.

[2] *EBRI Databook*, pp.69-70; and *Trends in Pensions 1992*, U.S. Department of Labor, Pension and Welfare Benefits Administration, edited by John Turner and Daniel Beller, p. 75.

ERIC supports this proposal. The combined limit is extraordinarily complex and extremely difficult to administer. Employees find the rule incomprehensible and its difficulty of execution far exceeds any policy objective. Thus, it is the type of unduly burdensome requirement that contributes to the excessive administrative cost and complexity inhibiting the growth of plans.

2. Reform of the leased employee rules.

While some proposals would improve the definition of a "leased employee," others would alter the safe harbors under the leased employee provisions.

ERIC supports changing the definition of a "leased employee." Specifically, ERIC supports the provisions in H.R. 3419 (103rd Congress) and H.R. 2037 (104th Congress) that would replace the complex and inadministrable "historically performed" test in current law with the simpler "significant direction or control" test. ERIC also believes that these provisions would be improved by using a "primary direction or control" test in lieu of the "significant direction or control" test and by extending the one-year period in the current statute to two years. ERIC does not support the approach of reforming the leased employee rules by amending the statutory safe harbors; that approach fails to deal with the heart of the problem: the current definition of a "leased employee."

3. Bar State source taxes on deferred compensation.

Under State source tax laws, retirees can be taxed on the same income by multiple jurisdictions. As a result, retirees, employers, and plan administrators face intractable recordkeeping, allocation, and apportionment problems. Unless States are prohibited from taxing nonresidents on their retirement income, increasing numbers of retirees will be overtaxed, and more and more retirees, employers, and plan administrators may be forced to endure an endless and mind-boggling tax-accounting nightmare.

ERIC supports H.R. 394, which addresses these problems by prohibiting any State from imposing an income tax on the retirement income of an individual who is not a resident or domiciliary of that State. ERIC prefers H.R.394 to proposals to deny federal tax information to States imposing source taxes; H.R.394 addresses the problem directly and ensures that employers and employees will not at any time be faced with the need for records that do not exist and that cannot be constructed.

4. Repeal of the $150,000 compensation limit.

OBRA 1993 reduced the maximum compensation that may be taken into account under a tax-qualified pension, profit-sharing, or savings plan from $235,840 to $150,000, beginning in 1994.

ERIC supports repeal of the $150,000 limit. The OBRA reduction in the dollar limit was a mistake. The new, lower limit reduces plan funding and national savings, causes more and more employees to receive benefits from unfunded nonqualified plans, and reduces retirement security.

5. Modify notice, consent, and waiting-period requirements.

In general, under current law, an employee can start to receive pension benefits only after the plan and the employee comply with an elaborate and technologically obsolete series of notice, consent, and waiting-period requirements.

ERIC proposes that Congress allow distribution notices to be provided by electronic or telephonic media as long as the employee can obtain a copy of the written notice upon request. ERIC also supports other changes in the notice, consent, and waiting-period requirements; ERIC believes that these additional reforms can be effected by regulation and hopes that the Committee will encourage the Treasury to act promptly on ERIC's proposals.

6. **Allow excess pension assets to fund certain benefits**.

Because of the restrictive § 415 limits, a growing number of employees have a portion of their retirement benefits paid from unfunded ERISA excess benefit plans.

ERIC proposes that Congress allow the excess benefits of retirees to be transferred to the underlying qualified plan if the qualified plan would still be at least 125% funded after the excess benefits are transferred to the qualified plan. This proposal would have a positive impact on federal revenues.

7. **Simplified definition of highly compensated employee**.

Some proposals would treat an employee as highly compensated if he or she earns $66,000 or more, without regard to whether the employee is in the top 20% of the payroll; other proposals would eliminate the 20% test but increase the dollar threshold to $80,000.

ERIC opposes elimination of the 20% test. However, ERIC is considering whether setting the dollar threshold at $80,000 (as in H.R. 2037), rather than at $66,000, adequately addresses ERIC's concerns about the elimination of the 20% test.

8. **Repeal of the family aggregation rule**.

This proposal would repeal the cumbersome and burdensome rules under which employees who are members of the same family must be treated as though they are a single employee for purposes of certain tax qualification requirements.

ERIC supports this proposal. The family aggregation rule complicates nondiscrimination testing and unfairly penalizes family members who work for the same firm.

9. **Elimination of the § 401(a)(26) minimum participation rule for defined contribution plans**.

Some proposals would eliminate the minimum participation requirement for defined contribution plans and apply the requirement only to defined benefit plans.

ERIC supports this proposal. The minimum participation rule is designed to prevent individual defined benefit plans from being used to favor highly compensated employees over nonhighly compensated employees. Since such problems do not arise under defined contribution plans, there is no reason to apply this rule to defined contribution plans.

10. **Safe harbors and use of prior year data under § 401(k) & § 401(m).**

The safe harbor proposals would exempt plans falling within certain safe harbors from § 401(k) and § 401(m) nondiscrimination testing. The prior year data proposal would require plans to apply the § 401(k) and § 401(m) nondiscrimination tests on the basis of the contributions made for nonhighly compensated employees for the *preceding* year.

ERIC supports the safe harbor proposals. Although few major employers are likely to use the safe harbors, ERIC supports the safe harbors because they will help to expand the number of employees covered by retirement savings plans.

ERIC supports the use of prior year data only if the plan is permitted to elect to use current year data instead. The rate at which employees contribute to plans and the rate at which the employer matches employee contributions can vary markedly from year to year, especially in cyclical industries. It is inappropriate to impose limits based on the plan's experience in a year that differs markedly from its experience in the current year. The most sensible approach is to allow a plan to use its data for either the current year or the prior year, at the plan's option.

11. **Simplify the taxation of annuity distributions.**

This proposal would simplify the basis recovery rules for contributory plans that distribute benefits in the form of an annuity by providing that the simplified IRS-approved *alternative* method will be the *required* method.

ERIC supports this proposal. This proposal will significantly simplify the rules that determine the portion of the annuity payment that is taxable and the portion that is not.

12. **Reform of the § 401(a)(9) minimum distribution rules.**

This proposal would eliminate the requirement that distributions start at 70½ regardless of whether the employee has retired, except for distributions to 5% owners and distributions under IRAs. In all other cases, distributions would not be required to start until April 1 following the later of the year in which the employee reaches 70½ or the year of retirement. However, if the plan postpones the start of distributions beyond 70½, the employee's benefits would be required to be actuarially increased.

ERIC supports this simplification because it largely eliminates the requirement that a plan start paying benefits to an employee who is still working.

13. **Reform of the alternative full funding limit.**

This proposal would authorize the Secretary of the Treasury to give employers flexibility in determining the full-funding limit.

ERIC supports this proposal only if it does not authorize the Treasury to reduce the full-funding limit for other employers. ERIC supports the proposal to the extent it allows the Secretary to increase the full-funding limit for certain plans, including newly established plans. However, ERIC opposes any provision that allows the Secretary to "balance" any such increase with a reduction in the full-funding limit for other plans. This would be the equivalent of "robbing Peter to pay Paul" and would erode the retirement security of those employees who participate in the plans for which the full-funding limit is reduced.

14. **Clarification of the affiliated employer rules for VEBAs.**

Some proposals would clarify that employers in the same line of business may establish a voluntary employees' beneficiary association (a "VEBA").

ERIC supports clarification of current law for employers in all industries. We are concerned that § 506 of H.R. 2037 applies only to employers in certain industries and that it is therefore drafted too narrowly. We support applying this clarification of current law to *all* employers, not just to employers in selected industries.

15. **Facilitate contributions for disabled employees.**

This proposal would simplify the law and encourage employer contributions to defined contribution plans on behalf of disabled employees by eliminating the need for an employer election and by allowing contributions for both highly compensated and nonhighly compensated employees.

ERIC supports this proposal. It would simplify and rationalize current law.

16. **Modify the definition of uniform retirement age.**

This proposal would provide that for nondiscrimination testing purposes, the Social Security retirement age is a uniform retirement age.

ERIC supports this proposal. The proposal would make the nondiscrimination rules more consistent with the Social Security rules.

17. **Eliminate excise tax on certain reversions to government contractors.**

Under this proposal, amounts that government contracting rules require to be paid to the United States are exempt from the reversion excise tax.

ERIC supports this proposal. The proposal would prevent a government contractor from being required to pay an excise tax on funds that must be paid over to the United States. ERIC opposes eliminating this provision from H.R. 3419.

18. **Reform the separate line of business rules.**

In their present form, the separate line of business rules are excessively complicated and burdensome. As a result, the separate line of business rules are useless to most employers with multiple lines of business -- the very employers to which the separate line of business rules were designed to apply.

ERIC supports reform of the separate line of business rules. ERIC looks forward to working with the Committee and its staff on these much-needed reforms.

19. **Modify the interest rate mandated by the Retirement Protection Act for purposes of § 415.**

Under the IRS interpretation of the Retirement Protection Act, in the case of a benefit subject to § 417(e)(3) (such as a lump-sum distribution), t e 30-year Treasury rate must be used both to make the adjustment for opt nal forms of benefit and to make the adjustment for early tirement (retirem it before age

62) By contrast, the early retirement adjustment for other forms of benefit (such as a life annuity or a qualified joint and survivor annuity) is made on the basis of a rate that is no less than the greater of 5% or the rate specified by the plan.

If the 30-year Treasury rate is used for reductions of benefits subject to § 417(e)(3) that are paid before age 62, the § 415 limit for lump sums paid before age 62 will not be actuarially equivalent to the § 415 limit for other forms of benefit that start before age 62. Thus, the IRS interpretation causes widely varying §415 limits to be imposed on similary situated employees, depending on the form in which they elect to receive their benefits.

ERIC proposes legislation that would make clear that the 30-year Treasury rate is to be used only for purposes of making the adjustment for optional forms of benefit and not for purposes of the pre-62 early retirement adjustment. It is confusing and irrational to apply a § 415 limit to one form of benefit that is not actuarially equivalent to the limit on other forms of benefit. If the employer does not maintain an excess plan, an employee could inadvertently lose a significant portion of his or her retirement benefit. ERIC's proposal differs from other proposals that were presented to the Committee at these hearings.

20. Allow permissive aggregation of represented and nonrepresented employees.

Under current law an employer is not permitted to aggregate its union-represented and nonrepresented employees for nondiscrimination testing purposes, even when both groups of employees participate in the same plan under the same general terms and conditions.

ERIC proposes that Congress adopt of a permissive aggregation rule under which an employer could elect to aggregate its represented and nonrepresented employees. Permissive aggregation would allow an employer to receive credit for the fact that it provides the same benefits to represented and nonrepresented employees.

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STATEMENT OF
THE SMALL BUSINESS COUNCIL OF AMERICA
BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON MISCELLANEOUS TAX ITEMS

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which sponsor retirement plans or advise small businesses which sponsor private retirement plans. The Small Business Council of America is fortunate to have substantial business and legal advisory boards which have tremendous depth of technical expertise in the qualified retirement plan system for small businesses. Our focus in this statement is exclusively on the pension simplification items.

The graying of America, and the burden that it will place on future generations, should not be ignored. The American Council of Life Insurance reports that from 1990 to 2025, the percentage of Americans over 65 years of age will increase by 49%. This jump in our elderly population signals potentially critical problems for Social Security, Medicare and our nation's programs designed to serve the aged.

While we must assure our citizens that Social Security and Medicare will remain strong and stable, private pensions, savings and private sources for retiree health care will have to play a more significant role for tomorrow's retirees. The savings that will accumulate for meeting this need will contribute to the pool of investible capital that will provide the economic growth needed to finance the growing burdens of Social Security and Medicare. But such savings won't be forthcoming in the face of the kinds of policy directions reflected by the Administration proposal.

Clearly a factor that is contributing to the stagnation of private pension and welfare plans is the unrelenting drive to suffocate our private benefits system with questionable costs due to increased burdens imposed by regulation.

Thus it is essential to understand how important it is for small business to simplify these technical compliance burdens so that small businesses are able to sponsor qualified retirement plans. The pension simplification provisions being discussed by the Administration would greatly assist small businesses in sponsoring retirement plans; similarly the Pryor-Hatch Pension Simplification Bill is desperately needed. But these must be seen as the beginning of a process to shore up the retirement plan system - more is needed.

The SBCA supports the following items in Pension Simplification:

1. **401(k) Safe Harbors**. *Optional safe harbors are the easiest and most cost effective way to make the retirement plan system user friendly*. For example, if a company makes a 3% contribution for all non-highly compensated employees, then the company no longer has to pay for the complex 401(k) antidiscrimination testing (nor does it have to keep the records necessary in order to do the testing). It is certainly true that many companies

would choose to stay outside the safe harbor because the 3% cost of admission is too high and because it is more cost-effective to stay with their current system (including software and written communication material to employees). Other employers, particularly small businesses, would embrace a voluntary safe harbor that does away with costly complex testing. This single change could very well prove to be enough of an incentive for companies to begin sponsoring a retirement plan. Also, it should be made clear that the second safe harbor takes the place of the top-heavy rules - if this were the case this would open up this safe harbor for small businesses also. The voluntary 401(k) safe harbors are contained in both the Pryor-Hatch bill and in the Administration's proposal. The Pryor-Hatch provisions are somewhat preferable to the Administration's, but either version is a whole lot better for small business than current law.

The look back rule for the ADP tests would also be a welcome change for small businesses that sponsor 401(k) plans and do not want to use one of the voluntary safe harbors. We would suggest that if such a look back rule is adopted that it should be voluntary.

2. **Repeal Family Aggregation.** These rules require a husband and wife and children under the age of 19 who work in the business together to be treated as one person for certain plan purposes. The family aggregation rules discriminate unfairly against spouses and children employed in the same business. There is no justification for them. The Pryor-Hatch and Administration proposals both call for a repeal of these unfair provisions.

3. **Repeal $150,000 Compensation Limit.** The $150,000 limit in 1974 (ERISA) dollars is about $53,800 (assuming 5 percent average inflation). This is far below the $75,000 that represented the highest amount upon which a pension could be paid under then-new Code Section 415. This cutback has hurt several groups of employees - owners and other key employees of all size businesses who make more than $150,000 and mid-range employees and managers (people making in the $50,000 to $70,000 range) who are in 401(k) plans and in defined benefit plans. Ultimately, it is essential for this country to do everything possible to encourage retirement plan savings so that individuals are not dependent upon the government for their retirement well-being. This cutback is perceived by key employees as one more disincentive in establishing a retirement plan.

4. **Change GATT Lump Sum Provisions.** Section 415 of the Internal Revenue Code limits the maximum single sum benefit allowed to be paid to a participant. The new GATT law requires that lump sum benefits be calculated using a 30-year Treasury rate rather than a stated interest assumption set out in the plan document. Small plans simply cannot fund properly for a moving target. When combined with a 50% tax for overfunding and a 10 to 100% tax for underfunding, this law works a real hardship on small to mid-size defined benefit plans. Some data suggests that the 30 Year Treasury Rate has approximately 80% of the volatility of the stock market. There is a workable solution - the law should be changed so that the lump sum distribution must be based on a set interest factor set forth in the plan (say between 6% to 8%) or the 30 year Treasury rate, provided the plan treats all participants the same.

5. **Repeal 401(a)(26) for Defined Contribution Plans.** The original intent of Congress was to limit this Code Section only to defined benefit plans. This repeal is included in both the Pryor-Hatch bill and the Administration bill.

6. **Repeal Top Heavy Rules.** These rules are virtually duplicative of other qualification requirements and all they do now is add complexity. In fact, they probably now operate primarily as a "trap for the unwary" for mid-size businesses at this point - this is because distributions to non-key employees do not count in the 60% test, but distributions to key employees do count for a five year period. Also, in most businesses the key employees tend to stay while non-key employees tend to move around more. No bill has this provision in it at this time. It would significantly simplify the retirement system with no detriment to any policy adopted by Congress during the last decade. (The only possible negative to repealing the top-heavy rules is if the compensation limit were restored to the pre $150,000 level, then the top heavy minimum could become meaningful under some plan designs.)

7. **Tax Credit For Establishing Qualified Retirement Plans.** A start up credit similar to that found in Senator Pryor-Hatch's bill is clearly an incentive for small businesses to begin sponsoring plans. Personal service organizations should not be excluded. It is not fair to distinguish between these companies and other small businesses and there is no reason why as a country we should not want to encourage retirement plan coverage for employees of a personal service organization as compared to any other small business.

8. **Repeal the 15 Percent Excise Tax or Repeal 415(e).** From a policy standpoint, perhaps the complexities of Code Section 415(e) are more bearable than the success penalties inherent in the excise tax. The repeal of 415(e) is currently contained in both the Pryor-Hatch Bill and the Administration's proposals.

9. **Repeal Code Section 401(a)(9) for Plans and IRAs.** The minimum distribution provisions are extraordinarily complicated with too many technical rules. This Code Section has outlived its business purpose since pension and IRA accounts are subject to estate taxes. The delay in benefit receipts is a self-correcting problem, since anyone foolish enough to not take lifetime pension or IRA distributions will be heavily taxed through the estate tax. This is not addressed in any simplification bill to date and appears to be a bold move. Upon reflection though, repeal of this section would probably not affect revenue or pension policy adversely. If such a repeal were accomplished, the simplification to the retirement system and the tax code would be enormous.

10. **Repeal OBRA '87 Current Liability (150 percent) Rule in IRC 412(c)(7).** This is a very technical issue, but basically defined benefit plans are not allowed to fund in a level fashion. Code Section 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current "termination liability." This is misleading because termination liability is often less that the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. In effect, current law inappropriately mortgages benefit promises by prohibiting the level funding that is the

reasonable way for plans to fulfill benefit obligations and, instead, requires plans to be funded with payments which escalate in later years. The full funding limitation should be based on ongoing (projected) liabilities, and not on termination liability.

11. **Simplify and Expedite the Prohibited Transaction Exemption Process.** This is in the Administration proposal and it is excellent.

12. **Simplify the Definition of Highly Compensated Employee and the Definition of Compensation.** The Pryor-Hatch Bill is the choice here except we would recommend the threshold be $100,000 and it should be irrelevant whether someone is a 5% owner of the company. We also believe that simplifying the definition of compensation for all purposes is desirable.

13. **Allow Employer Plans to be Established at the Same Time as SEP plans.** Plan documents should be allowed to be executed up to the due date of the employer's tax return, including extensions, instead of by the last day of the plan year. A similar rule already exists for SEPs.

15. **Change in 415 Definition of Compensation for Government Plans and Multiemployer Plans** - extend to all employers or do not change for anyone. Equity in the system - between public and private is important.

The NEST or the Pryor-Hatch Bill's changes to the SARSEP are fine. Money should be required to stay in the SEP for at least two years so that there is a chance the employee will keep it in the IRA for some length of time. Our advisors tell us that employees take out their SEP funds almost immediately and see a SEP as nothing more than a bonus plan. We do not believe that a SEP is as desirable to a company from the viewpoint of recruitment and retention of key and non-key employees for a small business. The SBCA believes that the 401(k) plan is a far more desirable plan in the long run than a SEP.

These few changes could dramatically improve the existing retirement plan system. By making the system user friendly, more small businesses would sponsor retirement plans. Easing administrative burdens would reduce the costs of maintaining retirement plans. The changes would revitalize the retirement plan system for small business. Finally, most of the substantive changes made by Congress over the last ten years would be retained and the time tested ERISA system would stay in place.

It is important for the Committee to understand that retirement plans sponsored by small businesses operate under a most stringent and complicated statutory and regulatory system. There are rules as to the rights of spouses, the amounts of contributions that must be given to non-highly compensated employees, limitations on contributions for key employees, required vesting schedules, etc., etc. These limitations and rules are now so complicated that the costs of sponsoring a retirement plan often outweigh the benefits that a small business can reasonably expect to obtain. By making the changes listed above, the cost/benefit ratio will be brought back into line and most of the suggested changes are

revenue neutral. The SBCA respectfully submits that these changes will dramatically improve the system.

This statement was prepared by Paula Calimafde, Esquire, Chair of the SBCA. She is also a practicing attorney in Bethesda, Maryland specializing in tax, pension and estate tax law. Much of her work is spent with family businesses as well as privately-owned, closely held businesses.

Allied Pilots Association

Statement to the

Committee on Ways and Means
United States House of Representatives

Miscellaneous Tax Reforms

Proposal To Repeal The OBRA 93 Provision Limiting Compensation Considered For Pensions To $150,000 As It Applies To Airline Pilots

Submitted by
James G. Sovich
President
Allied Pilots Association

July 27, 1995

INTRODUCTION. The Allied Pilots Association (APA) was founded in 1963 and is the recognized bargaining agent for more than 10,000 active pilots and retired pilots of American Airlines, Inc. In addition, APA represents over 1,500 pilots of Flagship Airlines, Inc. and Executive Airlines, Inc., wholly owned subsidiaries of AMR Eagle, Inc.. APA is headquartered in Arlington, Texas and is governed through a Board of Directors and three National Officers who are elected by the membership.

APA thanks the Committee on Ways and Means for allowing it to comment on an issue that will have a significant impact on its members. For the reasons which follow, APA strongly supports the limited repeal of the $150,000 limitation (**Pay Cap**) placed on earnings allowed to be considered under a qualified pension plan (**Pensionable Earnings**) as enacted under the Omnibus Budget Reconciliation Act of 1993 (**OBRA 93**) for plans that are established and maintained pursuant to collective bargaining under the Railway Labor Act. While APA feels that no earnings limit should be imposed on pension plans that are maintained through the collective bargaining process, the reduction in the earnings limitation due to OBRA 93 poses a significant threat to the retirement security of our membership and a potentially large liability for the Pension Benefit Guaranty Corporation (**PBGC**) in an industry not known for its stability.

STATEMENT IN SUPPORT OF LIMITED REPEAL OF OBRA 93 PAY CAP. The legislative reform supported by APA does not exempt pilots from any limit on Pensionable Earnings, but restores the limit on Pensionable Earnings to the pre-OBRA 93 maximum, indexed in increments of $10,000 for inflation. The impact of the proposed legislation on the Federal budget is *de minimis*. While an updated analysis has been requested, the Joint Committee on Taxation of the United States Congress in their letter of May 5, 1994, estimated the reduction to Federal fiscal year receipts to be "less than $10 million over the 1994-1999 budget period." (Exhibit I). APA has estimated that this provision will affect over 2,000 American Airlines pilots when it becomes effective following the ratification of our next contract.

BACKGROUND. By way of background, qualified pension plans are governed by numerous requirements established by Congress, the Internal Revenue Service (**IRS**) and the Department of Labor (**DOL**). Through their laws and regulations, most aspects of qualified pension plans are governed in substantial detail (e.g., participation and vesting requirements, anti-discrimination requirements, timing and amount of benefit payments, etc.). Several sections of the Internal Revenue Code (**Code**) limit both benefits payable from, and contributions made to, a qualified pension plan (e.g., Sections 401(k), 401(m), 402(g), 412, 415, et. al.).

While most of these provisions have been in effect since the Employee Retirement Income Security Act of 1974 (**ERISA**), a limit on Pensionable Earnings is a relatively recent development. Until the passage of the Tax Reform Act of 1986, there was no limit, except for self-employed individuals, on the amount of Pensionable Earnings under a qualified pension plan. The Tax Reform Act of 1986 (TRA 86) first introduced a limit on Pensionable Earnings effective January 1, 1989, for most plans by amending Section 401(a)(17) of the Code. Under TRA 86, the limit was initially established at $200,000 and indexed annually for changes in inflation as measured by the Consumer Price Index (**CPI**).

OBRA 93 amended Section 401(a)(17) of the Code to reduce the limit on Pensionable Earnings to $150,000, indexed in increments of $10,000 for inflation beginning in 1995. The OBRA 93 limit applied to most qualified pension plans effective January 1, 1994. OBRA 93, however, delayed the effective date for any plan maintained pursuant to collective bargaining under the Railway Labor Act which was in effect on the date OBRA 93 was enacted until the first plan year following the ratification of the next collective bargaining agreement, the ratification of an extension of the current collective bargaining agreement, or January 1, 1997, whichever comes first.

When introduced by TRA 86, the limit on Pensionable Earnings was established to address two primary concerns: (1) reducing the Federal deficit and (2) limiting benefit accruals and\or contributions which significantly favored highly-compensated individuals under small, non-union qualified pension plans.

APA'S REASONS FOR SUPPORT. The following presents the reasons APA supports a limited repeal to the pre-OBRA 93 limit for any qualified pension plan whose employees negotiate pension benefits with their employers pursuant to collective bargaining under the Railway Labor Act. Since APA represents the airline pilots of American Airlines, much of the comments will address this issue from the pilot's perspective.

Reduced Pension Security. When enacted in 1974, ERISA was one of the most controversial acts ever passed by Congress. It reshaped the realm of employee benefits in the United States. One of the most sacred of its tenets was pension security for the participant and the participant's family. Among the numerous changes ERISA made to ensure benefit security was the requirement to maintain pension plan assets in a separate trust from company funds.

Under the OBRA 93 Pay Cap, the pensions of pilots whose earnings exceed the limit will be less secure since they will either be permanently lost or paid from a non-qualified pension plan. In order to restore the level of pension benefit, a non-qualified pension plan will be required. Unlike payments from a qualified pension plan which are made from a separate trust, payments under a non-qualified pension plan are usually made from the general assets of the company. (While many companies currently use non-qualified pension plans, these types of plans are better suited for executives since

they are usually part of an individual employment contract established to reward the executive if the company is successful.) Since payments are usually made from the company's general assets, utilizing a non-qualified pension plan means that a portion of the pension benefit is subject to the company's continuing ability to pay -- a true risk in the airline industry. This erodes one of the most fundamental tenets of ERISA -- *Pension Security*.

Increased Financial Risk to the PBGC. Another measure established by ERISA to help ensure pension security was the establishment of a program for defined benefit pension plans which guarantees pension benefits up to a maximum level. This program is administered by the Pension Benefit Guaranty Corporation (**PBGC**). Under this program, pension plans must pay an annual premium to the PBGC which guarantees each plan participant's pension benefit up to a maximum monthly amount. When a plan terminates with pension assets less than the amount needed to cover plan liabilities, the PBGC assumes the pension liability and pays each plan participant's benefit up to the maximum monthly pension benefit. For 1995, the maximum monthly pension benefit is $2,573.86 per plan participant.

Even under the OBRA 93 Pay Cap, most pilot pensions exceed the maximum monthly pension benefit guaranteed by the PBGC. Thus, the Pay Cap under a pilot pension plan will not significantly affect the liability to the PBGC. However, the Pay Cap will impact the size of the trust fund and the amount of funds that will be available to pay benefits in the event of plan termination. Under prevailing Code provisions, the OBRA 93 Pay Cap will reduce the amount of compensation that can be used to determine the company's contribution under the pension plan. Since airlines have based their contributions on higher projected compensation in previous years, their pension plans will appear overfunded and result in significantly lower contributions in the years immediately following the effective date of the OBRA 93 Pay Cap. With lower allowable contributions, pension plans will not be able to build the same level of fund reserves as they did before the OBRA 93 Pay Cap.

In the event of plan termination, the rules change. Plans can no longer use the long term interest rates and other valuation assumptions that they used to fund an ongoing plan. The interest rates and other assumptions required by the PBGC for a terminating plan are generally much lower than the long term interest and discount rates used for funding an ongoing pension plan. These lower rates produce substantially higher benefit present values and thus, create a larger liability for the trust fund. This could pose a serious threat to the financial security of the PBGC.

For example, consider the American Airlines defined benefit pension plan for pilots. American Airlines provides one of the lowest, if not the lowest, pension benefit from a defined benefit pension plan within the industry. American Airlines also claims to have one of the best funded pension plans in the industry. According to the 1994 actuarial valuation report, the "Present Value of Accumulated Plan Benefits [was] 115.7% funded as of January 1, 1994."

However, on a plan termination basis, our actuaries estimate that the pilot pension plan is only 80% funded. In addition, they have estimated that the assets of the American Airlines' defined benefit pension plan for pilots are expected to be $110.2 Million less than they would have been for the first five years following the effective date of the OBRA 93 Pay Cap limitation. (This reduction in assets is due solely to the effect of the Pay Cap limitation.) When coupled with no decrease in the maximum pension benefit that the PBGC would have to pay if the American Airlines pilot pension plan were terminated, this decrease in plan assets increases the potential exposure to the PBGC, on a plan termination basis, by an estimated $83.3 Million over the first five years. (Exhibit II). PBGC exposure for each defined benefit pension plan of the other

airlines is likely to be at least as great as American's plan.

Thus, in the event of the termination of a pension plan covering airline pilots, less money will be available in the pension trust to pay benefits with virtually no reduction in the maximum benefit payable by the PBGC creating a significant additional financial exposure. When considering the different airlines within the industry (e.g., their financial stability, the funded status of their pension plans, among others) and the possibility that an airline will voluntarily, or involuntarily, terminate its pension plan, it appears to us to create a significant additional exposure and risk to the PBGC for a *de minimis* reduction in the Federal fiscal year budget.

De Minimis Revenue Impact. As previously cited, the Joint Committee on Taxation of the United States Congress evaluated the proposed impact of exempting collectively bargained pension plans from the Pay Cap limitations of OBRA 93. In their letter of May 5, 1994, they estimated "the proposal would reduce Federal fiscal year receipts by less than $10 million over the 1994-1999 budget period" (Exhibit I). This impact, less than $2 Million per year for *ALL* commercial airlines, is *de minimis* when the potential impact to the PBGC of an estimated $83.3 Million for American Airlines *alone* for the same period is considered.

Career Limitations of Airline Pilots. Airline pilots are a highly skilled work group. To continue in their chosen profession, airline pilots must pass rigorous medical examinations annually (first officers) and semiannually (captains and international officers) and maintain high technical skill levels through extensive recurrent training. Due to these requirements, careers for some pilots are shortened due to disabilities that, for people in other occupations, would be an inconvenience and not end a career. In addition, commercial airline pilots cannot continue their careers beyond a federally-mandated retirement age.

The obvious purpose of these extraordinary requirements is to ensure the safety of the passenger. While we fully support the purpose of these standards, airline pilots do not have the option, which is available in most other occupations, of continuing their careers to offset the pension reduction resulting from this OBRA 93 change.

Precedents for Exemptions on Benefit Issues. The limited repeal of the OBRA 93 Pay Cap which APA supports would not be the first time that an exception has been made. The Code contains several exceptions for employee benefit plans that are maintained through collective bargaining and some exceptions for plans covering airline pilots. These exceptions occur in key provisions of the Code such as:

- Discrimination (Code Section 401(a)(4) and IRS Regulation 1.401(a)(4)-2(a)(1)(c)(5)),

- Coverage requirements (Code Sections 410(b)(3)(A) and 410(b)(3)(B) and IRS Regulation (1.410(b)-2(b)(7)), and

- Benefit accruals and limitations (Code Sections 415(b)(7) and 415(b)(9) and IRS Regulations (1.401(k)-1(g)(11)(ii)(B) and 1.401(m)-1(a)(3)).

Code Section 505(a)(2) even excludes Voluntary Employees' Beneficiary Associations (VEBAs) that are maintained pursuant to a collective bargaining agreement from the Pay Cap limitation under Section 505(b)(7).

While there are many more citations that could be made, exceptions for collectively bargained benefit plans exist in recognition of the fact that benefits are the products of good faith negotiation. Through this give-and-take process, companies and

employee representatives reach agreement on working conditions which include pay and benefits. Through collective bargaining, APA over the years has given up pay and other issues to retain the level of pension benefits currently enjoyed by its retiring members. The Pay Cap limitations under OBRA 93, however, unintentionally undermined this process by forcing a reduction in these benefits.

Currently, the collective bargaining agreement between APA and American Airlines is amendable. APA is currently negotiating with American Airlines on several issues. Restoring the level of the pension benefits lost due to the OBRA 93 Pay Cap is one of the major issues in our current round of negotiations. The limited repeal of the OBRA 93 Pay Cap limit, as proposed in this tax reform package, would put us one major step closer to an agreement.

CLOSING REMARKS. APA, again, wishes to thank the members of the Committee on Ways and Means for providing the opportunity for us to comment on an issue that is significant to our members. We feel there is sufficient justification for this limited repeal based on the facts presented in this document. We feel that the additional risk exposure to the PBGC alone ($83.3 Million for American Airlines only) presents a compelling reason to repeal this OBRA 93 Pay Cap limitation and restore the pre-OBRA 93 Pay Cap for pension plans maintained pursuant to collective bargaining under the Railway Labor Act.

Exhibit I

Congress of the United States

JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

MAY - 5 1994

Honorable Peter Hoagland
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Hoagland:

This is in response to your request dated April 6, 1994, for a revenue estimate of a proposal that would exempt collectively bargained pension plans for pilots from the $150,000 cap on the level of compensation used to determine future benefits under qualified pension plans.

The Omnibus Budget Reconciliation Act of 1993 reduced the compensation taken into account for qualified retirement plan purposes. The limit on compensation taken into account under a qualified plan (section 401(a)(17)) was reduced to $150,000. The limit is indexed for inflation in increments of $10,000 on an annual basis. Corresponding changes were made to other provisions (sections 404(l), 408(k)(3)(C), (6)(D)(ii), and (8), and 505(b)(7)) that take into account the section 401(a)(17) limit.

The proposal would exempt collectively bargained pension plans for pilots from the limit. The proposal would be effective for plan years beginning after December 31, 1992.

We estimate that the proposal would reduce Federal fiscal year receipts by less than $10 million over the 1994-1999 budget period.

I hope this information is helpful to you. If we can be of further assistance, please let me know.

Sincerely,

John L Buckley

John Buckley

Exhibit II

American Airlines, Inc.
Pilot Retirement Benefit Program
Fixed Income Plan

Forecast of Estimated Impact of New GATT Rules
on PBGC Liabilities and Premiums
(In millions of dollars)

	Year 1	Year 2	Year 3	Year 4	Year 5*
A) Reduction in projected plan assets due to reduced minimum required contribution under IRC Section 412:	$18.0	$37.9	$59.7	$83.7	$110.2
B) Increase in PBGC premiums due to the GA83 Mortality Table and premium phase-out rules:	$ 1.2	$ 4.4	$ 8.5	$ 9.7	$ 10.3
C) Reduction in PBGC current liability due to pay cap limitation	$ 2.4	$ 5.7	$ 9.7	$13.6	$ 16.6
D) Total Increase in PBGC Liability (A-B-C):	$14.4	$27.8	$41.5	$60.4	$ 83.3

Assumptions:

Discount rate used to calculate PBGC liability: 5.0%

Rate of return on assets: 10.%

CPI: 3.0%

Additional Current Liability estimated assuming a 10% increase due to mortality table change.

All other assumptions same as January 1, 1992 actuarial valuation report as follows:

Mortality: Healthy lives: 1983 Group Annuity Mortality table
Disabled lives: 1971 Group Annuity Mortality table

Discount Rate: 10.00%

Investment Return: 10.00%

Current Liability Rate: 9.26%

Turnover: Specimen annual rate are as follows:

Age	Rate
30	1.9%
40	0.9%
50	0.4%
60	4.0%

In addition, the rates above are increased 100% during the first year of plan participation and 50% during the second year of plan participation.

Disability: The disability rates used are 75% of the 11th Retirement Board Disability Rates.

Future Salaries: Graded salary rates by age. Specimen annual rate are as follows:

Age	Increase in Year Following Age Specified
25	17.5%
35	11.5%
45	5.5%
55	4.5%
60	4.0%

Retirement Age: It is assumed that Pilots will retire, on average, at age 60.

Percent Married: For purposes of valuing the pre-retirement surviving spouses benefit, it is assumed that 80% of all employees are married at the time of death.

Cost Method: Projected Unit Credit Actuarial Cost Method.

Asset Valuation: Three Year Moving Market Value.

* Year 5 amounts are estimated based on patterns in years 1 through 4.

ARTHUR ANDERSEN
ARTHUR ANDERSEN & CO, SC

January 20, 1995

ADDRESS:
American Council of Life Insurance
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2599

DATE OF HEARING:
July 11 and 12th

HEARING ON MISCELLANEOUS TAX REFORMS

This statement addresses provisions in the list of miscellaneous tax reforms that affect employer sponsored pension plans

This statement is submitted on behalf of the American Council of Life Insurance (the "ACLI"). The ACLI is the major trade association of the life insurance business. Its 606 member companies have, in the aggregate, 89% of the assets of all life insurers in the United States and account for more than 93% of the funds related to all pension business with insurance companies.

The ACLI commends you for holding hearings on miscellaneous tax reforms including provisions that would significantly strengthen the nation's private retirement system. We think the future of that system is one of the most critical issues of our time, particularly in light of the impending retirement of the "baby boom" generation. Employer sponsored retirement plans are a critical component of an individual's retirement income as well as an important element of our national savings and capital formation. These plans have a track record of being an effective tool to utilize in meeting the nation's retirement needs.

That is why we applaud your willingness to hold hearings to discuss, among other matters, provisions which would encourage employers that do not currently maintain a pension plan to adopt a plan and for employers that have adopted plans to continue to maintain those plans for their employees. ACLI strongly supports any provision that furthers the goals of expanding pension plan coverage and maintaining stability in the existing pension plan universe.

We highlight the following pension provisions included in the Committee's list which meet these goals by reducing the costly administrative burdens placed on employers that sponsor pension plans thereby encouraging the formation and continuation of these plans for American workers.

- Repeal of the special nondiscrimination tests for qualified cash or deferred arrangements
- Repeal of the top-heavy rules
- Repeal of the OBRA '93 provision limiting compensation taken into account to $150,000.

In a nutshell, the ACLI believes that, unless things change significantly over the next decade, the baby boom generation will not have adequate funds to enjoy a comfortable, secure retirement. An Employee Benefit Research Institute Public Attitudes Survey regarding retirement age and planning confirms that most baby-boomers do not realize how long they will spend in retirement. Fully one-third of people surveyed who had not yet retired have not even begun to save for retirement. In part, this lack of preparation for retirement has been due to the mindset of the baby boom generation during the 1980s. People were consumption-oriented, and the United States' personal savings rate reached an all-time low of 4.9%. But beyond this consumption mentality, there existed (and still exists) a variety of other forces that have resulted in a less-than-adequate level of personal savings in general and retirement savings in particular. These forces are described in detail later in this statement. However, we wish to highlight one of these forces now - the substantial legislative and regulatory burdens placed upon employer-sponsored retirement plans over the past 20 years, since the enactment of ERISA. The continual legislative change has both hindered the growth of and fostered the termination of many employer-sponsored plans, which we believe to be the back-bone of the retirement system.

America Needs a Vibrant Pension System

The graying of America, and the burden it will place on future generations, is perhaps the most significant trend of our time. From 1990 to 2025, the percentage of Americans over 65 years old will increase by 49 percent, from one in eight to nearly one in five.

This trend signals potential problems for the Social Security system. For every 3.8 workers paying into Social Security today, there is one person receiving benefits. But only 2.1 workers will be paying into Social Security for every person receiving benefits in 2030. When the baby boom generation retires, Social Security will be stretched to its limits.

This trend is even more troubling since Social Security plays a larger role in the lives of retirees than the system's architects ever envisioned. According to a December 1991 study by the Advisory Council on Social Security, 62 percent of America's elderly families rely on Social Security for at least half their total income, and 38 percent rely on the program for at least 80 percent of their total income. Social Security was the single largest source of income for elderly families, accounting for 41 percent of total income.

Although Social Security must stay a strong and viable system that Americans can rely upon, it should not, and cannot, be the primary source of retirement income for most Americans. Private pensions and other personal savings will have to play a greater role in the financial plans of tomorrow's retirees. Therefore, the remainder of our statement will focus on the role of employer-sponsored retirement plans in the nation's retirement system and the need for a well-defined retirement income policy that supports the continuation and growth of such plans.

Growth in Pension Plans Has Slowed in Recent Years

Until recently, the growth in private pension plans has been remarkable. According to the Department of Labor:

- Since 1950, the number of workers covered by private pension plans (both part-time and full-time) increased from 9.8 million to 41.8 million.
- During the same period, the percentage of workers covered by pensions increased from 25 percent to 46 percent.
- From 1950 to 1989, private pension plan assets grew at six times the rate of total financial assets in the U.S. economy. Private pension plans now hold $3.1 trillion in assets.

Because of this growth in the private pension system, tax qualified pensions have provided an increasingly important source of retirement benefits. From 1980 to 1990, benefits paid by private pension plans tripled to more than $140 billion per year, and public pension benefits doubled to $100 billion.

In recent years, however, America's private pension system has shown signs of stagnation. The share of the full-time work force covered by employer-sponsored plans has leveled off since the 1970s, falling slightly in recent years. This trend is especially troubling in light of the increased pressure that the Social Security system will be under as the baby boom generation ages.

There are three factors that account for most of this stagnation. The first is the continual legislative and regulatory initiatives that have significantly raised the burden (both direct expenses and administrative complexity) of establishing and maintaining qualified pension plans. In fact, since ERISA was passed in 1974, over eighteen laws have been passed which affect pension plans (including the recently enacted GATT bill). For many employers, the anticipation and uncertainty regarding the continual changes in the rules has caused them to question the benefits of maintaining pension plans. The complex and ever-changing regulatory climate has had its greatest impact on defined benefit plans. The average cost to employers as a percentage of payroll to maintain a defined benefit plan in 1990 was 3 26% – 18% more than the cost for all other plans, which was only 2.75%.

The second factor contributing to stagnation in the growth of pension plans is shifts in the economy's industrial composition, which have led to the reduction of the work force at many large firms and the establishment of more small service firms. People without pension coverage differ from the covered work force largely in one respect - they are disproportionately employed in firms with fewer than 100 employees. Only 27 percent of full-time employees in firms with fewer than 100 employees are

covered by pensions, compared with 73 percent of larger firm employees.

The third factor contributing to the decline in pension plan coverage is the reduction in the tax incentives associated with qualified plans. Since ERISA's enactment, limits on both contributions to and distributions from all types of retirement plans have significantly reduced the benefits received from these plans. In addition, there are currently penalties for putting too much or too little into a plan, taking too much or too little out of a plan, and receiving benefits from a plan too early or too late.

Unfortunately, the constant legislative and regulatory activity affecting retirement plans and the reduction in tax incentives have had their greatest impact on small employers, who have limited ability to absorb such regulatory "overhead." Ironically, because of the changing nature of the workplace, this is where the need for pension plan formation is the greatest.

Pension Benefits are Distributed Fairly

Pension benefits have been criticized as primarily benefiting highly paid workers. But pension plans provide benefits throughout all income classes, especially to the middle class. In fact, the tax benefits afforded to pension savings are much more fairly distributed than other tax incentives. This is largely because there are significant limitations on pension accumulations and distributions for upper-income workers and legal restrictions ("nondiscrimination" rules) to ensure that benefits are not tilted unfairly in their favor.

- o A 1993 Employee Benefit Research Institute ("EBRI") study found that taxpayers with income between $30,000 and $50,000 pay 18 percent of taxes and receive 28 percent of the value of pension tax incentives.
- o In 1991, workers earning less than $50,000 accounted for 92 percent of all workers and 89 percent of workers covered by pension plans.
- o In 1988, the majority of 401(k) participants earned less than $30,000.

Social Security should also be considered in any evaluation of the effects of our tax system on the distribution of retirement income. The Social Security system not only transfers wealth between generations, the benefits formula has been designed to achieve an intentional redistribution of pay within each generation of retirees: low-income workers receive more in benefits than they pay in taxes, while high-income workers receive less.

Taxing Pensions Will Not Solve The Deficit Problem

The fiscal 1995 "tax expenditure" for all public and private pension plans is estimated to be $69.4 billion. Not surprisingly, some advocates of deficit reduction view pension funds as a tempting target. However, most do not realize that only $19 billion is attributable to private-sector pension plans. Public-sector plans including federal, state and local government and military plans account for $50.4 billion of the tax expenditure.

Reducing pension tax incentives to reduce the federal deficit will be counterproductive. The deficit is a problem, in part, because it decreases national savings, of which pensions are a key component.

Encouraging savings is essential for long-term economic growth. Savings, including pension assets, form the capital pool that finance investment in infrastructure, start-up companies, and the modernization of existing production facilities. The $3.4 trillion in private pension plans represents a substantial portion of that capital pool.

The harm caused by deficit spending is compounded by a decline in personal savings. The decline in personal savings indicates that tomorrow's retirees are ill-prepared for a self-sufficient retirement. Excluding home equity, for example, the average 50-year-old has only $2,300 in personal savings. In 1991, the U.S. household savings rate as a share of disposable income was 4.9 percent, the lowest among the seven major industrialized nations. Great Britain was second lowest, at 9.8 percent. Taxing pensions will reduce savings, thus making our problems worse, not better.

There are many reasons for the low personal savings rate, but an important one is that personal savings are subject to income tax, creating a strong disincentive to save. Particularly in periods of significant inflation or for individuals with high marginal tax rates, taxing savings reduces (or eliminates) the incentive to save. During such times, individuals may actually have incentives to consume income quickly to maximize its purchasing power.

A worthy exception to the taxation of savings is provided by qualified retirement

plans. For most people, the only place it makes sense to save is in a retirement plan and much of personal savings can be attributed to pension savings. Over the last five years, Americans on average saved 4.4 percent of their disposable income, 31 percent of which is attributable to private pension contributions.

Pensions Plans Increase Personal Savings

Questions have been raised about tax incentives for retirement savings. Do they actually increase overall savings? Critics of pension tax incentives argue that individuals simply shift existing savings to a tax-favored vehicle and that the tax incentive loses revenue without encouraging any new savings.

Most economic studies of savings patterns show that pensions represent new savings; they provide convincing evidence that the favorable tax treatment for pensions does increase national savings. It is clear from studies of family behavior that different forms of savings are not lumped together and treated as if they are interchangeable. Money set aside in pension plans does not reduce the amount of money deposited in a bank account or the amount of equity in the family home. Even when people borrow to fund an IRA account, for example, they pay off the loan and the IRA savings remain as a net addition to national savings.

For many non-highly paid employees, employer-sponsored pensions provide an opportunity to save that would not otherwise be available to them. For many, employer-sponsored retirement plans will be their only additional source of retirement income beyond Social Security.

Encouraging savings is essential for the nation's economic health and long-term financial security. With our high deficits and low private savings rates, much of the current investment in America is financed by foreign savings. When our baby boomers retire, the returns on these investments will be transferred abroad to support the aging populations of other nations, not to our own retirees. Pensions provide one of the few sources of new domestic savings and investment, the returns on which will be used to support our own aging population.

The Need for a Comprehensive Policy

The ACLI encourages adoption of a comprehensive and consistent national retirement income policy that explicitly recognizes the essential components of retirement income security (e.g., government provided benefits such as Social Security, employer-provided benefits such as retirement income plans and retiree health benefits and personal savings, such as a home, savings accounts and life insurance benefits).

We hope that Congress will recognize that tax incentives have been and will continue to be the cornerstone of a viable private retirement system and that restricting those incentives in the name of deficit reduction and adding layers of administrative and compliance procedures will impede its health.

A piecemeal, revenue-driven approach is wholly inappropriate for dealing with retirement income issues. Employers need stable and consistent policy. When employers implement employee benefit plans they make a long-term commitment to benefit continuation. For the private employee benefit system to prosper, government must follow a consistent and coherent long-term approach and not continually shift policies.

A national retirement income policy would ensure this stability. In this regard, we endorse past Congressional legislative attempts to create a national retirement income Commission to study these issues and develop a coherent long-term policy.

The two primary goals of such a policy should be to: (1) increase private pension coverage of all full-time workers to the maximum extent possible, and (2) provide an environment that will encourage sufficient replacement of pre-retirement income to ensure workers an adequate living standard after retirement. Achieving these two interrelated goals will require:

- Ensuring the fiscal soundness of the Social Security system
- Strengthening the private pension system
- Encouraging and expanding individual savings in general and retirement savings in particular.

Any legislative or regulatory initiative affecting the retirement system must be examined with these goals in mind. To judge the appropriateness of any particular initiative, several key questions must be answered:

- Does the initiative encourage retirement savings, either on an individual

level or through an employer-sponsored arrangement?
- o Does the initiative promote broader coverage?
- o Is the initiative good pension policy as measured by the extent to which it addresses emerging social, demographic and economic changes or is it motivated primarily by revenue concerns?

The components of a secure retirement income used to be analogized to a "three-legged stool" but the components have expanded over the years to more accurately reflect other sources of retirement security (e.g., employer provided retiree health benefits). As demographic and social changes have occurred (e.g., retirees living longer), the retirement income system has evolved, as have the sources and products to realize retirement needs. These demographic and social trends will continue to evolve into the next century and the current savings vehicles may be inadequate to meet future retirees' retirement income needs. Therefore, we urge Congress to recognize these changes and to develop a rational retirement income policy that reflects these trends. It is also vital for Congress to recognize and, if possible, quantify the growing gap between what our current system, which is heavily based on savings and asset accumulation, can provide, and what the retirement income security needs of an aging population will be. We believe that, once this gap is addressed and quantified, new approaches to retirement income security must be developed.

Conclusion

The framework of our present system of providing retirement income is sound although under stress. On the whole, Social Security is doing a good job of providing a basic floor of retirement protection. The private sector is making an important and indispensable contribution towards supplementing this basic floor of protection through employer-sponsored pension plans. Individual savings for retirement remain weak. What is needed now is a consistent and rational approach to ensure that the components of the retirement system continue to grow and provide stability and security for individuals who retire in the next century. A national retirement income policy would ensure this stability. The ACLI strongly believes that it is time to begin a full and open debate on the issues and to develop guidelines for such a policy and to halt further legislative or regulatory changes until a rational retirement income policy is adopted.

Statement of Rep. Howard L. Berman
before the
Committee on Ways and Means
Hearing on Miscellaneous Tax Reforms

Mr. Chairman, I am pleased to have this opportunity to express my strong support for proposed legislation that would greatly simplify pension regulation compliance for employee leasing firms and help ensure that leased employees receive the most generous pension benefits permitted by law.

I am grateful to Congressman Bill Thomas for bringing this proposed legislation to the Committee's attention, and I look forward to working with him and other members of the Committee from both parties to get it passed in the 104th Congress.

In my opinion, this legislation addresses an issue that isn't Republican or Democratic, conservative or liberal. Rather, it is a matter of common sense and economic efficiency.

Employee leasing companies play an important and growing role in our economy. They facilitate the flexibility American companies need to be competitive in the global economy. Unlike "temp" firms, however, employee leasing companies are required under most circumstances to provide full pension benefits to their employees as if they were employed directly by the so-called "recipient" firms that utilize leased employees.

Unfortunately, the effectiveness of employee leasing is limited by the difficulty of complying with pension non-discrimination rules. Make no mistake about it -- these rules serve an extremely important purpose by prohibiting highly-compensated individuals from obtaining lucrative financial benefits at the expense of rank and file employees. However, the application of these rules in the employee leasing arena deserves another look.

Under current law, an employee leasing company is required to prove that the pension plan it offers to its employees is comparable to the plan offered by each recipient firm to its own employees. Since employee leasing companies generally have numerous companies as clients, numbering in the hundreds or even thousands, the human and financial resources required to undertake these comparisons can be staggering.

The beauty of the employee leasing legislation lies in its simplicity. The proposal says the following: <u>if</u> a qualified employee leasing company offers its employees the most generous pension plan permitted by law, and if it incorporates a specific vesting schedule at least as favorable as that maintained by the recipient's pension plan, then it should be considered <u>automatically comparable</u> to the pension plan offered by recipient firms to their own employees.

In addition to simplifying pension regulation compliance for employee leasing firms, the proposed legislation would also help separate the wheat from the chaff in the employee leasing industry. On some occasions, employee leasing has been utilized as means of excluding rank and file employees from their fair share of pension benefits. This legislation would help ensure that leased employees in general would receive more generous pension benefits.

I would not support this proposed legislation if I thought that it were not in the best interest of leased employees. With some hard work and bipartisan cooperation, I am confident that we can turn this proposal into a solid piece of legislation that can win the support of all interested parties.

Once again, thank you very much for giving me the opportunity to express my views on this important issue.

ON BEHALF OF

National Association of State Retirement Administrators
National Council on Teacher Retirement
National Association of Counties
U.S. Conference of Mayors
Government Finance Officers Association
National League of Cities
National Conference of State Legislatures
National Public Employer Labor Relations Association

On behalf of the Nation's states, counties and cities, and the millions of public employees, retirees and beneficiaries who depend on our public employee retirement systems for their retirement security, we appreciate this opportunity to express our grave concerns with the application of the pension nondiscrimination provisions of Section 401(a)(3) of the Internal Revenue Code. The Committee has asked for comments on the desirability of exempting state judicial plans from these requirements. We believe that this is an appropriate course of action, and for the reasons expressed below, we urge the Committee to adopt an expanded exclusion to apply to all state and local government retirement systems.

State and local government retirement systems are designed to provide benefits to a diversified work force. Pending federal nondiscrimination rules will require these plans to be radically redesigned or lose their tax-exempt status. The required changes are not because these plans are discriminatory, they are not, but rather because they have been established to provide benefits to specific sectors of the work force.....teachers, police, fire fighters or general workers. Each of these plans reflects a reasonable benefit structure for the employee group it covers. The pending rules, however, would require jurisdictions to lump all employees into one large group for testing purposes. This type of comparison, which was designed to identify discriminatory practices in the private-sector, is an inappropriate measure in the public-sector. Indeed, in our discussions with Treasury over the past two years regarding possible approaches to nondiscrimination rules for state and local government plans, they have been unable to identify any abuses or even significant concerns that would warrant an imposition of such a cumbersome thicket of federal rules on public plans that already are the subject of state and local government regulations.

Background

The benefit levels, investment practices, reporting and disclosure requirements of public employee retirement systems (PERS) are established by public laws and subject to the oversight of states and localities. These public plans provide broad coverage to workers and even-handed treatment to all employees within specific occupational groups whose benefit structures reflect the unique work history of that particular occupation. According to the Bureau of Labor Statistics over 90 percent of full-time state and local government workers are covered by their employer's defined benefit plan.

To qualify for federal tax-exempt status private pension plans have to meet nondiscrimination standards designed to ensure that the plans are not providing disproportionate benefits to the owners, officers or highly compensated individuals. These rules were enhanced by the passage of the Employee Retirement Income Security Act of 1974 (ERISA). State and local government retirement systems are excluded from the reach of ERISA and historically have been governed by some, but not all, federal tax rules that apply to pension plans. Furthermore, in 1977, the Internal Revenue Service placed a moratorium (IRS News Release 1869) on the enforcement of the nondiscrimination rules on the public sector which lasted until 1989.

Unique Characteristics of Public Retirement Plans

The existing nondiscrimination rules do not work in the public sector for the following reasons:

- Work force Profile: Separate benefit structures have been established for different categories of public employees. Each of these occupational groups has benefit structures that reflect the duties and/or longevity which can reasonably be expected in a particular position. The structure of public plans and the profile of the state and local government work force is very diverse. States and localities employ police, firefighters, teachers, general workers, doctors, college professors and judges. As a general practice states and localities have set-up separate plans or benefit structures for each occupational group.

- Benefit Guarantees: Public-sector employers are constrained by state and federal constitutional limitations, local statutes and contract law from reducing the benefits of existing employees. Under these "impairment of contract" rules, most public-sector systems cannot prospectively limit benefits for persons already employed. This severely limits the ability of public-sector systems to retroactively apply a new detailed set of regulations. Rather, compliance would have to be accomplished on a going-forward basis.

- Development of Benefit Structures: Some state and local retirement systems date back to the early 1900s. All public pension plans have matured under the legislative control of states or localities. Public sector systems have developed apart from federal regulation and are governed by rules enacted by state legislatures or similar legislative bodies.

In view of the great difficulty of applying the nondiscrimination rules to state and local government plans because of their unique characteristics, the Treasury Department has repeatedly delayed the application of the nondiscrimination rules to governmental plans, most recently to plan years beginning in 1999.

A coalition of governmental plans and groups spear-headed by GFOA has met repeatedly with the Treasury Department over the past two years in an effort to craft a workable solution to the problems involved in applying the private plan nondiscrimination rules to state and local government plans. There was general agreement that the private plan nondiscrimination rules simply do not work in view of the unique characteristics of state and local plans. After all of these meetings, a workable solution does not seem to be readily at hand for applying the nondiscrimination rules to governmental plans.

In light of the great difficulties encountered in formulating a workable set of nondiscrimination rules tailored to the unique characteristics of state and local government plans and the absence of any demonstrated abuses or significant concerns that would warrant the application of cumbersome federal rules on state and local government sovereign personnel functions that already are subject to regulation at the state and local level, we believe that the most appropriate approach is to adopt an appropriate exclusion for state and local government plans from the nondiscrimination rules.

We would be pleased to work with the Committee to formulate that exclusion.

NATIONAL
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July 25, 1995

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
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Washington, D.C. 20515

VIA FEDERAL EXPRESS

WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE
MISCELLANEOUS TAX REFORMS

Modify Leased Employee Rules

Thank you for the opportunity to present this written statement in lieu of a personal appearance with regards to Miscellaneous Tax Reforms and in particular, the proposal to modify the leased employee rules under Section 414(n). My name is Eric Jay Selter, Esquire, and I am making this statement on behalf of National Staff Network and Practice Service Corporation.

I. **ISSUES:**

1. Leased employees have historically been excluded from a recipient's pension plan. The recipient would claim that the employee was an employee of the employee leasing company and not the recipient. The employee was, therefore, excluded from recipient's plan.

2. There is a need to provide all rank and file employees, without discrimination, pension benefits. IRS approved "Age weighted" and "comparable plans" are being used to "legally" discriminate. (See attached articles).

3. Government must set industry standards by enacting legislation to eliminate abusers that seek to discriminate against rank and file employees. Treasury, IRS and DOL must have a common basis to police and audit employee leasing companies.

II. **CURRENT LAW:**

Congress enacted Section 414(n) requiring that recipient include leased employees in his/her pension plan (414(n)(1)(A)). Section 414(n)(1)(B) provides the recipient a "credit" or "offset" in the recipient's plan for benefits provided to the leased employee by the employee leasing company. In complying with the requirements of 414(n)(1)(A) and (B) by providing comparable and/or superior benefits to rank and file employees, employee leasing companies have complied with Congressional intent.

Section 414 (n) also includes a Safe Harbor which exempts a recipient from the rules of 414(n)(1)(A) under certain conditions. In order to take advantage of the Safe Harbor, only 20% of recipient's employees may be leased and excluded

7651 Haskell Avenue, Van Nuys, California 91406-2006
The Nation's Leading Employee Leasing Organization℠

from recipient's pension plan, so long as the employee leasing organization provides a 10% money purchase pension plan with immediate participation and vesting.

Today, other code sections and regulations law allow a recipient to legally discriminate by utilizing an IRS qualified plan. The new devices, called "Age Weighted" and "Cross Tested" plans enable owners to keep as much as 95% of the annual contributions to the plan, to exclude lower paid employees, and to reduce the total annual contributions they make to the plan on behalf of rank-and-file workers.

Employers can do this by blending rules used in retirement savings plans with rules used in pension plans. When the resulting formulas combine with regulations meant to prevent retirement plans from discriminating in favor of the highly paid, the result is a legal way to discriminate in favor of the top-paid. How much an owner can actually keep depends on how much goes into the plan, the number of employees, their age and salaries. (Wall Street Journal, Monday, August 16, 1993, page C 1, see chart).

The proposed legislation seeks to "even the playing field" by allowing an employee leasing organization to provide superior pension benefits.

III. **PROPOSED LAW:**

The proposed legislation is not a carve-out. It provides maximum benefits to all rank and file employees without discrimination. It provides the mechanism for Treasury, IRS and DOL to effectively police and audit employee leasing companies' pension plans.

The new Safe Harbor will allow an employee leasing company to provide a 100% of compensation defined Benefit Pension Plan (415(B)) or Maximum Defined Contribution Plan (415)(C)) but will not subject the recipient to any limit on the number of leased employees assigned to recipient.

The proposed legislation has been modified and improved numerous times based upon the input of Members of Congress, Treasury and the Internal Revenue Service. Companies who have provided Maximum Pension Benefits have been referred to as "the White Hat Guys" or the "Good Guys" because they have always provided maximum pension benefits to employees and not utilized employee leasing as a way to avoid pension benefits for rank and file employees. Attempts to project or anticipate potential abuse have led to inclusive protections being written into the Bill. For example, under the Bill a recipient can not maintain a better vesting schedule than the leased employees. The recipient must pay an excise penalty for the leasing company's failure to properly fund its plan, which causes the recipient to become the policing mechanism and not the IRS.

Some opponents attempt to create unrealistic scenarios which are already addressed in the Bill. For example, at one time Treasury opposed the Bill stating that high turnover in the leasing industry would cause employees to fail to vest in their benefits. However, this does not recognize that if an employee is covered under this Bill and provided maximum benefits by the leasing organization, they can never be in any worse situation than if they were employed directly by the recipient. Since part of the Bill deals with true employee leasing in its definition, the turnover factor can be no worse in the leasing situation when the tenants of the Bill are followed.

Another unrealistic proposal is to conform this proposed Safe Harbor with the current Safe Harbor of 414(N)(5). When leasing only 20% of a recipient's staff, the current Safe Harbor requires a 10% Money Purchase Plan with immediate

participation and vesting. The current proposal provides for a graded vesting over five years. The purpose of a vesting schedule is to encourage employees to maintain longevity with the company.

When isolating 20% of a recipient's assigned staff under the current Safe Harbor, longevity may not be prevalent therefore causing the need for immediate participation investing. But as stated above, the new proposal prevents a recipient from vesting faster than a leased employee. In the real business world, a recipient will typically not utilize an immediate vesting element for not only the cost factor but also the "golden handcuffs" encouragement to maintain good employees. The cost of turnover is more than the additional pension cost and it is in the best interest of a business to maintain a stable work force.

The bottom line: The Bill has been written so that it cannot be abused by even the most crafty practitioner. It does not attempt to exempt certain employees or recipients, but is an all-inclusive Bill that will benefit all rank and file employees.

With today's headlines predicting the collapse of the Social Security System, pension cuts and a majority of the people failing to plan for their retirements, this Bill will help ensure the retirement benefits for thousands of workers.

IV. KEY ELEMENTS OF THE PROPOSAL:

1. It requires an employee leasing company to provide either a maximum 415(b) or 415(c) pension plan to all rank and file employees assigned to a recipient (under ERISA guidelines). This benefit is far superior to the current safe Harbor plan.

2. The plan utilizes 100% of a participants' compensation with highest three-year averaging.

3. No FICA integration.

4. No minimum age requirements.

5. Unlike the current Safe Harbor, the proposal provides maximum pension benefits to all rank and file employees without exclusion.

6. Five-year graded vesting which provides that no participant in recipient's plan may have a more favorable vesting schedule than the leased employees. Therefore, with or without employee leasing, the rank and file employees will be subject to the same vesting schedule as recipient.

7. Provision that recipient's benefit may not exceed 100% of available benefits.

8. Provision for failure of employee leasing company to meet minimum funding standards. The recipient will be penalized for the employee leasing company's failure to meet minimum funding standards. This will force recipients to police the leasing organization to ensure compliance.

9. Non-highly compensated employees are completely protected because the proposed legislation provides that all rank and file employees, without discrimination, must be provided with the maximum benefits.

10. The proposal provides specific plan attributes and definitions/standards needed for protections of employees and recipients alike. By establishing standards, all parties are aware of their rights and obligations.

11. The maximum 415(B) or 415(C) plans will ensure provision of maximum benefits to rank and file employees. Contrast this to proposed target benefit plans which allow recipients to make contributions for themselves far in excess of the small, "comparable" benefits that are provided to rank and file employees. (See attached article.)

V. ADDITIONAL ELEMENTS OF THE PROPOSAL:

The proposal adds a new rule which would treat certain leasing organizations as the sole employer of their leased employees. In today's changing work force, there are numerous components which require definition. These include temporary staffing services, professional employer organizations, facility management organizations, leasing organizations, placement and payroll services (see Personnel Services Industry, Definition of Components attached hereto). One of the biggest issues facing employers and the courts today is the discussion of sole employer versus shared employment. This falls in the realm of not only Department of Labor, Equal Employment Opportunity Commission, FSLA and State Unemployment agencies, but also in the areas of wrongful termination and workers' compensation. Rank and file employees should not have to litigate their status and rights by searching through a burgeoning morass of case law. The ability to refer directly to statutory requirements setting forth the legal relationships of employer and employees in the staffing industry is imperative.

The proposal sets forth very specific, and stringent guidelines in order to be deemed a sole employer leasing organization. Current employers can then recognize those companies that do not meet these requirements, and clearly understand their liabilities and responsibilities under shared employment. In the changing work force in the United States today, this is imperative.

VI. **In Summary, the proposed legislation is not a carve-out. It provides maximum benefits to all rank and file employees without discrimination and regardless of whatever benefits recipient provides to him/herself. In response to the ever-changing rules and regulations under ERISA, TEFRA, TRA '86, OBRA, etc., this proposed legislation will pull together all the elements and intention of these laws: <u>to provide, and protect, the retirement benefits for rank and file employees</u>.**

The proposed legislation also sets clear definitions of the types of employment available in the US work force today. This will protect not only the rank and file employees, but will also protect insurance carriers, State Funds, and the Tax Collection agencies of State and Federal government. It will enable the applicable government agencies to monitor and audit the different companies with specific, and straightforward guidelines without any increased costs.

Thank you again for the opportunity to present this statement and your consideration.

Cordially,

NATIONAL STAFF NETWORK

Eric Jay Selter
Corporate Counsel

cc:

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THE WALL STREET JOURNAL.

MONDAY, AUGUST 16, 1993 C1

MONEY & INVESTING

Small Firms Turn Retirement Plans Into Owners' Gain

YOUR MONEY MATTERS

By ELLEN E. SCHULTZ
Staff Reporter of THE WALL STREET JOURNAL

Is it a retirement plan, or a tax shelter?

At a growing number of small companies, it can be hard to tell the difference.

More and more small business owners – including doctors, dentists, accountants and lawyers – are discovering lush loopholes that let them turn retirement plans intended for all employees into tax shelters that benefit mostly the owner or a handful of highly paid people at the top.

The new devices, called "age-weighted" and "cross-tested" plans, enable owners to keep as much as 95% of the annual contributions to the plan, to exclude lower-paid employees, and to reduce the total annual contributions they make to the plan on behalf of rank-and-file workers.

Employers can do this by blending rules used in retirement savings plans with rules used in pension plans. When the resulting formula is combined with regulations meant to prevent retirement plans from discriminating in favor of the highly paid, the result is a legal way to discriminate in favor of the top-paid. How much an owner can actually keep depends on how much goes into the plan, the number of employees, their age and salaries.

"They're tax-planning devices," is how David Wray, president of the Profit Sharing Council of America in Chicago, characterizes them. "Basically, they're put in because one person want to defer as much salary as possible," he adds.

Further, the new tax law will cause these plans to spread like brush fire, pension experts predict. "Before the tax law changed, it was a good deal. Now it's a better deal" for owners, says Marcy Supovitz, vice president of retirement plans for Pioneer Mutual Funds in Boston.

The plans make it possible for em-

Please Turn to Page C17, Column 1

Keeping a Bigger Piece of the Pie

Business owners can replace existing retirement plans with ones that provide them with a greater percentage of the money contributed. As this illustration for a five-person plan shows, the owner gets 52% of the total contributions to a traditional profit sharing plan in which all employees received 15% of their pay. But under "age-weighted" and "comparability" plans, the owner can keep as much as 85%. Comparability plans also let the owner lower the amount contributed for rank-and-file workers; in this example, saving $8,026.

EMPLOYEES		CONTRIBUTIONS TO PROFIT-SHARING PLANS		
AGE	INCOME	TRADITIONAL (15% OF PAY)	AGE-WEIGHTED	CROSS-TESTED
55	$235,840	$22,500	$28,784	$30,000
55	50,000	7,500	9,595	1,955
45	40,000	6,000	3,395	1,564
35	30,000	4,000	1,126	1,173
25	20,000	3,000	600	782
TOTAL CONTRIBUTIONS		$43,000*	$43,000*	$35,474

*The total amount that can be contributed to plan, by law; this is 15% of the total eligible compensation pool of $290,000. (Under the new tax law, only $150,000 of an employee's pay can be used when calculating contributions to a plan.)

Source: National Life of Vermont

Smaller Firms' Retirement Plans Are Turned Into Owners' Bonanza

Continued From Page C1

ployers to escape restrictions in the new tax law on contributions to top-paid employees. The new law effectively limits the annual contribution an employer can make for a person in a traditional profit-sharing plan or SEP (simplified employee plan) to no more than $22,500 – 15% of the total "eligible" compensation of $150,000. But with these new types of plans, the amount that can be distributed to an individual remains 25% of pay, up to $30,000.

Already, these new mutant species of retirement plans are growing like kudzu vines, and strangling milder, existing competitors, such as traditional profit-sharing plans, 401(k) plans and SEPs. Over the past two years, thousands of employers have converted their retirement plans to age-weighted and cross-tested profit-sharing plans.

The plans have been given their biggest push by life insurance companies, which administer them for a fee, and sell investments to the plans they oversee. At National Life of Vermont, age-weighted plans comprise 25% of all profit-sharing plans they administer; at Berkshire Life Insurance Co., age-weighted plans account for most of its new retirement plan business.

Some mutual fund companies that have retirement-plan divisions are also moving quickly into this market, including Oppenheimer & Co., Dreyfus Service Corp. and Pioneer Mutual Funds.

There's a lot of room for growth: According to the Department of Labor, 88% of businesses in the U.S. today employ 20 or fewer employees, and those businesses are typically owned by people who are older and better paid than their employees.

Critics say that the new plans pervert the social policy goals of retirement plans, which are given tax breaks because they are intended to help lower- and middle-income Americans put money aside for retirement.

Further, some people note that the plans give employers an incentive to discriminate against older workers. "It makes hiring an older person more expensive," says Harry Conaway, a principal at the Washington office of William M. Mercer Inc., a benefits-consulting concern.

But many pension experts say the new plans fill a need for employers. "These are people who have poured their profits back in their businesses, and don't have that many years until retirement," says Ms. Supovitz. "Younger employees would rather have more take-home pay, rather than retirement savings."

Age-weighted plans were made possible by an Internal Revenue Service ruling, 401(a)4, that went into effect two years ago.

Essentially, it said that retirement savings plans offered by employers could use formulas similar to those pension plans use when determining how much money to allocate for employees. Pension formulas give older workers the lion's share of the contributions an employer makes to a plan. The reasoning is that they have fewer years until retirement, so a dollar given to them is worth less than a dollar given to a younger person.

About a year ago, the pension community realized it could also use cross-testing rules to provide even more advantage to top-paid employees. Cross-testing formulas were designed to prevent retirement plans from discriminating in favor of the older, higher-paid workers. The rules basically require the administrator to divide employees into highly paid and lower-paid groups, and make sure that the higher-paid group doesn't get a significantly higher percentage.

When these provisions are combined with age-weighting formulas, the owner can keep most of the money. "From a theoretical perspective, the plans are nondiscriminatory," says Mr. Conaway. "If you convert the dollar amount [that lower-paid people get] to age-65 dollars, the benefit is the same percentage of pay."

But as helpful as the new plans may be for small-business owners, they have serious drawbacks for rank-and-file workers. To begin with, the plans can exclude altogether some lower-paid employees, as long as 70% of the lower-paid employees are eligible to participate in the plan.

Even those who participate may never see a dime of retirement money, however, because these plans have vesting schedules lasting as long as six years. Since younger, lower-paid employees typically have high turnover, many aren't likely to qualify to receive their profit-sharing money. Forfeited contribution are reallocated to the remaining people in the plans, on an annual basis.

"The bottom line is, a large portion of those contributions never go to those employees at all, because of the forfeitures," say Ms. Supovitz.

FEDERAL HOME LOAN ARM INDEXES

Cost of funds indexes supplied by the Office of Thrift Supervision. These indexes may be used by federally chartered institutions in establishing rates on adjustable rate mortgages (ARM) for previously occupied homes

Contract rate for major lenders-a	7.02%
Cost-of-funds May natl mnthly median-b	4.18%
Jan. - Mar. national average-b	4.34%
Jly. - Dec. national average-b	4.82%
11th OTS district average for June	4.060%

a-National average supplied by the Federal Housing Finance Board for June. b-To Savings Association Insurance Fund (SAIF) insured institutions.

Tax Requirements Passes the House

By Jackie Calmes
Staff Reporter of The Wall Street Journal

WASHINGTON – Taxpayers could pay taxes by credit card and various businesses and groups would have simpler tax requirements, under a long-pending package of changes unanimously passed in the House.

The House also voted 413-0 for a separate bill making the Social Security Administration independent of the Department of Health and Human Services. Chairman Dan Rostenkowski (D., Ill.) of the House Ways and Means Committee said the bill, which is expected to pass in the Senate soon and be signed into law by President Clinton, would raise the agency's stature and insulate it from political meddling.

It isn't clear when the Senate might act on the tax-simplification measure, even though Congress has passed nearly identical bills twice before. Finance Committee Chairman Daniel Moynihan (D., N.Y.) said, "I need to take a look at it."

The package has scores of mostly minor provisions to correct mistakes in tax laws passed since 1990. And there are provisions to simplify laws for pension plans, large partnerships, international operations of U.S. corporations, small businesses known as Subchapter S corporations, regulated investment companies, tax-exempt bonds and estates. Most of the provisions were included in two broader tax bills that Congress passed in 1992, but that President Bush vetoed over items no longer in the legislation.

Under the bill, individual taxpayers could use credit or debit cards, or electronically transfer funds to the Internal Revenue Service to pay income taxes. Also, individuals with losses of less than $200 a year on so-called passive investments could deduct those losses in the year they occurred, rather than having to carry the loss forward to the next year as required under current law.

The package would ease so-called nondiscrimination rules barring employers from providing more generous pension plans to higher-paid employees than lower-paid ones. Also, tax-exempt groups would be able to take advantage of tax-deferred 401(k) plans.

The changes would reduce federal revenues by nearly $500 million over five years, so the bill has four provisions raising revenues to comply with pay-as-you-go budget rules. They would increase taxes withheld from large gambling winnings in bingo and keno; require those who rent their homes for less than 15 days in a year to pay taxes on that income, which is now untaxed; require tax-exempt entities to pay taxes on certain income from foreign investments; and slightly limit thrifts' bad-debt deductions.

PERSONNEL SERVICES INDUSTRY

Definition of Components

Because the relationships between staffing firms, their clients and employees is ill-defined and of interest to legislators, regulators, insurers and others, the following is a generic definition for each type of service.

TEMPORARY STAFFING SERVICES

Temporary staffing services are provided by an organization that supplies employees it has recruited to supplement their client's existing work force for limited periods of time. The client has work site supervisory responsibility for the temporary service's employees and management accountability for the function performed as it relates to output and results. Organizations providing temporary staffing services assume employer responsibilities, rights and risks by establishing and maintaining an employment relationship in regard to assigned employees.

EMPLOYEE LEASING SERVICES

Employee leasing services are provided by an organization that leases its own employees for the purpose of performing the operations of the client's business on a regular, on-going, rather than a temporary basis. Initially, the leasing company may hire the client's existing employees. An employee leasing company, as the sole employer, pays the employees out of its own accounts, provides and administers universal fringe benefits, maintains the sole right to hire and fire, maintains the right to direct and control under federal code and invoices from a standard fee schedule on a fee-for-services basis after the payroll has been paid. The employee leasing company does not have management and/or operational accountability for the functions of its employees in regards to results or output.

PROFESSIONAL EMPLOYER ORGANIZATIONS

Professional employer organizations provide administrative, human resource, benefits administration and other employee-related services to a portion or all of a client's existing work force on an on-going basis in a co-employment relationship with the client. The professional employer organizations do not have management accountability in regards to results or output for the functions performed by the assigned employees.

FACILITIES MANAGEMENT

Facilities management companies assume management accountability for their clients' entire facility or function (i.e. department, division or subsidiary). The facilities management company manages the entire operation, including providing and supervising staff and assuming responsibility for output. Facilities management companies are generally the sole employers of the employees.

PLACEMENT SERVICES

Placement service companies recruit employees, verify employment history, academic credentials, licensure, etc. for potential employers. The fee may be paid by the employee or the employer. The placement service does not become the employer.

PAYROLL SERVICES

Payroll services process and prepare payroll checks, provide tax reports, accounting reports and other information relating to payroll for the employees of their clients. The payroll service company carries no employer responsibility for the employees of the client companies that they prepare the payroll for.

THE NATION'S NEWSPAPER

USA TODAY

NO. 1 IN THE USA ... FIRST IN DAILY READERS

DAY 2 OF 4-DAY REPORT

Can the baby boom retire?

Today
Your worksheet for financing retirement, 4B

Wednesday
Hot line: Experts take your calls

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Poll: 42% saving for retirement

By Anne Willette
USA TODAY

About 4 of every 10 people are taking active steps to get ready for retirement — a strategy financial experts say is a must to prevent financial hardship as they grow older.

A new USA TODAY/CNN/Gallup Poll shows that members of this disciplined group save methodically.

Still, they'll face a future in which Social Security and pensions likely will be cut. And for most people who don't save, the poll finds, retirement is shaping up as a nightmare.

Experts say that's likely true — especially if they're among the 76 million baby boomers born from 1946 through 1964.

"I wouldn't be surprised if a significant number of the baby boom generation falls right out of the middle class," says Craig Karpel, author of *The Retirement Myth*, out this month.

The poll shows people's attitudes toward retirement puts them in one of four groups:

▶ Contented Realists — 26%. They are the biggest savers and the most prepared, in part because they have the highest incomes. Most earn more than $50,000 a year.

▶ Worriers — 32%. They earn slightly less than the Contented Realists, but save significantly less. They are the most pessimistic: 55% expect their standard of living to decline.

▶ Cautious Optimists — 18%. These are the heroes of retirement planning. Half earn less than $30,000 a year, yet they save aggressively.

▶ Woefully Unprepared — 24%. These are the people who need virtually all they earn for living expenses. Six in 10 saved nothing last year. Four in 10 say Social Security will be their main income in retirement.

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Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Moseley:

This letter is in reference to the hearings held on July 11-12, 1995. I would like to bring to your attention my concern over the following issues related to pensions and employee benefits.

The current limitation on contributions (sec. 415) which were modified by the General Agreement on Tariffs and Trade (GATT). The application of the discount value of the benefit associated with the interest rate version set by GATT, when used with the lump sum conversion, impact the evidence of the actuarially of the sums. This creates a situation where the amount the individual receives for the lump sum payment is not actuarially equal to the annuity sum. The provisions seem to create a situation where individuals are treated differently based on how they elect to receive their pension.

Section 415 treats the pension plan and the 401K plan as a single savings plan. When calculating the maximum amount of government allowed savings that will be treated as tax deferred income, the individual who saved the maximum allowed figure is penalized by not being allowed to roll the full amount of the tax deferred plan. Upon retirement an individual who has amassed the maximum saving in a 401 k and has a pension plan will lose some of their tax deferred ability of their investment. Limits are placed upon savings. I believe the government is sending mixed signals when it comes to savings. By viewing the tax deferred pension plan and a 401k plan as one, you in effect, discouraging an individual from savings. Employees are being asked to save for their retirement, but the current rules are forcing individuals to reevaluate their percentage of savings.

I am asking you to revisit the limitations of section 415 in view of the current savings trends or lack thereof. Please consider a plan which will encourage individuals to focus on building their retirement without penalties if they save too much.

If you have any questions please call or write. Thank you for your time in reference to this matter.

Sincerely

John P. Wloszek

TESTIMONY OF VESTER T. HUGHES JR.
HUGHES & LACE

I. Identity of Clients Represented.

The Estate of Charles A. Sammons
Sammons Enterprises, Inc.

II. Background of the Problem.

Congress has long recognized that employee stock ownership should be encouraged. As early as 1938, Congress allowed a deduction for contributions to a trust to pay employee pensions. Congress later made clear that employer securities were proper investments for profit-sharing and pension plans, and added stock bonus plans to the list of tax-qualified retirement plans. Ultimately, the employee stock ownership plan or "ESOP" evolved. Congress wisely provided that the employer receives an income tax deduction for contributions to such plans and that the employee is not currently taxed either on the value of such contributions or on any increase in value until the plan actually makes distributions to the employee.

Unfortunately, the estate tax treatment of contributions to an ESOP has not been made consistent with the income tax treatment described above. Individuals who bequeath employer securities to ESOPs suffer adverse estate tax consequences because no estate tax deduction is available for such contributions.

In 1984, the U.S. Senate passed legislation that would have addressed this perceived inconsistency. See S. Prt. 98-169, 98th Cong., 2d Sess., § 107 (1984); see also Senate Committee on Finance, 98th Cong., 2d Sess., Statutory Language of Provisions Approved by the Committee on March 21, 1984 340 (Comm. Print April 2, 1984). Sammons Enterprises, Inc., the primary proponent of H.R. 1962, was not involved in the 1984 legislation, but its founder, Charles A. Sammons, among others (such as the owner of a flour milling company in Minnesota and the owner of a chain of drug stores in California), watched it with some interest. The 1984 bill did not become law -- possibly in part because of concern that it could be used to pass stock to a decedent's family members or to other significant shareholders rather than to rank and file employees. Moreover, the 1984 bill did not contain limits on the amount of stock that could annually pass through an ESOP to the beneficiaries. Thus, the 1984 bill could have made instant millionaires of certain beneficiaries, decreasing their incentive to continue to work for and to build their company. Although the 1984 bill had its flaws, it is instructive in that it reflects a long-term, broadly supported interest in estate transfers to ESOPs. A copy of the 1984 statutory language and the Senate Finance Committee report is attached hereto as Exhibit A for your convenience.

Mr. Sammons saw the failed bill, and thought with changes to limit the perceived abuses and to restrict the annual distributions to employees, the bill could promote employee stock ownership. Indeed, he took his message to heart, leaving a majority of the stock of Sammons Enterprises, Inc. to a charitable remainder trust, with instructions that the stock should be distributed in part to his company's ESOP if, on the distribution date, ESOPs are permissible beneficiaries of charitable remainder trusts. The ESOP of Sammons Enterprises, Inc. has over 2,700 employee-participants, residing in 28 states. See Exhibit B, attached hereto, for a list of those states and the number of such employees located in each state. None of these employee-participants is related to Mr. Sammons. Moreover, none of these employees owns (other than through their participation in the ESOP) any stock of Sammons Enterprises, Inc. Thus, the direct beneficiary of Mr. Sammons' generosity is an ESOP in the classical sense. It is clear that Mr. Sammons' intent was to benefit only his employees.

As the law currently stands, and if it is not changed, the trust will be forced to distribute the stock to the various named charities because ESOPs are not currently permissible beneficiaries of charitable remainder trusts.

III. Solution (H.R. 1962).

On June 29, 1995, Congressman Sam Johnson (R, Tx.) introduced a bill (H.R. 1962) that would make employee stock ownership plans permissible beneficiaries of charitable remainder trusts in certain limited circumstances. Under H.R. 1962, the securities must be left by a

decedent to a charitable remainder trust, which then might be used to pass the securities to an ESOP. Once distributed to the ESOP, no allocation of such securities can be made to participants who are related to the donor or who own more than 5% of the stock of the issuing corporation. As a result, the proposed legislation cannot be manipulated to move assets to family members or significant shareholders. Because the bill is limited to closely-held corporations, it cannot become a tool for the financiers of Wall Street.

IV. H.R. 1962 has negligible revenue effect.

Although, at the time I am preparing this statement, the staff of the Joint Committee on Taxation has not yet published a revenue estimate with respect to H.R. 1962, it has reviewed the revenue effect of almost identical legislation introduced in the 102d Congress and the 103rd Congress. In each instance, the Joint Committee staff determined that the effect of the predecessor legislation (H.R. 3485 in the 102nd Congress and H.R. 1807 in the 103rd Congress) would be to "reduce fiscal year Federal budget receipts by less than $1 million annually." Copies of the Joint Committee staff's revenue estimates are attached hereto as Exhibit C and Exhibit D, respectively. Thus, under the Joint Committee staff's evaluation, only a de minimis revenue effect would result. Furthermore, a strong case can be made that the effect of H.R. 1962 would be revenue positive.

It is very unlikely that taxpayers will establish a charitable trust to benefit an ESOP unless they, like Mr. Sammons, would otherwise leave such assets to charities, but such situations are not all that uncommon. In my practice, I have seen several among my clients, and more outside my own practice, who would like, or would have liked, to make an estate transfer to an ESOP but instead opted for a charitable donation due to the absence of legislation like H.R. 1962. H.R. 1962 will therefore keep assets in the taxable sector that would otherwise move to the tax-exempt sector. As you know, the value of assets donated to charities leaves the tax revenue stream. In contrast, the value of assets which pass to an ESOP will ultimately be subject to taxation when the assets are distributed to the employees. In any event, any negligible revenue effects of this bill are well worth the added employee ownership that H.R. 1962 makes possible.

V. H.R. 1962 does not present "targeted tax relief."

H.R. 1962 would definitely appeal to, and promote employee ownership of, a number of closely-held companies. It could be used by any shareholder of any closely-held corporation that has an ESOP. I have contacted a number of attorneys around the country and have been assured that they and their estate planners will make their clients aware of this opportunity if the legislation is enacted. These same attorneys stressed that in appropriate circumstances, H.R. 1962 will fulfill a vital need and be useful. Moreover, I am told that the majority shareholders of a Michigan industrial supply company and a Texas country club management company are actively considering using it, if enacted, and that several other owners of closely-held companies have more than a casual interest in its passage. I also understand a Texas individual has written the Chairman of this Committee to express his interest in this legislation, and that the ESOP Association is watching the bill with some interest and supports its passage.

The fact that estate transfers to ESOPs were the subject of proposed legislation in 1984 (by parties unrelated to Sammons Enterprises, Inc. or any of the other parties who have expressed some interest in this bill) makes it clear that the legislation can, in no way, be considered "targeted tax relief." The 1984 bill reflects a long-term interest of some individuals in being able to leave stock for the benefit of their employees (who have built and will continue to build the company), rather than to charities (who may seek to break it up to secure immediate cashflow). The bill proposes a second avenue of non-familial giving -- which would serve to strengthen this nation's closely-held corporations -- and reflects good public policy.

Finally, assuming that the Joint Committee staff's revenue estimate is consistent with those of the prior Congresses, the revenue estimate itself recognizes that H.R. 1962 has application beyond Mr. Sammons' case. H.R. 1962 will make no tax difference in the Sammons' situation. Mr. Sammons' stock will go to charities if it does not go to the ESOP. Accordingly, no negative revenue effect will be caused by a distribution of stock to the ESOP under his charitable remainder trust. The determination that the provision has a negative impact of "less

than $1 million annually" presupposes that people other than Mr. Sammons will make use of this method of non-familial giving.

Even though the adoption of H.R. 1962 will have no effect on the tax dollars paid by the Sammons estate, those associated with Mr. Sammons obviously want to carry out his wishes. As mentioned above, Sammons Enterprises, Inc. has over 2,700 ESOP participants who are located in 28 states. These employees obviously would like to see Mr. Sammons' stock pass to the ESOP, as well.

VI. H.R. 1962 promotes employee ownership (and productivity) and future capital formation.

By their very nature, ESOPs hold stock in active businesses which generate economic activity and continue to expand the taxable revenue stream. ESOPs are designed to promote the long-term growth and vitality of active businesses by giving the employee's of such businesses a vested interest in the future economic performance of their company. ESOPs also promote future capital formation by encouraging employees to invest a portion of their income in the future growth of their employer.

* * *

In conclusion, when a taxpayer chooses to leave stock to his employees, the philosophy of an estate tax deduction is supported strongly by the same philosophy that lies behind the income tax deduction -- that employee ownership is a good thing. Thus, H.R. 1962 accords with the basic purposes of ESOPs and presents an opportunity for sound legislative policy.

DEFICIT REDUCTION ACT OF 1984
STATUTORY LANGUAGE OF PROVISIONS
APPROVED BY THE
COMMITTEE ON MARCH 21, 1984
COMMITTEE ON FINANCE
UNITED STATES SENATE
Volume II
April 2, 1984

SEC. 107. CERTAIN CONTRIBUTIONS TO ESOP TREATED AS CHARITABLE CONTRIBUTIONS.

(a) IN GENERAL.—Subsection (c) of section 170 (defining charitable contribution) is amended by inserting after paragraph (5) the following new paragraph:

"(6) A tax credit employee stock ownership plan (as defined in section 409A) or an employee stock ownership plan (as defined in section 4975(e)(7)) but only if—

"(A) such contribution or gift consists exclusively of employer securities (within the meaning of section 409A(l));

"(B) such contribution or gift is allocated (over a period not in excess of three plan years), pursuant to the terms of such plan, to the employees participating under the plan in a manner consistent with section 401(a)(4);

"(C) no part of such contribution or gift is allocated under the plan for the benefit of—

"(i) the donor,

EXHIBIT A

"(ii) any person who is a member of the family of the donor (within the meaning of section 267(c)(4)), or

"(iii) any other person who owns more than 25 percent in value of any class of outstanding employer securities under the provisions of section 318(a);

"(D) such contribution or gift is made only pursuant to the provisions of such tax credit employee stock ownership plan or such employee stock ownership plan;

"(E) such plan treats such employer securities as being attributable to employer contributions;

"(F) no deduction under section 404 and no credit under section 38 or 44G is allowed with respect to such contribution or gift;

"(G) any allocation under the plan of such contribution or gift which is based on compensation of the participants does not take into account any portion of the compensation of a participant that exceeds $100,000 per year.".

(b) PERCENTAGE LIMITATIONS.—Subparagraph (A) of section 170(b)(1) (relating to percentage limitations for individuals) is amended—

(1) by striking out "or" at the end of clause (vii),

(2) by inserting "or" at the end of clause (viii), and

(3) by inserting after clause (viii) the following new clause:

"(ix) a tax credit employee stock ownership plan (as defined in section 409A) or an employee stock ownership plan (as defined in section 4975(e)(7)).".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (a) of section 2055 (relating to transfers for public, religious, and charitable uses) is amended—

(A) by striking out "or" at the end of paragraph (3),

(B) by striking out the period at the end of paragraph (4) and inserting in lieu thereof "; or", and

(C) by inserting after paragraph (4) the following new paragraph:

"(5) to a tax credit employee stock ownership plan (as defined in section 409A) or an employee stock ownership plan (as defined in section 4975(e)(7)) but only if the requirements of section 170(c)(6) are met.".

(2) Subsection (a) of section 2522 (relating to charitable and similar gifts) is amended—

(A) by striking out the period at the end of paragraph (4) and inserting in lieu thereof "; or", and

(B) by adding at the end thereof the following new paragraph:

"(5) a tax credit employee stock ownership plan (as defined in section 409A) or an employee stock ownership plan (as defined in section 4975(e)(7)) but only if the requirements of section 170(c)(6) are met.".

(3) Section 415 (relating to limitations on benefits and contributions under qualified plans), as amended by this Act, is amended by adding at the end thereof the following new subsection:

"(m) CHARITABLE CONTRIBUTIONS.—The limitations provided under this section shall not apply with respect to any contribution or gift described in section 170(c)(6) if the requirements of section 170(c)(6) are met.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of enactment of this Act.

EXHIBIT B

STATE	NUMBER OF SAMMONS EMPLOYEES IN STATE
Alabama	18
Arizona	4
Arkansas	43
California	132
Colorado	4
Connecticut	46
Florida	114
Georgia	16
Illinois	25
Indiana	10
Iowa	4
Kentucky	13
Louisiana	108
Minnesota	4
Mississippi	45
New Jersey	69
New Mexico	2
New York	116
North Carolina	785
Ohio	6
Oklahoma	36
Pennsylvania	66
South Dakota	276
Tennessee	31
Texas	1884
Virginia	36
Washington	3
West Virginia	3

EXHIBIT C

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

JUL 29 1992

Honorable Michael A. Andrews
U.S. House of Representatives
Washington, DC 20515-4325

Dear Mr. Andrews:

This is in response to your requests dated April 6 and June 29, 1992, for a revenue estimate of H.R. 3485.

H.R. 3485 would permit an employee stock ownership plan (ESOP) to be a beneficiary of a charitable remainder trust with respect to the portion of the remainder interest in the trust that consists of stock that is not readily tradable. Stock transferred to an ESOP from the trust is to be held in a suspense account until allocated to plan participants. The stock cannot be allocated to, or for the benefit of, any person owning more than 5 percent of either the total number of outstanding shares or total market value of the corporation establishing the ESOP.

It is our understanding that this proposal would not affect the income tax or gift tax consequences of the transaction described.

H.R. 3485 would apply to transfers made by trusts to or for the use of an ESOP after the date of enactment of this bill. Assuming an effective date of October 1, 1992, we estimate that this bill would reduce Federal fiscal year budget receipts by less than $1 million annually.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Harry L. Gutman

EXHIBIT D

103D CONGRESS, 1ST SESSION

HOUSE
DAN ROSTENKOWSKI, ILLINOIS, CHAIRMAN
SAM GIBBONS, FLORIDA
J.J. PICKLE, TEXAS
BILL ARCHER, TEXAS
PHIL CRANE, ILLINOIS

SENATE
DANIEL PATRICK MOYNIHAN, NEW YORK, VICE CHAIRMAN
MAX BAUCUS, MONTANA
DAVID BOREN, OKLAHOMA
BOB PACKWOOD, OREGON
ROBERT DOLE, KANSAS

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

HARRY L. GUTMAN
CHIEF OF STAFF
PETER v.Z. COBB
DEPUTY CHIEF OF STAFF
MARY M. SCHMITT
ASSOCIATE CHIEF OF STAFF (LAW)
BERNARD A. SCHMITT
ASSOCIATE CHIEF OF STAFF (REVENUE ANALYSIS)

JUN 16 1993

Honorable Michael A. Andrews
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Andrews:

This letter provides estimates of the revenue effects of some of the issues that you submitted to Chairman Rostenkowski in connection with the Ways and Means Committee's consideration of miscellaneous Member amendments. We are generally providing estimates at this time for the issues scheduled for hearings by the Select Revenue Measures Subcommittee.

Attached is a revenue table that provides the estimated effects of your proposals on Federal fiscal year budget receipts. Please note that, unless otherwise specified, the revenue estimates for these proposals have been prepared relative to present law. If the budget reconciliation provisions currently under consideration by the Congress are enacted or if these proposals are included in the budget reconciliation package, the estimates we have provided in this table may change. This will occur primarily because of the interaction of the proposals with the higher individual or corporate income tax rates in the budget reconciliation proposals, but may also occur because of the interaction of these proposals with other provisions in the budget reconciliation package.

Any proposals relating to expiring tax provisions have been estimated relative to the budget reconciliation provisions passed by the House of Representatives. Thus, the expiring provisions have been assumed to be extended permanently and the revenue effects of any proposal relating to an expiring provision that are shown on the attached table provide the incremental revenue effect of the proposal after the permanent extension. If the expiring provisions are not extended as part of the budget reconciliation legislation or if the provision is extended for a temporary period, the revenue effect of your proposal may change significantly.

The descriptions of your proposals contained in the pamphlet prepared by the Joint Committee staff for the Select Revenue Measures Subcommittee hearings conform to the proposals for which we are providing revenue estimates. This pamphlet will be delivered to your office as soon as we receive the final version from the Government Printing Office. If there is an introduced bill relating to the proposal, we have described the introduced bill unless your staff has indicated that there are modifications to the bill that you want to make.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

Honorable Michael A. Andrews
U.S. House of Representatives

I hope this information is helpful to you. If we can be of further assistance or if you have any questions about the information that we are providing to you, please do not hesitate to contact me.

Sincerely,

Hank

Harry L. Gutman

Attachment

#93-1100-1
PRELIMINARY
16-Jun-93

- Ways and Means Committee -

ESTIMATED REVENUE EFFECTS OF VARIOUS PROVISIONS
SCHEDULED FOR HEARINGS BEFORE THE COMMITTEE

Fiscal Years 1994-1998

[Millions of Dollars]

Provision	Effective	1994	1995	1996	1997	1998	1994-98
M ANDREWS							
1. Charitable deduction for transfer of employer securities to ESOPs.............	DoE	[1]	[1]	[1]	[1]	[1]	[1]
[redacted]	[redacted]	[redacted]					

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column: bia = bonds issued after
DoE = date of enactment
ppisa = property placed in service after
TRA'86 = Tax Reform Act of 1986
tyba = taxable years beginning after
tyea = taxable years ending after

N/A Estimate not yet available

[1] Loss of less than $1 million
[2] Evaluated relative to House budget reconciliation bill (HR 2264).
[3] Evaluated relative to Administration's proposal.
[4] Gain of less than $500,000.

[Modified to appear on one page]

"Allowing Permanently Disabled Former Employees to Contribute to 401(k) Pension Plans"

STATEMENT
OF
UNITED CEREBRAL PALSY ASSOCIATIONS
BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
FOR THE RECORD OF THE HEARING ON
MISCELLANEOUS TAX REFORMS

JULY 12-13, 1995

Mr. Chairman:

Thank you for this opportunity to present testimony for the record on the proposal to permit permanently disabled persons to contribute to 401(k) plans. United Cerebral Palsy Associations (UCPA) is the nation's largest disability service organization. Our organization's mission is to advance the independence of people with disabilities. To that end, we are pleased to provide this testimony. The concept of permitting 401(k) contributions not allowed under current law merits full consideration. Legislation tailored to that purpose would be an important step in extending fair pension treatment to persons with disabilities. However, the current restriction is but one symptom of a much larger issue which the committee and the Congress should and must address: the impediments to career and employee benefit opportunities available to persons with disabilities. This statement focuses on the proposed 401(k) proposal within the that larger context.

An employee, under current law, may elect to have his or her employer pay a portion of the employee's current salary as contributions to a defined contribution plan on behalf of the employee. For purposes of making such contributions, Department of the Treasury regulations impose an unnecessary impediment. In particular, the regulations do not permit former employees, including individuals defined under federal law as "permanently disabled," to participate in a tax-deferred, employer-maintained arrangement, such as a 401(k) plan, regardless of whether they receive any form of compensation from the employer.

The concept under consideration by the committee would treat disability benefits from any source -- whether private insurance proceeds, state disability payments or federal monies such as Supplemental Security Income (SSI) or Social Security Disability Insurance (SSDI) -- as salary for purposes of establishing eligibility for participation in employer-sponsored 401(k) plans. Conceptually, the legislative proposal would permit permanently disabled former employees to contribute a percentage of the benefits they receive to a qualified tax-deferred plan. Individuals could "thus make elective deferrals with respect to employer-provided disability benefits," according to materials describing the proposal prepared by the Joint Committee on Taxation.

While UCPA is pleased by the proposal's reflection of interest in leveling the pension "playing field" for persons with disabilities, the 401(k) proposal raises a number of questions which must must first be resolved. In fact, the proposal appears to engender several legal, policy and administrative difficulties.

Specifically, UCPA urges the committee to consider the following:

• the impact of effectively "deeming" disability benefits equivalent to salary on an individual's continued eligibility for federal disability program benefits;

• the effect which designating such benefits for 401(k) eligibility purposes will have upon an individual's eligibility for other federal programs and tax code advantages for which he or she would otherwise be eligible;

• administrative means to be used by employers in determining the amount of a permanently disabled former employee's disability payments;

• if the employer "match" contemplated by the proposal will be considered income for purposes of ascertaining eligibility for federal, state and or private disability payments;

• whether an employee's 401(k) contribution may be set aside or discounted for purposes of determining income eligibility for non-disability public assistance programs for which the employee might otherwise be eligible.

As the committee determines whether and how to pursue this proposal, UCPA urges that members remain mindful that -- generally -- the income of federal disability benefits may not exceed the "substantial gainful activity level" of $500 a month. Once the SGA limit is exceeded, recipients lose some or all of their disability and health insurance benefits. Plainly, legislation which embodies the 401(k) eligibility concept will require most careful crafting. In the process, the committee should take special care not to unwittingly expose individuals with disabilities to the "earnings cliff."

The potential problems which UCPA has outlined above are representative of the various statutory and administrative factors which impede the access of persons with disabilities to the full range of workplace benefits and employment options routinely available to most people without disabilities. The Ways and Means Committee has an excellent opportunity to see firsthand the formidable nature of these barriers to full employment. As the committee examines how to pursue the 401(k) proposal, UCPA recommends that the committee give the fullest possible attention to "fine tuning" the tax code to emphasize individual empowerment and provide employment incentives -- not impediments -- to persons with disabilities.

The major assumption behind the current federal statutory definition of disability is that employment and disability are mutually exclusive. They are not. Many, although not all, individuals with disabilities are fully capable of working, if presented with an opportunity, appropriate supports, and the financial rewards which come with employment. Medical and technological advances have extended the post-disability lifespan and expanded the potential for

work opportunities for individuals with disabilities, including persons with most severe disabilities. UCPA recommends that the committee -- concurrent with its efforts to create pension equity for so-called "permanently disabled" individuals -- examine ways in which it may use the tax code to help the millions of individuals with disabilities who can work given appropriate supports take advantage of new and assistive technology to maximize their work opportunities and benefits.

The fact is that we cannot afford **not** to invest in a new kind of future -- one of productive independence for individuals with disabilities, and of increased productivity for the entire nation. While expecting every person with a disability to work is unrealistic, not assisting those who could work is inequitable and unsound public policy: UCPA believes a return to work goal must underlie tax code initiatives targeted to assist so-called "permanently disabled" former employees.

UCPA urges the committee to consider tax code changes which recognize and make more affordable the full panoply of services -- including, but not limited to, assistive technology and other supports -- available to persons with disabilities able and willing to work.

To that end, UCPA recommends that the committee ***provide direct income subsidies to disabled workers through income tax credits and deductions.***

Individuals with disabilities incur substantial expenses in the conduct of their everyday lives as they try to learn, work, recreate, and live in the community. The cost of personal assistance to enable individuals with severe disabilities to work can be a barrier to employment, as individuals with disabilities often do not earn enough in wages to afford to pay for personal assistance in addition to a rent or mortgage, utilities, food, and related life expenses. Other examples of extraordinary expenses include the cost of accessibility modifications such as a wheelchair lift for a van or hand controls for a car; a wheelchair ramp or alternative signaling device for an accessible home; or medications and medical supplies. There are major expenses for assistive technology including wheelchairs, hearing aids, animal companions, computers, augmentative communications devices and the training and maintenance costs of the equipment. Not the least of these extraordinary expenses is for health specialists above and beyond the typical health expenses incurred by the average person. All of these expenses conspire to trap individuals with disabilities in a cycle of poverty and total government dependency from which most cannot escape without tax assistance to level the economic playing field.

In order to promote the goal of employment and increased self sufficiency for individuals with disabilities, there must be financial incentives for beneficiaries and recipients to take the risk of leaving the disability roles for payrolls. This could be accomplished by modifying the current Earned Income Tax Credit for low-income workers to individuals with disabilities, and by creating a Personal Assistance Services Tax Credit for working individuals with disabilities who have significant needs for personal and technological assistance in order to work.

The Earned Income Tax Credit should be extended to include persons with disabilities age 18 and older, structured to ensure that it helps bridge the gap between the Substantial Gainful Activity level and a minimum income level for low-income workers with disabilities. The present Substantial Gainful Activity level for non-blind beneficiaries is $500 per month, or $6,000 per

year -- less than the Federal poverty level! It is impossible for an individual with a severe disability to live on this level of income, especially given their extraordinary expenses of living with a disability.

Accordingly, UCPA recommends changes to address the cost of long-term services for working persons with the most significant disabilities. To do this, we propose a tax credit of one-half of all personal assistance services up to $15,000 for any individual with a disability who is working. Expenses for personal assistance services beyond $15,000 per year should be deductible as a medical expense.

Personal assistance is defined as one or more persons or devices assisting a person with a disability with tasks which that individual would typically do if they did not have a disability. This includes assistance with such tasks as dressing, bathing, getting in and out of bed or one's wheelchair, toileting (including bowel, bladder and catheter assistance), eating (including feeding), cooking, cleaning house, and on-the-job support. It also includes assistance with cognitive tasks like handling money and planning one's day or fostering communication access through interpreting and reading services.

The proposed modification of the EITC and changes in medical care deductions for personal assistance will help to offset the extraordinary expenses of living with a disability and assist people with severe disabilities to re-enter the workforce by giving them a measure of economic equity with those wage earners and tax payers who do not need to pay these extraordinary costs.

In closing, UCPA notes that the linchpin of the 401(k) legislative concept is the receipt of disability benefits by "permanently disabled" former employees. We urge that the committee proceed with great care in evaluating the proposal and in resolving some of the statutory and administrative problems which the proposal appears to create. Concurrently, we strongly urge that the committee, as it carries out its mission to simplify the tax code, recognize and emphasize the ***ability*** of individuals to work -- including former and prospective employees alike. UCPA believes a disability need not and should not be presumed to be lifelong in nature. Tax code work incentives are just as appropriate as the pension equity which the committee proposes to consider. Moreover, work-directed tax incentives are certain to be widely utilized by persons with disabilities of all ages. Finally, the changes which UCPA proposes would create a more "user-friendly" tax code. Such a system is consistent with UCPA's vision of a system which encourages people with disabilities to become tax-payers rather than tax-takers, a system which reduces federal disability payments and increases the revenues which consumers provide to the American economy.

Thank you for this opportunity to submit this testimony for the record.

STATEMENT OF CHIEF MASTER SERGEANT JAMES E. LOKOVIC, USAF (RET.)
DIRECTOR, MILITARY AND GOVERNMENT RELATIONS
AIR FORCE SERGEANTS ASSOCIATION

Mr. Chairman and distinguished committee members, the federal government must take whatever steps it can to end the practice of certain states imposing taxes on retirees who were once stationed there but no longer reside in that state. A significant number of military retirees are forced to pay these unfair "source taxes." The 160,000 members of the Air Force Sergeants Association appreciate your assistance in ending this practice. AFSA represents the millions of enlisted active and retired Air Force, Air Force Reserve and Air National Guard members, and their families.

Action must be taken to prohibit these states from claiming a portion of this already-limited retired pay through source taxation. It penalizes military retirees for having been assigned to serve in those states. They were stationed there by the federal government -- not as a result of their own choice. While there, they were subject to paying taxes to their state of residence. Once retired, the military member should be subject to paying taxes only to the state where they currently live.

AFSA strongly believes military retired pay is not a "pension" that states can lay a claim to as the result of work performed within that state. Military retired pay is the result of years of relatively low pay and sacrifice in the national interest, far above what most people experience. Military retirees served a career expecting a reliable retirement income after their last assignment. This retirement was hard-earned through years of difficult life, oftentimes facing mortal risk. They should pay no more than other citizens and in ways no more unfair than the rest. If anything, there really should be a tax break for those who fought our wars and secured our peace -- not a penalty.

Military members are unique in that their retired pay was earned dollar-for-dollar from a career of service to their nation, *not to the individual states in which they served.*

Further, most enlisted members served in numerous states during their careers. These moves were not voluntary. They were ordered to locate there. And while there, they paid state taxes. The greatest unfairness is to those who served in more than one state that practices source taxation. Again, these retirees did so under government orders. To lose portions of retirement to more than one state is most burdensome to this group. If enlisted retirees are taxed, it should only be by the state where they currently reside and receive services.

We strongly appreciate and endorse your proposal to end the practice by penalizing source taxing states with a withholding of individual federal tax return information. This proposal would effectively prevent these states' ability to audit individuals. The threat of such a penalty would be a strong inducement to end the practice. We are also hopeful that if legislation is not passed that ends the practice in totality, then this committee's alternative approach would prevent any future efforts by other states.

Mr. Chairman, we again thank you for your proposal to use your legislative jurisdiction to end this unfairness. We appreciate your help in ending this unfairness. As always, AFSA is ready to assist you in matters of mutual concern.

Girard Miller
President and Chief Executive Officer

ICMA RETIREMENT CORPORATION

777 North Capitol Street, NE
Suite 600
Washington, DC 20002-4240
1-202-962-4600
Toll-Free 1-800-669-7400

August 3, 1995

Chairman Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Archer:

I am writing to you with respect to the recent hearing on miscellaneous tax proposals, and would respectfully request that this letter be included in the printed record.

The ICMA Retirement Corporation ("RC") welcomes this opportunity to present its views on the issue of individual ownership of assets of section 457 plans. RC was founded more than 20 years ago as a not-for-profit independent corporation by the International City/County Management Association exclusively for the benefit of public sector employees. RC manages $4.5 billion in Section 457 plan assets for more than 4,300 public employers and 200,000 public employees.

Recent developments in California have highlighted two flaws in Section 457 plans: Plan assets are subject to the claims of third parties and, under certain circumstances, may be used for other purposes by the employer itself. The recent bankruptcy filing in Orange County highlights the first concern; an earlier attempt by Los Angeles County to use $250 million of plan assets to balance its budget highlights the other.

On behalf of its public sector employer and employee clients, RC strongly endorses the letter and subsequent suggested language provided by the National Association of Government Deferred Compensation Administrators(NAGDCA), of which we are a member, to the Committee on Ways and Means.(See attachment.)

We believe that this language is preferable to the suggested language of the Joint Tax Committee because it is broad enough to accommodate the variety of vehicles currently serving Section 457 plans. Unduly limiting the types of investment options available to participants would burden both the participants and their employers by restricting their investment options and adding administrative obstacles. As structured, the suggested language would eliminate the ability of the public sector to invest in the ICMA Retirement Trust and many similar arrangements.

Again, we strongly endorse the language proposed by NAGDCA to protect the retirement savings of public sector employees.

Thank you for the chance to provide our point of view as you consider the best vehicles for Section 457 plans, while maintaining their flexibility and transferable benefits.

Sincerely,

Girard Miller

Girard Miller,
President and Chief Executive Officer
ICMA Retirement Corporation

Attachment

American Federation of State, County and Municipal Employees
United States Conference of Mayors
Government Finance Officers Association
National Association of Counties
National Association of Police Organizations
National Conference of State Legislators
International Association of Firefighters
National Education Association
National Association of Government Deferred Compensation Administrators
National League of Cities
National Association of State Retirement Administrators
National School Boards Association
International City-County Management Association
International Personnel Management Association

The above organizations urge Congress to protect $40 billion dollars of public employee retirement savings currently invested in Section 457 plans throughout the country. These deferred compensation plans are the primary vehicle used by government employees to set aside their own money for future retirement needs. The savings set aside under the rules of the plan are tax deferred until the money is actually received at retirement.

Section 457 of the Internal Revenue Code requires deferred compensation plans to follow a number of rules. Most rules exist to ensure that money saved is in fact used for retirement. One rule, however, defeats both that goal and the broader national purpose of encouraging saving for retirement.

Section 457 (b)(6) requires the governmental employer to own assets of the deferred compensation plan--without recognition of the employee's interest in those assets. The IRC also requires that plan assets must be subject to the claims of the employer's creditors. During times of fiscal stress this requirement creates the possibility of seizure or manipulation of this money. Recent fiscal problems faced by local governments in Southern California emphasize that this is real.

Placing public employees' retirement assets at risk is unnecessary and contrary to public policy. Therefore, the above organizations propose that Congress adopt a simple amendment to the Internal Revenue Code to recognize the employee interest in these funds, thereby protecting them from employer bankruptcy or manipulation. No other change in the structure or operation of these plans is intended.

Since Congress enacted Section 457 in 1978 over $40 billion dollars has been contributed to these plans by millions of public employees, including police, teachers, park rangers, and construction crews. Most plans exist without a penny of taxpayer support. The amendment set out below brings the Internal Revenue Code into line with the practical reality of these plans and employee expectations: it is employee money and the tax law should not require it to be placed at risk.

Proposed Amendment to Section 457 of the Code

Section 457 (b)(6) of the code is amended and restated in is entirety to read:
(6) which provides that
- (A) all amount of compensation deferred under the law,
- (B) all property and rights purchased with such amounts, and
- (C) all income attributable to such amounts, property, or rights.

shall be held in trust, custodial account, an annuity contract, insurance contract or other contract. The assets of such trust or contract shall be held and administered by the employer or its designee according to the requirements of this section and for the exclusive purpose of providing benefits for participants and their beneficiaries in the eligible deferred compensation plan.

July 19, 1995

Chairman Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer,

I am sending this letter in response to the recent hearing on miscellaneous tax reform and request that this be included in the printed record.

The National Association of Government Deferred Compensation Administrators (NAGDCA) is pleased to present its views on the protection of compensation voluntarily deferred by the employees of America's state and local governments. By far the majority of these funds, some $40 billion dollars to date, have been deferred pursuant to Section 457 of the Internal Revenue Code. Section 457 plans are the only elective tax-deferred retirement savings arrangement available to millions of such employees.

NAGDCA is the official organization representing public administrators of Section 457, with 49 state members, 74 members representing individual cities and counties, and over 70 private firms providing financial services or products to the governmental plans. Through four institutional members (International City-County Management Association, Michigan Association of Counties, National Association of Counties, and the U.S. Conference of Mayors) over seven thousand additional local governments are represented by NAGDCA.

NAGDCA and its members have been participants in the creation and administration of public deferred compensation plans from the outset. The Association, itself, is an outgrowth of the coalition of governments which worked with the Ways and Means Committee to design Section 457 in 1978.

Recent developments in California have highlighted two peculiarities of Section 457 plans: plan assets are subject to the claims of third parties and, under certain circumstances, may be used for other purposes by the employer, itself. The recent bankruptcy filing in Orange County highlights the first concern; an earlier attempt by Los Angeles County to use $250 million of plan assets to balance its budget highlights the other.

The threat of invasion places these voluntary retirement savings at risk, causes needless worry and concern, and have neither purpose nor policy behind them.

Section 457 should therefore be amended to remove these unnecessary and undesirable side effects, and to add language reflective of the way most governments administer their plans today. Generally, most plans assets are held for the exclusive benefit of the employees whose savings create those assets. No other change in the statute, or current arrangement, structure, organization or administration of these plans is either intended or suggested.

Several attorneys general and county and city attorneys are currently working with NAGDCA to assist in drafting language which crafts narrow but effective solutions to these concerns. NAGDCA is also reviewing their suggestions in conjunction with organizations such as the National Governors Association, the U.S. Conference of Mayors, Government Finance Officers Association, and the AFL-CIO. We look forward to sharing language options with the Ways and Means Committee as soon as completed.

Thank you for this opportunity to participate in your consideration of the least intrusive, most effective way to protect the retirement assets of public employees and to preserve their faith in the integrity of investments made on their behalf.

Sincerely,

John L. Kozusko
President,
National Association of Government
Deferred Compensation Administrators

Written Statement for the Record

Public Hearing on Miscellaneous Tax Reforms

Submitted by

National Volunteer Fire Council

International Association of Fire Chiefs

IAFC Volunteer Chief Officers Section

Firemen's Association of the State of New York

Association of Fire Districts of the State of New York

Florida Fire Chiefs' Association

State Firemen's and Fire Marshals' Association of Texas

Georgia State Firefighter's Association

Georgia Association of Fire Chiefs

Georgia Firemen's Pension Fund

Georgia State Fire Marshal

Minnesota Area Relief Association Coalition

Washington State Association of Fire Chiefs

California State Firefighters' Association

Committee on Ways and Means

U.S. House of Representatives

July 11 and 12, 1995

A Proposal to Exclude Length of Service Awards to Volunteers Performing Fire Fighting or Prevention Services, Emergency Medical Services, or Ambulance Services From the Limitations Applicable to Certain Deferred Compensation Plans Under Internal Revenue Code Section 457 and From Federal Insurance Contributions Act Taxes

This statement for the hearing record is submitted by National Volunteer Fire Council, International Association of Fire Chiefs, IAFC Volunteer Chief Officers Section, Firemen's Association of the State of New York, Association of Fire Districts of the State of New York, Florida Fire Chiefs' Association, State Firemen's and Fire Marshals' Association of Texas, Georgia State Firefighter's Association, Georgia Association of Fire Chiefs, Georgia Firemen's Pension Fund, Georgia State Fire Marshal, Minnesota Area Relief Association Coalition, Washington State Association of Fire Chiefs, and California State Firefighters' Association [see attached exhibit for brief description of each submitter].

We call your attention to a matter of vital importance to the national safety of the United States -- the ability to successfully provide adequate fire fighting and prevention services, emergency medical services, and ambulance services (collectively referred to as emergency services) to our citizens. In many areas of the country it is not economically or geographically feasible to provide these emergency services through paid career personnel. Instead, we must depend on the services of volunteer personnel. As we are sure you are aware, it is often difficult to attract and retain volunteers in any endeavor -- and it is especially difficult, while at the same time critically necessary, that volunteers be retained for extended periods in the emergency services area.

Only if volunteers are willing to make a long term commitment to the effort will they be able to become and remain adequately trained to provide the level of emergency services our citizens demand and deserve. But we need Congress' help in our efforts to attract and retain volunteer emergency services personnel on a long term basis. Our tax laws should not be allowed to act as a deterrent to the provision of these services.

In recent years, it has become very common for fire companies providing volunteer emergency services, which fire companies can be either government or non-governmental tax-exempt entities, to offer service awards to volunteer personnel as a means not only to attract volunteers, but also as a means to retain them on a long term basis. Typically, these benefits are provided under so-called Length of Service Award Programs, which generally provide dollar benefits at retirement age for years of voluntary service. The average monthly benefit is approximately $250. At present, programs such as these are in force in about three-quarters of the States, often pursuant to a State statute.

These service awards are taxable to the volunteer emergency services personnel as income at some point -- either when they are actually received at retirement or when they become vested (which may be years before retirement). Exactly when the awards are taxable depends on what provisions of the tax laws apply.

It appears that section 457 of the Internal Revenue Code, which governs deferred compensation plans maintained by governmental and non-governmental tax-exempt entities, may cause volunteers to be taxable on their service awards when they vest, instead of when they are received after retirement. Under section 457, an individual is not taxable on his annual service award until he receives it (after retirement), but only if the value of the award for the year does not exceed the lesser of $7,500 or 33 1/3 percent of the individual's compensation If this limit is exceeded, then an individual is taxable as soon as he vests in the award, which almost always occurs long before payments begin upon reaching retirement age.

Based on an informal survey of a number of the members of the National Fire and Police Pension Fund Association, and further data from the former executive director of the International Association of Fire Chiefs Foundation, there are approximately 150,000 volunteer fire and rescue personnel actively providing volunteer services in the United States who are covered by service award programs. Approximately 43 percent of these volunteers reside in New York, Pennsylvania, Maryland and Virginia where, either by state statute or practice, no compensation or other remuneration is provided to volunteers.

Another approximately 14 percent of these volunteers reside in states that pay only a nominal annual "expense reimbursement" of under $1,000. These states are Colorado, Connecticut, Georgia, Indiana, Kentucky, South Carolina and Tennessee.

In New Jersey, some fire commissioners are paid up to $3,000 annually, but the rank and file volunteers may receive in the neighborhood of $1,000 to $3,000 per year based on their level of service.

It appears that only one state, California, pays certain volunteers on an hourly basis. This practice started as a way of providing manpower for forest fires. In at least two departments several volunteers have received $8,000 in one year. However, it is rare for payments to any volunteer to exceed $6,000 per year.

Therefore, since most volunteers do not receive any payment for their services, and the small number that do receive something receive only a minimal amount, usually only enough to reimburse them for their expenses as a volunteer, the value of an annual service award, no matter how small, will always exceed 33 1/3 percent of the volunteer's compensation as a volunteer. And because volunteers almost always vest in their service awards long before actually receiving benefits upon reaching retirement age, if section 457 applies the volunteers will be taxed on benefits they will not receive for some time to come.

As a general rule, wages are subject to FICA and Medicare taxation when paid, although there are various exceptions to this rule. However, pension payments from certain types of plans, such as tax-qualified retirement plans, are exempt from FICA and Medicare taxation altogether. There is no similar exception for awards under Length of Service Award Programs for volunteer emergency services personnel. Consequently, it appears that these awards may be subject to the rules for nonqualified deferred compensation plans, which would result in awards being subject to FICA and Medicare taxation when they are vested. This almost always is long before benefits are received.

On June 20, 1995, HR 1893 was introduced to resolve the tax issues surrounding volunteer emergency services personnel Length of Service Award Programs. HR 1893, initially co-sponsored by Rep. Amo Houghton (R-NY), Rep. Jim Bunning (R-KY), Rep. E. Clay Shaw, Jr. (R-FL), Rep. Michael McNulty (D-NY), Rep. Gary Ackerman (D-NY), and Rep. Harold L. Volkmer (D-MO), would exempt these Length of Service Award Programs for volunteer emergency services personnel from section 457. [Since HR 1893 was introduced, the following have added their names as co-sponsors: Rep. Frank R. Wolf (R-VA), Rep. John J. LaFalce (D-NY), Rep. William O. Lipinski (D-IL), Rep. Lewis F. Payne (D-VA), and Rep. Lynn Rivers (D-MI).]

We want to stress that this legislation would not cause benefits to escape income taxation altogether. Rather, taxation would simply be deferred until the benefits actually were received by the retired volunteers. HR 1893 also would exempt service awards under these programs from FICA and Medicare taxation, just as are benefit payments from tax-qualified retirement programs for retirees who are rewarded for their past service. This corrective legislation would support the important role that volunteer emergency services personnel play in providing vital, cost effective services in communities across the United States.

Congress has previously recognized the need to support volunteer firefighters by enacting Internal Revenue Code section 219(g)(6)(B), which allows volunteers to establish IRAs on account of their activities as volunteer firefighters at the same time as they may be participating in a retirement plan on account of their regular paid employment. In the same vein, Congress has provided exemptions from FICA and Medicare taxation for certain classes of individuals performing services in special capacities similar to volunteer emergency services personnel. For example, Internal Revenue Code section 3121(i)(3) provides that allowances paid to Peace Corps volunteers prior to termination of service are not included in wages for FICA or Medicare taxation. Further, the IRS has ruled that certain allowances paid to volunteer firefighters are not wages for FICA and Medicare taxation. (Unfortunately, these IRS rulings do not involve amounts similar to annual service awards for volunteer

emergency services personnel.)

It has been said in the past [June 22, 1993 testimony of Leslie B. Samuels, Assistant Secretary of the Treasury (Tax Policy) before the House Ways and Means Committee Subcommittee on Select Revenue Measures] that there is no tax policy reason for providing the relief requested. On the contrary, there is no rationale for not providing the relief. Mr Samuels said that section 457 was designed to limit the amount of tax-favored deferred compensation that governmental and tax-exempt entities can provide to employees and independent contractors under "nonqualified" deferred compensation plans -- plans that do not have to satisfy nondiscrimination and other qualification requirements under the Internal Revenue Code that tax-qualified retirement plans must satisfy.

The policy rationale for the limits imposed by section 457 is that, without such limitations, a governmental or tax-exempt entity would be able to use a "nonqualified plan" to provide its highly compensated employees with large amounts of nontaxable deferred compensation benefits without also having to provide nondiscriminatory benefits to its nonhighly compensated employees. This rationale is inapplicable in the case of volunteer emergency services personnel. They receive little or no compensation for providing services as volunteers and thus would all be nonhighly compensated "employees." Therefore, because discrimination in favor of highly compensated employees is not possible in the case of volunteer emergency services personnel, Length of Service Award Programs should be exempt from section 457 and from FICA and Medicare taxation.

In taking a position that there is no tax policy reason for distinguishing "employees" who perform volunteer emergency services from any other employees of tax-exempt or governmental employers, the Treasury Department loses sight of the distinction between employees who receive "fair value" compensation for services rendered and "employees" who volunteer their services and are generally paid amounts, if any, that only reimburse them for expenses incurred. The Internal Revenue Service has issued private letter rulings that volunteer firefighters are employees for employment tax purposes. However, these letters are based only on the degree of control over volunteer activities that the fire company exerts BY NECESSITY; the important element of compensation for the services rendered was not considered. This absence of "fair value" compensation supports a tax policy exception that distinguishes volunteers from employees who receive compensation equal to the fair value of their services.

There also are strong social and public policy reasons for adopting the provisions of HR 1893 -- to promote volunteerism, especially to provide adequate fire protection and other emergency services to our citizens. In many areas of the country, it is not economically or geographically feasible to provide these services through paid career personnel.

Instead, state and local governments and communities must depend on the services of volunteers. It is difficult to attract and retain volunteers in any endeavor -- and it is especially difficult, while at the same time critically necessary, for volunteers to be retained for extended periods to provide fire protection and other emergency services. Only if volunteers are willing to make a long term commitment to the effort will they become and remain adequately trained to provide the level of fire protection and other emergency services our citizens demand and deserve.

Finally, HR 1893 will result in virtually no Federal revenue loss. Last year, the Joint Committee on Taxation estimated that the revenue loss from HR 4655 (introduced in the 103rd Congress with language identical to HR 1893), projected over a five year period, would have been only $44 million. Even this relatively small cost is grossly overstated. While we do not know what level of compliance the Committee used in its estimate, our understanding from conversations with active and retired volunteers is that very few individuals currently pay income tax on awards prior to actually receiving them at retirement, and awards are not now being included as wages for FICA taxation. Furthermore, the total number of affected taxpayers would not be significant and, in any event, the individual service awards involved would be small.

EXHIBIT

Description of Submitters

National Volunteer Fire Council: The National Volunteer Fire Council (NVFC) provides a voice for the 1.5 million volunteers in the United States who staff more than 30,000 fire departments and emergency medical service organizations throughout the nation. Its membership includes state-level organizations that represent volunteer firefighters and EMS personnel in 46 states across the country, more than 1,700 volunteer fire departments, individual firefighters, Corporate Members and a number of allied organizations. The Council monitors developments on Capitol Hill and in federal agencies to keep its members informed of current and forthcoming legislation and activities affecting them. NVFC is the volunteer fire service's representative not only in the national policy arena, but also on numerous national and international committees and organizations. The Council is represented on many NFPA committees, including: 1500, 1021, 1201, 1900, Clothing, Forestry, and Professional Qualifications Correlating Committee. The Council also serves on the Board of Visitors of the National Fire Academy, the Congressional Fire Services Institute Advisory Board, the Fallen Firefighters Foundation, and the Federation of World Volunteer Firefighters Associations.

International Association of Fire Chiefs: The International Association of Fire Chiefs (IAFC) was the first national fire service organization in the United States and is one of the oldest professional management organizations. The IAFC includes a membership of nearly 11,000 fire chiefs and chief fire officers in 40 countries worldwide. Of those members, more than 8,000 are fire chiefs who hold primary responsibility in their communities for ensuring the highest possible level of fire protection for their citizens. IAFC members provide fire, EMS and other emergency services to approximately 70 percent of the United States population. The IAFC has a structure of geographical divisions and topical sections dealing with a wide range of issues, including: firefighter health and safety, automatic fire protection systems, hazardous materials, building codes, emergency medical services, cultural diversity, fire prevention, fire service accreditation, voluntary standards, training, education, and arson.

IAFC Volunteer Chief Officers Section: The Volunteer Chief Officers Section of the IAFC has a membership comprised of paid and volunteer Chief Officers who manage volunteers in their delivery system. The volunteer section is charged with promoting the volunteer fire and rescue organizational concept in communities throughout the United States. The Section's mission is to provide Chief Officers who manage volunteers within the Fire/Rescue/EMS delivery system with information, education, services, and representation to enhance their professionalism and capabilities.

Firemen's Association of the State of New York: The Firemen's Association of the State of New York (FASNY) is dedicated to the volunteer fire service and the volunteer firefighter in the State of New York. FASNY's current membership is approximately 140,000 volunteer firefighters. FASNY's interests include fire prevention and suppression, the emergency medical service, arson investigation, the training and protection of the professional volunteer firefighter, the training and utilization of fire police, and legislation and laws pertinent to the myriad facets of modern complex fire control.

Association of Fire Districts of the State of New York: The Association of Fire Districts of the State of New York is an organization representing approximately 650 fire districts across the State of New York. The Association is a governmental entity, being a branch of the New York State government, and is in charge of the management and fiscal affairs of fire districts.

Florida Fire Chiefs' Association: The Florida Fire Chiefs' Association represents 295 fire departments throughout Florida. Its 895 members consist of chief fire executives, senior fire officers, public information officers, and firefighters.

State Firemen's and Fire Marshals' Association of Texas: The State Firemen's and Fire Marshals' Association of Texas is the oldest fire service organization in the state and among the oldest in the country, with over 14,000 members. The Association helps new fire departments organize and write by-laws, and assists with filing charters and submitting reports to the Internal Revenue Service. In Addition, the Association is responsible for Texas volunteer firefighter certification and is dedicated to firefighter training and safety.

Georgia State Firefighter's Association: The Georgia State Firefighter's Association is made up of firefighters, both paid and volunteer, who are affiliated with fire departments within the State of Georgia. The Association has approximately 7,500 members.

Georgia Association of Fire Chiefs: The Georgia Association of Fire Chiefs is made up of Chief Officers of fire departments within Georgia. Its membership is approximately 250.

Georgia Firemen's Pension Fund: The Georgia Firemen's Pension Fund is a retirement system created by an act of the Georgia General Assembly. Membership is open to any firefighter, paid or volunteer, who is affiliated with a Class 8 or lower ISO-rated fire department within the State of Georgia. There currently are 1,500 retirees and 7,500 active members in the system.

Minnesota Area Relief Association Coalition: The Minnesota Area Relief Association Coalition (MARC) is a coalition of the local relief associations that are associated with fire companies that receive funding from the state for service awards for volunteers. Local relief associations in the MARC group represent 19,000 volunteer firefighters.

Washington State Association of Fire Chiefs: The Washington State Association of Fire Chiefs has as its mission to be a source of information and education to its approximately 1,800 members and to take a lead role in influencing issues affecting the fire service. There are seven Divisions in the Association: Emergency Medical Services, Equipment and Apparatus, Fire Prevention Officers, Fire Service Secretaries, Public Fire Educators, Training Officers, and Hazardous Materials.

California State Firefighters' Association: The California State Firefighters' Association has three categories of membership, with a total membership of approximately 27,000: active membership, associate membership, and retired membership. Active membership is open to any member of the California fire service, paid or volunteer, involved in fire suppression or prevention, training, dispatching, rescue, or administration. Associate membership is open to fire department clerical staff, students of fire technology, or any person or organization with an interest in the California fire service. Retired membership is open to those members retired from a California fire department.

Mayo Foundation Statement for Hearing Record
U.S. House of Representatives
Committee on Ways and Means
July 12, 1995

The Mayo Foundation is submitting this statement for the hearing record of July 12, 1995, relating to deferred compensation for medical group practices. We fully support the testimony presented to the committee by the American Group Practice Association.

Mayo Foundation is a 501(c)(3) tax exempt not-for-profit organization. The Foundation owns and operates the Mayo Clinic, Saint Mary's Hospital, and Rochester Methodist Hospital, in Rochester Minnesota; Mayo Clinic Jacksonville and Saint Luke's Hospital, in Jacksonville, Florida; Mayo Clinic Scottsdale in Scottsdale, Arizona; and multiple regionally affiliated clinics and hospitals in Minnesota, Wisconsin, and Iowa. Mayo is an integrated health care delivery system. The Foundation also engages in medical research, graduate and undergraduate medical education, and related health-related sciences education programs. All employees of Mayo Foundation, including all physicians, are salaried, and do not receive additional income such as bonuses or equity interest.

We recognize that as a not-for-profit entity, Mayo should be subject to limitations on private inurement. We believe that a professional salary and fringe benefit package is the appropriate compensation in the not-for-profit sector, and all other surplus income should be used for the tax-exempt purposes of research, education, and charity care. However, we are very worried that recent changes in federal pension law will make it impossible for us to offer a quality benefit package to our professional staff.

Specifically, the 1993 Budget Reconciliation Act lowered the cap on compensation that can be counted in determining an individual's pension. The cap was reduced from $238,000 to $150,000. This change has made it impossible for us to keep our commitments to our staff to provide anticipated pensions. While this change in law negatively affected all sectors, those in the for-profit sector have other options to make up this pension loss through non-qualified deferred compensation. In the not-for-profit sector, this option is severely limited. The maximum we can offer in deferred compensation is less than $10,000, and this amount is reduced dollar-for-dollar for any tax-deferred annuity contributions made by the employee.

If the not-for-profit sector is to remain a viable force in the health care system, and research, education, and charity care are to continue to be provided, we need the to be able to compete for talented people. In order to facilitate our ability to compete, a reasonable pension package must be available. We know that we cannot offer unlimited deferred compensation as our for-profit competitors can, but we need more flexibility than current law allows. We hope the committee will address this problem, and allow more flexibility for not-for-profit medical groups to compete for the best talent available.

Statement by Section 457 Coalition

I. <u>Introduction</u>

Mr. Chairman, this statement is submitted on behalf of the Section 457 Coalition (the "Coalition"). The Coalition is represented by Theodore E. Rhodes and Donald E. Wellington of the law firm of Steptoe & Johnson, and by Stuart M. Lewis of the law firm of Silverstein and Mullens, P.L.L.C. We represent a group of tax-exempt employers that feel that section 457 currently discriminates against them in their ability to hire and compensate executives. The Coalition believe the amendment to section 457 included as part of the Tax Reform Act of 1986 and its subsequent interpretation by the IRS is resulting in treatment of employees of tax-exempt employers that is both discriminatory and inconsistent with basic principles of income tax policy. The Ways and Means Committee addressed a portion of this problem through legislation adopted as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). The Coalition urges the Committee to complete this process through the enactment of legislation that would return section 457 to its original intended purpose; that is, to only be applicable to elective deferred compensation. Similar language was previously adopted by the Committee on Ways and Means in 1987 and 1988 in H.R. 2499 and section 319 of H.R. 2641.

II. <u>Background</u>

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") broadened the coverage of section 457 of the Internal Revenue Code (the "Code") to apply to employees of private tax-exempt employers. Previously section 457 had applied only to state and local government employees.

Although the 1986 Act expanded the group of employers subject to section 457, there was no indication by Congress that the <u>substantive</u> scope of section 457 had been changed. Nevertheless, the Internal Revenue Service ("IRS") took a public position in 1987 that the types and nature of deferred compensation plans governed by section 457 included nonelective deferred compensation (e.g., vacation pay plans, which generally had been thought to be outside the scope of the section 457 rules since they previously applied to state and local governments). The direct effect of this interpretation is to tax individuals <u>currently</u> on amounts they have not yet received, never have had the right to elect to receive, and may not actually receive in the future. This interpretation is wholly inconsistent with basic concepts of federal income tax policy dating back to the origins of the income tax in 1913 under which individual taxpayers have historically been taxed generally only upon receipt of income.

In response to the IRS position, H.R. 3312 was introduced in 1987 by Mr. Matsui and Mr. Vander Jagt along with 22 other members of the Ways and Means Committee as co-sponsors. H.R. 3312 would have specifically reversed the effect of the IRS interpretation by providing that section 457 does not apply to any nonelective deferred compensation. The Committee on Ways and Means included H.R. 3312 in its 1987 tax bill but the language was dropped, along with all other nonrevenue-raising provisions, as part of the November 1987 Budget Summit Agreement. The Committee on Ways and Means again adopted this language as part of its version of TAMRA. As part of the compromise in conference on TAMRA, however, only certain classes of individuals performing services for tax-exempt employers received a clarification

that section 457 did not apply to their nonelective deferred compensation, specifically, independent contractors, church employees and employees under certain collective bargaining agreements. 1/ Earlier amendments to section 457 exempt other classes of employees from current taxation of nonelective deferred compensation as follows: state judges; employees covered by a deferred compensation plan of an Alabama nonprofit corporation which received an IRS ruling on March 17, 1976; employees covered by a deferred compensation plan with respect to which a letter dated November 6, 1975, submitted the original plan to IRS; and employees receiving nonelective deferred compensation under a plan in effect August 16, 1986, if they were covered by that plan prior to that date. In addition, employees of taxable employers may receive both elective and nonelective deferred compensation without being taxed until the time of actual receipt.

III. Detailed Discussion of Status of Current Law and Need for the Reform of Section 457

Legislation is needed that would provide that nonelective deferred compensation is not taxable until paid. Under current law employees of many tax-exempt organizations are taxed on nonelective deferred compensation before they are entitled to receive it. Taxing such amounts before the time when received is inappropriate because it results in current taxation of amounts that:

(1) the taxpayer has not received;

(2) the taxpayer never had the right to elect to receive; and

(3) the taxpayer may not actually receive.

An example of the unfair impact of this current law treatment is as follows:

> In 1994, trade association X hires Mr. Smith to manage its office. Mr. Smith is provided an employment agreement under which he will be paid \$50,000 per year for five years, i.e., 1994-99. If Mr. Smith works for the entire five years for the trade association, the agreement provides that Mr. Smith will be entitled to an additional \$10,000 payment in each year from 2000-04. The trade association has structured the compensation package in this manner to provide an incentive to Mr. Smith to make a long-term commitment and because its current budget does not have sufficient resources to pay these amounts any earlier than the schedule provided. Under the current law interpretation of section 457, if Mr. Smith works for the entire five-year period of 1994-99, he would be taxed in the 2000 tax year on the full present value of the five years of \$10,000 payments which he would be paid in each year from 2000-04 even though he would be entitled to, and receive, only \$10,000 in 2000. If you assume that the discounted present value of the five years of \$10,000 payments is \$30,000, the taxpayer would be subject to tax in 2000 of

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1/ In addition, TAMRA statutorily provided that section 457 does not apply to vacation pay, sick pay, compensatory time, severance pay, disability pay, or death benefits.

$11,200 2/ even though he received only $10,000 of payments for the year, for an effective tax rate of 112%. The above result would occur even if the trade association becomes insolvent in 2001 and is unable to pay the four remaining $10,000 payments. (This analysis assumes Mr. Smith does not apply for one of the eight exceptions to the "general rule" of section 457).

Congress has already recognized the unfairness of the general rule of current law which provides for taxation of nonelective deferred compensation before it is received. Specifically, Congress has exempted from this harsh and unfair treatment many classes of taxpayers as follows:

(1) Employees and independent contractors performing services for taxable employers are not taxed on either elective or nonelective deferred compensation until paid.

(2) Independent contractors performing services for tax-exempt employers are not taxed on nonelective deferred compensation until paid.

(3) Employees of tax-exempt employers performing services pursuant to a collective bargaining agreement in existence on December 31, 1987, are not taxed on nonelective deferred compensation until paid. This rule applies even if the employee is hired after December 31, 1987. In some cases, this represents a permanent exception because certain collective bargaining agreements are permanently considered to be in effect even though subject to subsequent amendment.

(4) Individuals covered by a plan maintained by a church for church employees are not taxed on nonelective deferred compensation until paid.

(5) State judges are not taxed on elective deferred compensation until paid.

(6) Employees covered by a deferred compensation plan of a nonprofit corporation organized under the laws of the State of Alabama with respect to which the IRS issued a ruling dated March 17, 1976, are not taxed on nonelective deferred compensation until paid even if they are employed in the future.

(7) Employees covered by a deferred compensation plan with respect to which a letter dated November 6, 1975, submitted the original plan to the Internal Revenue Service, which responded with a letter dated December 24, 1975, are not taxed on nonelective deferred compensation until paid even if they are employed in the future.

(8) Employees receiving nonelective deferred compensation under a plan in effect on August 16, 1986, are not taxed on nonelective deferred compensation

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2/ Calculated assuming the 28% rate applied to all the income.

until paid provided that they were covered by such plan prior to August 16, 1986.

Employees of tax-exempt employers not within the various classes of exceptions set forth above generally are currently taxed on nonelective deferred compensation even though they have not actually received payment, never had the right to elect to receive payment, and may not actually receive payment in the future. Such treatment is discriminatory and unfair. Moreover, it undermines the credibility of the income tax system because comparably situated taxpayers are not subject to comparable tax rules. This absence of comparable treatment for similarly situated taxpayers is illustrated by many situations. First, many tax-exempt employers have both employees covered by the August 16, 1986 grandfather provision and employees not covered, notwithstanding the fact that they are performing identical services. Second, some employees within the tax-exempt sector are covered by the various exceptions, e.g., independent contractor, church employees, etc., while others are not. Finally employees of taxable employers may receive both elective and nonelective deferred compensation without being subject to current taxation. This latter situation presents significant difficulties for tax-exempt employers in recruiting talented individuals from the taxable sector because they are unable to offer compensation arrangements comparable to those available in the taxable sector. The Coalition believes that employees of taxable and tax-exempt employers should be treated the same. Legislation should provide comparable treatment for all employees of tax-exempt employers and reverse tax treatment of certain tax-exempt employees which is both unfair and inconsistent with long-standing, basic principles of federal income tax policy.

The balance of this testimony discusses section 457 in the context of its legislative history, and explains why the general scope of section 457, which was not changed by the 1986 Act, should be limited to nonqualified, elective deferred benefit arrangements. Nonqualified, nonelective retirement pay plans (as well as other nonelective deferred benefit plans) of both tax-exempt and state and local government employers should be unaffected by section 457 in accordance with the clear Congressional intent which accompanied the original enactment of section 457 and its subsequent extension to private tax-exempt employers as part of the Tax Reform Act of 1986.

IV. The History of Section 457 Indicates That it was Never Intended to Apply to Nonelective, Nonqualified Deferred Compensation Plans

A. Deferred Compensation Rules Before 1978 -- Constructive Receipt Rule

Before 1978 nonqualified deferred compensation arrangements were subject to broad statutory guidelines and regulations. A cash-basis employee included deferred amounts in income when those amounts were "actually or constructively received." 3/ IRS administrative rulings further defined the income recognition rules for various nonqualified deferred

3/ Treas. Reg. §1.466-1(c)(1)(i). See also, Code §451; Treas. Reg. §1.451-2 (constructive receipt of income).

compensation arrangements. 4/ Under traditional constructive receipt principles, deferred amounts are not taxed currently unless they are "made available" to the taxpayer so that the taxpayer can elect to receive such amounts currently. 5/

B. Proposed Regulation Section 1.61-16

In 1978, the IRS published Prop. Reg. §1.61-16 (the "Proposed Regulation"), which would have eliminated the ability of employees to defer compensation at their individual option. 6/ Specifically, the Proposed Regulation would have required all cash-basis taxpayers covered by elective, nonqualified deferred compensation arrangements to recognize deferred amounts as income in the taxable year such amounts otherwise would have been payable, rather than in the later taxable year when the deferred amounts actually were paid.

By its terms, however, the Proposed Regulation only affected those amounts deferred "at the taxpayer's individual option." 7/ Thus, nonelective, nonqualified retirement plans that basically consisted of deferred commitments to pay benefits pursuant to a formula or schedule were not the target of the Proposed Regulation. Since the benefits under such plans were not attributable to amounts deferred "at the taxpayer's individual option," they would not have been covered by the Proposed Regulation.

C. Congressional Response to the Proposed Regulation

Congressional response was swift. Sections 131 and 132 of the Revenue Act of 1978 (the "1978 Act") specifically addressed most elective deferred compensation arrangements jeopardized by the Proposed Regulation. 8/

Section 131 of the 1978 Act created section 457, which applied to state and local government deferred compensation plans. Section 132 of the 1978 Act rejected application of the Proposed Regulation to deferred compensation plans of private, taxable employers. In section 132(a) of the 1978 Act, Congress pronounced that the legal principles governing private deferred compensation plans would be those

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4/ See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174 (guidelines for applying rule of constructive receipt to deferred compensation arrangements), modified Rev. Rul. 70-435, 1970-2 C.B. 100 (replacing one factual example).

5/ See Metcalfe v. Commissioner, 43 T.C.M. (CCH) 1393, 1396 (1982).

6/ See 43 Fed. Reg. 4638 (Feb. 3, 1978).

7/ Id.

8/ See Public Law 95-600, 92 Stat. 2779-83 (Nov. 6, 1978), reprinted in 1978-3 C.B. 13-17. See also, H.R. Rep. No. 1445, 95th Cong., 2d Sess. 52-53, reprinted in 1978-2 C.B. 226-27 (reasons for change); S. Rep. No. 1263, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 363 (reasons for change); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 538 (reasons for change).

in effect on February 1, 1978 (two days before publication of the Proposed Regulation). 9/

D. The 1986 Act

The 1986 Act originated from The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (May 1985) ("President's Proposals"). The President's Proposals included the proposed extension of section 457 to all tax-exempt employers. As described in the President's Proposals, the change in section 457 would affect elective deferrals by employees:

> The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees, a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or tax-exempt employer under an ineligible deferred compensation plan would be includable in the employee's gross income when there is no longer a substantial risk of forfeiture. 10/

There is no indication that section 457, as then in effect, was understood to apply to anything but elective deferral arrangements. In fact, the tenor of Treasury's description of the changes suggests that the employees of the tax-exempt community could be receiving a benefit from the extension of section 457, a suggestion clearly inconsistent with an extension of section 457 to nonelective deferred compensation.

Generally adopting the President's Proposals, the 1986 Act extended section 457 rules to tax-exempt employers. 11/ The operative language of section 457 remained substantially the same except for the deferral coordination rules of section 457(c) and the new distribution rules of section 457(d).

The Conference Report accompanying the 1986 Act did not give any indication of any Congressional intent to expand the scope or nature of plans encompassed by section 457. 12/ The Joint Committee's General Explanation of the Tax Reform Act of 1986 13/ confirms that section 457 "continues to apply to the same types of deferred compensation to which it

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9/ Id. at 92 Stat. 2782-83, reprinted in 1978-3 C.B. 16-17.

10/ President's Proposals, Chapter 14.10 at 381 (emphasis added).

11/ 1986 Act §1107, H.R. Rep. No. 841, 99th Cong., 2d Sess. at I-361 to 366.

12/ See Id. at II-397 to 400.

13/ The "1986 Blue Book," published May 4, 1987.

applied under prior law." 14/ Thus, although the 1986 Act expanded the group of employers affected by section 457, it was not intended to change the type or nature of deferred compensation plans subject to the section 457 rules.

V. Notice 87-13 and Examples of Plans to Which Section 457 Should Not Apply

On January 5, 1987, the IRS released Notice 87-13 15/ which contained the preliminary IRS views regarding the scope and application of section 457. At Q&A-26, the IRS adopted the following position:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or a defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select group of executives or other highly compensated employees (e.g., a "top hat" plan). Also, section 457 applies to the amounts deferred even though the deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).
>
> Section 457 applies to amounts deferred under a deferred compensation plan, whether or not such deferral is pursuant to the election of the individual taxpayers. Thus section 457 applies to both elective and nonelective deferred compensation amounts. 16/

The position adopted by the IRS disregarded the historical distinction between the tax treatment of employee elective deferrals and employer-provided, nonelective deferred benefits.

The IRS position threatened many unfunded retirement programs and other benefit programs (e.g., vacation pay and sick pay plans) maintained by tax-exempt organizations and state and local governments. The unfairness of the IRS position was acknowledged when the IRS announced that it would not enforce the interpretation of section 457 as applied to vacation pay, sick pay, and severance pay even before TAMRA was enacted. Congress subsequently provided for this by statute in TAMRA by providing specifically that section 457 does not apply to vacation pay, sick pay, compensatory time, severance pay, disability pay, or death

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14/ Id. at 654.

15/ Published January 26, 1987 in Internal Revenue Bulletin 1987-4.

16/ 1987-4 I.R.B. at 26.

benefit plans. TAMRA also provided that independent contractors, church employees, and employees under certain collective bargaining agreements would not be taxed on non-elective deferred compensation until such amounts are paid. Legislation is needed that would complete this much-needed effort to reform section 457 by providing that all employees of tax-exempt employers are subject to the same fair rules under which they would be taxed on nonelective deferred compensation only when paid, thus ending the current law treatment applicable to only certain classes of employees of tax-exempt employers whereby they generally are taxed currently on amounts that (1) they have not yet received, (2) never had the right to elect to receive, and (3) may not actually receive.

The Coalition congratulates the Committee on Ways and Means for its past actions in attempting to address the problem associated with section 457 and encourages the Committee to complete this process.

TESTIMONY OF JOHN W. BACHMANN
MANAGING PRINCIPAL, EDWARD D. JONES & CO.
Before the U.S. Congress Ways and Means Committee

Mr. Chairman, I am John Bachmann, the managing principal of Edward D. Jones & Co. I appreciate the opportunity to appear before this Committee to present the views of Edward D. Jones & Co., and more importantly to communicate what we believe to be the views of our clients on the restoration of the tax-deductible IRA.

Edward D. Jones & Co. is an investment firm based in St. Louis, Missouri. We serve in excess of 1.8 million customers in the United States. Our clients invest for primarily one reason, to save for their future retirement or to maintain their standard of living in retirement. As you might suspect, they are keenly interested in the savings crisis this country faces. So what should be our first step to incent savings and investment?

Quite simply, restore the tax-deductible IRA. Why? People need to be encouraged to save. A tax deduction does just that. I remember the flood of IRA contributions we used to receive each year from January to April 15. The people making these contributions were not the rich but rather were people of moderate means who knew the importance of saving for retirement. We saw young people saving in record numbers. They understood that by setting aside $2,000 each year from age 22 to age 65; assuming a 7 percent interest rate; would result in more than half a million dollars for their retirement. After the tax deduction was eliminated for many individuals, the number of people making contributions dropped dramatically. Yes, they still understood the need to save and the value of compounding tax deferred, but they quite simply needed the nudge that a tax deduction gave them.

We have all seen studies that suggest IRAs are merely a shift of savings. We've also seen the studies that suggest IRAs create new savings. The reality is, the tax-deductible IRA probably did not exist long enough to make either argument conclusively. I can tell you from my own experience and from those of our investment representatives, that more of their clients responded when IRAs were tax deductible and responded again when the tax incentive was removed!

I know there are a variety of proposals currently being discussed that will affect IRAs, but our clients tell us that offering a tax deduction initially will be a great incentive to save. I also understand the revenue costs of restoring the tax deduction and would suggest that if an up-front tax deduction is not possible that a back-loaded IRA will get us on the right track to encourage people to save for their future.

If neither of those options is viable, I suggest a compromise. As people age, saving for retirement becomes more of a priority. Around the age of 45, when retirement is actually no longer a dream but fast becoming a reality, people tend to save more. They don't necessarily need as great of a tax incentive to start saving. Their age is incentive enough. Young people, on the other hand, need a tax incentive to save, so perhaps a solution is to offer a tax deductible IRA for those individuals 45 and younger. After the age of 45, the tax deduction would no longer be available, but distributions from the account would be tax free. This form of IRA would incent both groups to save and also minimize the amount of lost revenue.

Edward D. Jones & Co. is committed to helping our clients prepare for a comfortable retirement. I sincerely appreciate the opportunity to provide this Committee with our views and the views of our clients. I hope you agree it's time to restore the tax-deductible IRA to encourage Americans to save.

TESTIMONY OF MARY L. MOHR
ON BEHALF OF THE
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202/682-4736

BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING H.R. 682
THE SAVINGS AND INVESTMENT INCENTIVE ACT OF 1995
JULY 11, 1995

Introduction

My name is Mary Mohr. I am Senior Vice President of First Trust Corporation of Denver, Colorado. First Trust is the country's largest independent trust company, specializing in self-directed retirement plans. I am also Chair of the Savings Coalition of America. The Savings Coalition includes 55 members representing a wide variety of interests, including consumer, health care, education and business groups, engineers, home-builders, realtors, trust companies, banks, security firms and financial service companies.

The Coalition would like to thank the Committee for holding hearings and for the invitation to submit testimony in support of H.R. 682, the Savings and Investment Incentive Act of 1995. On behalf of the Coalition, I want to commend you for the leadership and vision demonstrated in your efforts to restore tax incentives for saving to all Americans.

The Savings Coalition of America was established in 1991 to support incentives to increase personal saving rates. It has as its primary objective:

> To encourage Congressional and Administrative approval of expanded IRA legislation.

The Coalition is committed to seeking the enactment of expanded retirement account legislation and supports the key features of H.R. 682 - The Savings and Investment Incentive Act of 1995 also known as the 'Super IRA.' The Coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for the future. By restoring the American dream of owning a home, sending children to college and retiring comfortably, the Super IRA will respond to many of the concerns that members of the middle class express today. The reasons for supporting this proposal are compelling and reasonable. We look forward to working with both houses to pursue expanded retirement savings legislation.

Council for Economic Development (CED) Findings of America's Retirement Situation

In May 1995, the Council for Economic Development (CED) released its report entitled, *"Who Will Pay For Your Retirement? The Looming Crisis."* In its findings, the CED found that this country's retirement system is in dire straits and unless corrective action is taken soon, America will be confronting a major economic crisis. The CED report concluded that "America's retirement system is underfunded, overregulated, and soon to be challenged by unprecedented growth in the retirement-age population. Consequently, our nation will confront a major crisis in financing the needs of the elderly at the beginning of the twenty-first century unless policies are reformed to make retirement savings a top priority." One of the recommendations of the CED is the implementation of "tax incentives and regulatory reform to encourage individual retirement saving and to achieve increased funding of, and coverage by, private pensions." H.R. 682, the Savings and Investment Incentive Act of 1995 provides <u>all</u> Americans with the savings incentives they need for retirement, especially when one considers the problems illuminated by the CED in its report.

Americans Prefer Expanded IRA Legislation Over Other Forms of Tax Cuts

In a poll conducted by Dr. Frank Luntz of Luntz Research Companies for Merrill Lynch, one of the members of the Savings Coalition, it was revealed that an overwhelming majority of Americans do not believe that Social Security and Medicare will provide them with "peace of mind" in retirement. The poll also found that a majority of Americans feel that government policies do not encourage retirement saving. One of the most interesting findings of the poll was that ***"among the various proposed forms of tax relief, Americans believe that expanding the IRA should be the highest priority."*** Other members of the Savings Coalition have conducted polls which have similar results. In a poll conducted by the Institute of Electrical and Electronic Engineers, the majority of the respondents favored expanded IRA provisions. In one day, through an 1-800 number sponsored by USA Today and manned by the International Association for Financial Planning, a member of the Savings Coalition, 73,000 phone calls were made requesting help for retirement planning. This is from a total circulation of 2 million. These results reveal that Americans are very concerned about their retirement. Provisions in H.R. 682 give them the incentive to help them help themselves and be less reliant on a retirement system which will soon be overburdened.

Self-Reliance, Prudence and Independence

United States saving rates are now lower than during any comparable period in American history. According to the Congressional Budget Office, personal saving rates have decreased steadily over the past 25 years, falling from 8% in the 1960s and 70s to less than 4% today. The causes and consequences of saving rate declines have been the subject of considerable debate among economists and policy-makers, but the policy solutions were best articulated to Congress more than 24 years ago:

"Self-reliance, prudence, and independence are qualities which our government should work to encourage among our people. These are also qualities which are involved when a person chooses to invest in a retirement savings plan, setting aside money today so that he will have a greater security tomorrow. In this respect pension plans are a direct expression of some of the best elements in the American character. Public policy should be designed to reward and reinforce these qualities." President Richard Nixon, December 9, 1971 *(Schultz, 1994, p.224).*

It was with this vision that Individual Retirement Accounts ("IRA") legislation was first introduced. By emphasizing the values of self-reliance, prudence and independence, the IRA was designed to empower American taxpayers to take control of their long-term finances and to place ultimate responsibility for their retirements squarely on their own shoulders.

Enacted in 1974 and liberalized in 1981, the IRA tax incentive allowed every U.S. worker to save and invest up to $2,000 in earnings annually in his or her own personal pension plan. During the IRA's most popular period, from 1982 to 1986, American workers contributed more than $172 billion to IRAs **(Table 1)** *(IRA Reporter, August 1994).* Increasingly, Americans became aware of the importance of long-term saving and recognized that for many of them, the IRA represented their best opportunity to accumulate retirement funds.

Joseph Nocera cites the IRA as "the financial device that brought home the realization that the American middle class was going to have to take control of its own financial future" *(Nocera, 1994, p.288).* Among the American middle class, the success of the IRA precipitated what has been described as a major cultural shift. Before the IRA, many middle class Americans felt powerless to control their long-term finances and, although they might save at their local bank or thrift, few had experience as investors. The IRA industry not only helped the middle class to assume a role in securing a more comfortable retirement, but also offered opportunities to expand their understanding of and participation in financial markets.

But when the Tax Reform Act of 1986 ("TRA") sharply curtailed IRA eligibility by excluding taxpayers with incomes over $50,000 (or $35,000 for single taxpayers) who participated in a pension plan at work, it caused a dramatic decline in annual IRA contributions. According to the Internal Revenue Service, contributions fell from an annual average of $34.5 billion during 1982 to 1986, to an annual average of $11.9 billion from 1987 through 1993 **(Table 1)** *(IRA Reporter).*

Not only did the number of IRA participants decline, but more importantly, many of those working Americans who once considered the IRA as "the people's nest egg" *(Nocera, p.289)*, now found that they no longer had their government's support and encouragement to establish long-term savings.

Fewer Incentives, More Obstacles to Saving

By 1986, Americans watched opportunities to increase their "nest egg" slip away just as quickly as the IRA had been embraced as the solution to saving rate declines. Without tax incentives, many Americans found they could not afford to save. In addition, workers increasingly encountered economic, social and demographic obstacles to maintaining or improving their financial existence. Consider the environment in which middle class families are trying to achieve the American Dream.

Economic Uncertainty

Having experienced job layoffs and economic stagnation throughout the last decade, members of the American middle class continue to feel uncertain about their ability to provide for themselves and their families in the future.

Aging Population, Longer Retirement

The retirement period has lengthened, requiring more financial support. In 1960, Americans aged 65 and over made up 9% of the population. By 1990, this proportion reached 13%. It is expected to reach 18% by 2020 and 23% by 2050. Retirees reaching age 65 can expect to live, on average, another 16.7 years. A longer retirement period results in "an increasing portion of Americans who will have to depend on sources other than employment for income and vital services" *(Employee Benefit Research Institute, 1992, p.8)*.

Social Security Cutbacks

The Social Security Old-Age and Survivors Insurance ("OASI") program can no longer be depended upon as a primary source of support throughout retirement. Currently, Social Security and private pensions combined provide only 45% of the average married person's retirement income. Yet, Money magazine (June 1991) found that its readers consistently overestimated the amount they will receive from Social Security and their pension funds, and underestimated how much they will need to save for retirement. In addition, existing law will soon begin to push back the current retirement age when Americans can receive full Social Security benefits. These cutbacks will apply to and increase for all workers born after 1937 in anticipation of the disproportionately large number of baby-boomers who will soon be entering retirement *(EBRI, 1992)*.

Underfunded Private Pensions

Reports of the Pension Benefit Guaranty Corp. ("PBGC") taking over the underfunded pension plans of well-known, financially-troubled corporations, have sparked alarm among many workers who are depending on their employer's pension plans to provide a major portion of their retirement income. The PBGC indicates that pension plan underfunding is a problem that will continue to pose risks for many retirees *(Wall Street Journal, February 4, 1993, p.1)*.

Rising Health Care Costs

The aging population and the rapid upward pace of health care costs are having a tremendous impact on medical expenses. Between 1970 and 1990, the price level of medical services and commodities rose 479%, compared with a 337% increase in consumer prices. Even with health care benefit programs, these rising health care costs make it very difficult for working Americans to financially recover from major catastrophic illnesses *(EBRI)*.

Dependent Parents

Today, approximately 60% of the elderly are dependent on their children for support. The proportion of health costs associated with nursing home care and other long-term care will increase as Americans get older. According to the Employee Benefit Research Institute, Medicaid financed up to 43% of the $48 billion U.S. nursing home tab in 1989. But, in the absence of private insurance coverage for long-term care, consumers paid out-of-pocket expenses of approximately 45%.

Higher Education Expenses

The value of a college education has become increasingly important since the early 1970s. The difference between the earnings of a man with a high school diploma and one with a college degree was 39% in 1970 and had grown to 64% by 1988 (Byron, 1991). American parents recognize the importance of higher education, as well as the need to save for college, but few have the resources to do so. This is supported by a Roper Poll commissioned by the National Institute of Independent Colleges and Universities (1991) that showed that only half of the parents who expect their children to attend college save anything at all for future college expenses. Those who do save average only $517 per year. With the average cost of a year of college ranging from $10,000 to $25,000 today, what will Congress do to help aging baby boomers pay for their children's college education?

Housing Affordability

Since the 1980s, Americans have demonstrated declining rates of home ownership, particularly among those in the 25- to 34-year-old-age range. Payments on a typical home in the 1950s represented about 14% of an average 30-year-old's gross income. Today, a median priced home claims about 44% of income *(Burton, Dittmer, Loveless, 1992, p.154)*. Young families have also been squeezed out of the housing market because of their inability to save for a down payment. As housing prices have escalated, down payments of 10% to 20% have become out of reach for the average young American family. Providing opportunities for home ownership not only extends the American dream to more young families, but also pumps millions of dollars into the national economy through new housing starts and increased employment. Job creation then extends to the plumbers, electricians, real estate salespersons and all those working Americans participating in the housing industry.

Family Financial Pressures

Economic forces have made it nearly impossible to raise a family on one income and those families that attempt to must do so without much help from government policy. Under current rules governing IRAs, married couples are limited to a deductible contribution of $2,250 per year if only one person earns income. But, when both spouses work outside the home, each is permitted to contribute up to $2,000, for a total of up to $4,000 annually in an IRA *(Brennan, 1994)*.

The American middle class is experiencing a period of unprecedented uncertainty. For the first time in American history, parents cannot assume that their children's lives will be economically better off than their own. Without a consistent, comfortable standard of living, families are unsure how they will be able to:

- Become homeowners
- Send their children to college
- Support their aging parents
- Support themselves in retirement

Saving rates have declined, and so has the opportunity to achieve the American dream of a better tomorrow.

The Savings and Investment Incentive Act of 1995 - The Solution for the 1990s and Beyond

The proposed Super IRA is designed to respond to citizens' concerns about the future. By offering tax incentives and empowering workers to accept responsibility, the Super IRA provides hope, as well as a means to achieve long-term financial goals. It also provides savers with two options, by restoring the traditional benefits to all savers, as well as providing the "back-loaded" IRA feature. This proposal allows for penalty-free withdrawals, in the event of major life events.

The Super IRA will offer benefits for which most Americans are not currently eligible. By offering a tax incentive that is universally available to all savers and that includes the flexibility to accommodate major life events, the Super IRA is indeed a solution for the 1990s and into the 21st Century. H.R. 682 incorporates the original values of self-reliance, prudence and independence, while addressing present day concerns. With its approval, the American public's faith in the future and their resolve to achieve their own financial dreams, will be restored.

The Savings Coalition of America Supports H.R. 682

The Savings Coalition of American looks forward to working with the Committee on Ways and Means, and would like to take this opportunity to extend an offer of assistance on any issues related to the legislation. Our members are committed to pursuing the enactment of expanded retirement account legislation and believe that with your leadership, Americans will once again have the opportunity and incentive to save and invest for their future.

TESTIMONY OF GOVERNOR BILL ANOATUBBY
THE CHICKASAW NATION

INDIAN TRIBES SHOULD BE PERMITTED TO UTILIZE SECTION 403(b) RETIREMENT PLANS

My name is Bill Anoatubby. As Governor of The Chickasaw Nation, I am pleased to present this testimony on the critical issue of the ability of Indian tribes to offer section 403(b) tax-deferred retirement plans and to voice our strong support for H.R. 1966, introduced by Mr. Shaw and currently co-sponsored by Messrs. Kleczka and Hastings.

The Chickasaw Nation, in Oklahoma, is the eighth largest federally-recognized Native American nation in the United States. The Chickasaw Nation has an active membership of over 35,000, with tribal members living principally within the exterior boundaries of The Chickasaw Nation, Indian Territory.

During the last decade we have made great strides toward economic independence with economic development for the tribe and its members. The Chickasaw Nation has become the largest employer in south central Oklahoma with 1400 employees and has an annual budget that has grown to $99 million, with revenues coming from a variety of tribal business enterprises.

In order to continue this great progress in economic development and to continue our move toward economic self-sufficiency, our tribe must be able to offer the type of flexible retirement plan that section 403(b) represents.

Background

Importance of flexible retirement programs tailored to individual choice

The availability of flexible retirement programs is critical to attracting and retaining capable long-term employees. An important element of a flexible retirement program is a plan that permits our employees to make elective contributions tailored to his or her personal circumstances and needs.

Section 401(k) cash or deferred compensation arrangements are popular with private businesses. State and local government employers use section 457 deferred compensation plans as well as section 403(b) tax-deferred annuity plans (applicable to public school employees). Even charities exempt under section 501(c)(3) may utilize section 403(b) annuity plans and section 457 plans.

Continuing confusion over ability of Indian tribes to use such retirement plans

There has been continuing confusion over the years regarding the ability of an Indian tribe to utilize such a flexible retirement program for its employees. Part of this confusion stems from the lack of a clear statutory basis for the tax-exempt status of Indian tribes. It is well established that Indian tribes and tribal-owned businesses incorporated under federal law are exempt from federal income tax; the tribal-owned business incorporated under federal law is deemed to be exempt as an extension of the tribe itself. However, the tribe's exempt status does not arise by reason of section 501(c)(3), section 115, or any other provision of the Internal Revenue Code, but rather is the result of longstanding I.R.S. policy that has never been codified. (See, e.g., Rev. Rul. 94-16, 1994-1 C.B. 36; Rev. Rul. 67-284, 1967-2 C.B. 55).

Thus, over the years The Chickasaw Nation, as a sovereign nation, has been unable to clearly fit within any of the categories of organizations outlined above that are permitted to use retirement plans with elective employee contributions.

The Indian Tribal Governmental Tax Status Act of 1982 (P.L. 97-473) sought to clarify the federal tax treatment of tribes by treating them as States for a number of purposes, including the ability to adopt section 403(b) plans. Following adoption of the Act, as many as a dozen or more tribes throughout the country have adopted section 403(b) plans for their employees. These include major, strong business-oriented tribes located in Oklahoma, Florida, Montana, New Mexico, Minnesota, Wisconsin, Washington, Arizona, Alabama, and perhaps in other states as well.

The typical section 403(b) plan adopted by a tribe has broad coverage of tribal employees, including employees of the tribal government and tribally-owned businesses. These plan participants typically have relatively modest salaries. The Chickasaw Nation makes its section 403(b) plan available to all of its full-time employees and has more than 890 participants.

The Problem

There has been continuing confusion among the Indian tribes as to whether the 1982 Tribal Tax Status Act provision treating tribes as States permits utilization of section 403(b) plans on an across-the-board basis for all tribal employees. Closer scrutiny gives rise to the interpretation that parallel treatment with States limits section 403(b) plans to tribal school employees.

If the tribes' section 403(b) plans covering tribal employees on an across-the-board basis lack tax-qualified status, the effect of such disqualification could be devastating. As a threshold matter, it should be noted that because of the tribe's exempt status, there is no employer deduction with respect to plan contributions. Accordingly, we understand it is the participant who would directly bear the harsh brunt of plan disqualification. Each participant could be subject to current tax on the full amount of his or her vested benefit. This harsh impact would be particularly magnified in light of the modest income levels of the participants and the likelihood that the section 403(b) plan is the sole retirement plan in which most of them are participating.

It makes no sense -- from a federal tax policy standpoint or otherwise -- to impose such a punitive burden on workers of modest means who have been saving in good faith over the years for retirement.

From the perspective of the tribe as employer, the ability to offer a flexible retirement program in the form of a section 403(b) plan that is competitive with programs offered by other employers is critical to attracting qualified employees and retaining them for the long term. Having a capable and stable workforce is crucial to our continuing efforts to move away from federal assistance and to achieve economic self-sufficiency. Tribes should be encouraged to provide retirement coverage to their employees, not placed at a disadvantage relative to tax-exempt charities, State and local governments, and private businesses in the flexibility to do so.

The Solution

Clarification of current law

Ideally, current law should be clarified to permit Indian tribes and tribal-owned businesses that are exempt from federal income tax to utilize section 403(b) plans. Such a clarification would place tribes and their exempt activities on a par with section 501(c)(3) charitable organizations that long have been able to use section 403(b) plans for all of their employees.

At a minimum, a clarification should be adopted to protect the current section 403(b) plans of Indian tribes, as H.R. 1966 would do. These tribes established the plans in a good faith belief that they were qualified. To disqualify the plans now or in the future would only visit a harsh penalty on the participants. We understand that legislation identical to H.R. 1966 was estimated by the Joint Tax Committee staff earlier this year to have a "negligible" revenue effect.

Past Congressional action

In the last two Congresses, there has been bipartisan support in both the House and the Senate for solving the section 403(b) problem faced by Indian tribes. H.R. 11, passed by Congress in 1992 but ultimately vetoed by President Bush, included a provision similar to Mr. Shaw's H.R. 1966 that would have protected existing section 403(b) plans of Indian tribes.

In the last Congress, similar legislation was sponsored on a bipartisan basis in both Houses, and in August, 1994 a bipartisan group of 12 Senators signed a letter to the Chairman of the Senate Finance Committee seeking clarification that section 403(b) plans established by Indian tribes qualify for tax-deferred treatment.

Conclusion

We strongly urge the Committee to clarify that section 403(b) plans adopted by Indian tribes, including those plans already established, qualify for tax-deferred treatment under Code section 403(b). We commend Rep. Shaw for his leadership on this issue and urge his fellow Committee Members to join in supporting H.R. 1966.

Seminole Tribe
of Florida

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Statement of the Seminole Tribe of Florida

Before the

Committee on Ways and Means
United States House of Representatives
Miscellaneous Tax Reform Hearings

July 11, 1995

The Seminole Tribe of Florida is pleased to submit this statement to the Ways and Means Committee regarding an existing inequity in current tax law impacting Indian tribes throughout the United States -- the inability of Indian tribes to offer tax favored "salary reduction" retirement plans to their employees. We commend Representatives Clay Shaw, Jim McDermott, Gerald Kleczka and Alcee Hastings for introducing legislation which would make clear that employees of Indian Tribes have available to them for retirement plan purposes tax deferred annuities under section 403(b) of the Internal Revenue Code. We urge this Committee's favorable consideration of such a provision in any tax legislation considered this year.

Like other employers, Indian tribes should have available to them employer-funded retirement plans that enjoy favorable tax treatment under the Internal Revenue Code. Indian tribes may be the only non-taxable (income tax) entities in the country that do not have available to them a tax favored "salary reduction" retirement plan (a retirement plan funded in whole or part by elective employee salary contributions, such as 403(b) or 401(k) plans). The availability of all such salary reduction plans under the Code is affected by the tax-exempt status of the employer, and the status of Indian tribes for this purpose is ambiguous, at best.

Under current law, "section 403(b) plans" are available to employees of entities that are tax-exempt under section 501(c)(3) of the Code and public school systems. Although it is well established that Indian tribes and their federally chartered tribal corporations are not subject to federal income tax,, they do not derive this status from Code section 501(c)(3) or any other provision of the Internal Revenue Code. Rather, the tax-exempt status of Indian tribes has evolved as a result of long-standing IRS policy that has never been codified.

In an effort to clarify the federal tax treatment of tribes by treating them as States for a number of purposes, including the ability to adopt section 403(b) plans, Congress passed the Indian Tribal Governmental Tax

6073 Stirling Road • Hollywood, Florida 33024 • (305) 584-0400

Status Act of 1982 (PL 97-473). Upon enactment of this Act, tribes were, and continue to be, solicited by a number of well-known insurance and financial services companies to participate in section 403(b) plans, representing that the 1982 Act allows the utilization of section 403(b) plans for all tribal employees. As a result, over a dozen tribes, including the Seminole Tribe of Florida, have adopted section 403(b) plans for all of their employees.

However, upon later scrutiny and interpretation of the 1982 Act, it was discovered that the section treating Indian tribes as States for the purpose of utilizing section 403(b) plans applies only to employees of tribal schools, not to all employees of Indian tribes. If the IRS should choose to disqualify these plans, those tribes that have already adopted such pension plans for their employees would experience a devastating economic and administrative impact -- not only for the tribal employers, but more so for their Indian and non-Indian employees, who would be subject to current tax on the full amount of their vested benefit. The impact of this penalty would be significant given the modest income levels of most tribal employees, and the inability to participate in other similar plans.

In our efforts to achieve economic self-sufficiency and self-determination, Indian tribes across the country have created sophisticated businesses, increasing the standard of living for tribal members and non-Indians. The ability for Indian tribes to offer a flexible retirement program in the form of a section 403(b) plan that is competitive with programs offered by other employers is critical to attracting and retaining qualified, long-term employees. While Congress has created tax-exempt pension plans utilizing elective employee contributions for private businesses, state and local governments, and tax exempt charities, Indian tribes and their federally chartered tribal corporations, due to their unique tax status, have been unable to clearly "fit" within any of the categories of employers who may adopt such plans. Our ability to offer a deferred compensation plan, the most sought after benefit offered to prospective employees, is essential if we are to be competitive in today's environment.

Current law needs to be clarified to permit Indian tribes and their federally chartered tribal corporations that are not subject to the federal income tax to utilize section 403(b) plans, or, at the very least, protect those tribes who have already established 403(b) plans. During the 102nd Congress, such a clarification was included in the Revenue Act of 1992 (HR 11), which was subsequently vetoed by President Bush. In the last Congress, bipartisan legislation clarifying that section 403(b) plans adopted by Indian tribes qualify for tax-deferred treatment under the Internal Revenue Code was introduced in both the House and Senate. Again, we commend Congressman Shaw and his colleagues for introducing similar legislation this year. The Joint Committee on Taxation has estimated that the implementation of this legislation would have a negligible revenue impact.

We respectfully request that language allowing for Indian tribes to utilize 403(b) plans be included as part of any tax legislation considered by the Ways and Means Committee this year.

JUL 18 1995

MARY M. KENNY
71 Princeton Street
West Hartford, CT 06110

July 18, 1995

Representative Barbara Kennelly
1 Corporate Plaza
Hartford, CT 06013

Dear Congresswoman:

I am writing to address a problem which has affected my family and me very deeply, namely the taxation of Heart and Hypertension benefits.

My husband, Deputy Chief William Kenny, a firefighter (a highly stressful occupation) for 34 years and father of seven, died after a heart attack while on the job in 1980.

Where is the fairness of the laws that allows the Heart and Hypertension portion of Workers' Compensation benefits to be taxed and the rest not? This is particularly true of the IRS retroactively taxing these benefits back to 1991 (plus penalty interest) when their 1040 instruction booklet clearly stated that Workers' Compensation benefits were not taxable, making no distinction for Heart and Hypertension benefits. These back taxes (both federal and state) amounted to over $8,000 which I could not afford.

We appreciate deeply your efforts on our behalf and urge you to continue for those unable to do this themselves.

Gratefully,

Mary Kenny

Mary Kenny

Statement of Representative Dan Schaefer

Before the

Ways and Means Committee

on

Tax Status of Disability Benefits For Colorado Fire Fighters And Police Officers

July 11-13, 1995

Thank you, Mr. Chairman and members of the committee, for holding this hearing on miscellaneous tax reforms. As this committee works to improve the current tax code, I would recommend that it address a problem specific to the tax status of the Colorado fire fighters and police disability plan.

Under Internal Revenue Code section 104(a), disability payments for on-the-job injuries are generally tax-exempt. Most pension plans for fire fighters and police officers distinguish between on-the-job and off-the-job related disability benefits because there is a different benefit formula. The Colorado fire fighter and police disability pension plan pays the same benefit for injuries that occur on-the-job or off-the-job. Because the plan covers both types of disability at the same benefit level and under the same section of the state code, the Internal Revenue Service ruled that <u>all</u> benefits paid from the plan are subject to taxation, despite the fact that disability payments for on-the-job injuries are generally tax-exempt.

This ruling has caused great hardship for Colorado fire fighters and police officers who incur on-the-job injuries. The basic benefit for an unmarried officer is 30 percent of base pay and 50 percent for married officers. These officers often have difficulty finding other employment and the cost of health insurance coverage, if available at all, takes a significant bite out of their disability retirement benefits. The added burden of paying taxes on their benefits has caused great financial hardship for these public servants.

I, along with Representative David Skaggs and the entire Colorado House delegation, have introduced legislation (H.R. 1630) to address this problem. H.R. 1630 would provide tax-exempt status for prospective disability payments for on-the-job disabilities that occurred since 1980, the year the Colorado plan went into effect. To obtain tax-free disability benefits, there would have to be an admission by the employer or a state or local workers compensation board that the disability was due to an occupational injury or sickness. H.R. 1630 would simply provide the same tax status to Colorado fire fighters and police officers as is enjoyed in other states. The International Association of Fire Fighters has endorsed H.R. 1630.

The Colorado Fire and Police Pension Association has estimated that 127 current recipients of the Colorado plan may qualify for on-duty or line-of-duty disability benefits. These recipients have a total projected payroll of $2,614,382 and the total federal income taxes for these officers is approximately $737,000 in 1995. The amount of lost revenue to the U.S. Government because of H.R. 1630 would be relatively insignificant, while the benefit to the officers who must retire early would be immeasurable.

I strongly encourage this committee to incorporate H.R. 1630 into its legislation correcting problems with the current tax code.

John F. Scalise
41 Fowler Avenue
Meriden, Ct 06451
(203) 235-1060

July 26, 1995

Congressman Bill Archer
1236 Longworth House Office Building
Independence & New Jersey Aves. SE
Washington, DC 20515

Dear Congressman Archer:

I am writing you this letter on behalf of my mother who is the widow of a deceased Police Chief to encourage support for H.R.98.

My father a naval veteran of the South Pacific campaign of World War II and a 28 year veteran of the Berlin Connecticut Police Department died of a massive heart attack in 1988. Leaving my mother with a small pension and social security. In Connecticut heart disease is recognized as an occupational illnesses for police officers and the death benefit was applied for.

My mother originally received money through the Connecticut Heart & Hypertension laws in 1989. At that time she specifically inquired as to whether taxes were owed on the money awarded her. She was told no. That was the standard answer since the Heart & Hypertension laws fell within the purviews of the Connecticut Workers' Compensation Statutes and there is no tax liability on workers' compensation. Everyone understood and believed Heart and Hypertension to be of the same status - from her attorney to the town's attorney to the Workers' Compensation Commissioner.

The money received by my mother was put to good use. Our home town church received new tapestries and other needed items in my father's name. Students at the local high school wishing to pursue a career in law enforcement received scholarships and a fund was set up to help financially assist a disabled family member.

In 1992 my mother was notified that an IRS ruling had determined that Connecticut's Heart and Hypertension benefit was taxable and that the ruling would be imposed retroactively for three years. All of the money was gone - given to church, charities, community and family members. Now, in order to pay the money the IRS says is owed them would financially devastate her. My mother would have to liquidate the assets from which she exists, including my father's pension, which would cause her to pay large tax penalties besides paying the money to the IRS. She would even have to sell her home to come up with the money requested by the IRS. The end result would be to bring a 65 year old widow, who cares for a disabled daughter, to financial ruin.

My mother did not ask to be in the position she is in now., As stated, the first thing she did was inquire as to the tax consequences of such an award. It is not her fault that she now lives in fear of reprisal from the IRS because the IRS arbitrarily decided at the time of its decision to impose a three year retroactivity. Every day my mother goes to her mailbox scared that there is another letter from the IRS waiting for her either telling her they are going to lien her property or sending her letters showing how the interest just keeps growing to the point of obscurity.

I respectfully implore you to include H.R. 98 in this tax reconciliation package and bring tax relief to disabled police officers and widows of deceased police officers of the state of Connecticut.

I sincerely thank you for your attention to this matter

Respectfully yours

John F Scalise

John Scalise

**Statement for the Hearing Record
of the House Committee on Ways & Means
in connection with it's hearings on
Miscellaneous Tax Reform proposals
by
Riverwood International Corporation
Atlanta, Georgia**

July 27, 1995

To the House Committee on Ways & Means:

Riverwood International Corporation wishes to take this opportunity to explain our views on the subject of the so-called "golden parachute" rules that were enacted as part of the Tax Reform Act of 1984 and subsequently revised in 1986 to ameliorate the unintended adverse impacts of this provision on companies not appropriately encompassed within the scope of the 1984 Act. Riverwood has serious concerns with the application of these rules under certain circumstances and therefore recommends an additional revision to this Section 280G to correct another unintended impact of the original law.

__Summary__

Riverwood believes that the golden parachute rules require modification because they can produce harsh, unintended results for certain types of shareholders and corporations, as well as for the recipient employees, when economic necessity requires the corporation to undergo a "change in control." Instead of preserving the value of the shareholder's equity investment on a transfer, the golden parachute rules artificially compel a vast increase in transfer costs. For these reasons, we believe an additional modification to the golden parachute rules under Section 280G is warranted that is consistent with that provision's original policy rationale. This amendment would exempt compensation paid in "change in control" cases where one non-publicly traded shareholder holds, directly or indirectly, a majority position in the corporation and is not related to any officer receiving the compensation benefit. In cases such as this, the abuses which the golden parachute rules purport to redress simply never exist.

__Legislative History__

The "280G" provisions were enacted in response to certain well publicized cases where corporate officers had awarded themselves generous compensation packages in connection with hostile takeovers of the corporations they managed. Congressman Pete Stark, one of the principal advocates of the golden parachute provisions, explained that the legislation was intended to deal with a situation where

> corporate officials have devised another way to get a better deal at the expense of the other shareholders. Before the rest of the shareholders can anticipate the corporate change, these officials use their power to get one last piece of the rock before they are ejected from their seat of corporate power. *(Congressional Record of November 10, 1993, page E5469)*

The stated rationale for the golden parachute rules was that widely dispersed shareholders with little direct and practical control over a corporation needed protection against the self-interested motivations of corporate officers and other key personnel. The tax penalties imposed by the golden parachute rules—denial of the corporate deduction for the cost of the "excess" compensation and the imposition of a 20 percent excise tax on the recipient of that amount—were intended to offset for that lack of shareholder control by discouraging large compensation packages tied to a change in corporate control.

Two exceptions to those rules—designed to limit their application in cases where shareholders in fact *did* have adequate protection or control—were subsequently adopted as part of the 1986 Tax Reform Act. The first exception exempted all Subchapter S corporations from the 280G rules altogether, while the second exception exempted those corporations whose shares are not traded on an established securities exchange and where 75 percent of the existing shareholders have explicitly approved of the executive's special compensation package.

Riverwood believes that a third exception, consistent with the two modifications enacted in 1986, should be adopted. This exception, detailed below, would benefit Riverwood's ownership and similarly situated companies, but, critically, *is likely to have little if any negative impact on the U.S. Treasury, and possibly could have a positive effect on revenues.*[1].

Background on Riverwood International

Riverwood International is a vertically integrated paper and paper packaging manufacturer headquartered in Atlanta, Georgia. It employs approximately 6,400 people in the successful management of various timberlands, paper mills, converting plants and related production facilities in the United States and abroad. The company is 81.5 percent owned by Manville Corporation of Denver, Colorado, which itself is 80 percent owned by a court-supervised independent trust fund—the Manville Personal Injury Settlement Trust ("the Trust")—and both these shareholders are fully represented on the Riverwood Board of Directors.

The Trust was created in the mid-1980's out of Manville's Chapter 11 reorganization proceedings to compensate persons injured by past exposures to Manville predecessor companies' asbestos-containing products. Its trustees remain fully accountable to the U.S. District Courts for the Eastern and Southern Districts of New York. An integral aspect of the court-approved reorganization was the vesting in the Trust of majority ownership of the reorganized company, with the explicit expectation that over time, the trustees would monetize this asset (by selling off its stock, consummating asset sales, or some combination thereof) and in so doing guarantee future revenue streams with which to compensate asbestos victims.

Riverwood was one of the Manville subsidiaries included in the Chapter 11 proceedings. As a debtor-in-possession during the pendancy of the court-supervised reorganization, and thereafter as a reorganized company seeking to reestablish its viability in the marketplace, it confronted many difficult internal and external issues. The company not only had to overcome competitive disadvantages related to the well-publicized court proceedings, it had to do so with a new management in an environment where its new ownership endorsed a basic compensation philosophy—continued to this day—aimed at providing "below market" base salaries, coupled with "performance-based" short-term incentive plans that supplement those salaries only when annual corporate financial goals are met. All of this in an environment where Riverwood's ultimate owner, the Trust, is obligated to monetize its ownership interests through asset sales or other means. Given this uncertain business environment, it quickly became clear that some employment security incentive would have to be offered if talented and visionary leadership was to be induced to remain with or join the company. As a result, the Board of Directors approved various long-term incentive plans and employment contracts for approximately 22 key management employees.

Impact of Section 280G on Riverwood

Recently, Riverwood's majority owner issued a public statement confirming that it was examining its strategic options regarding its continued investment in Riverwood. As noted above, the court-approved reorganization plan explicitly envisions just such transactions to provide future funding to the Trust. This development does, however, heighten employee concerns that a "change in control" event—with all its attendant uncertainty—may be imminent. In turn, this situation raises immediate questions about the propriety of applying Section 280G to cases like Riverwood, where one shareholder controls more than 50 percent of the corporation's common stock.

The employment agreements and long-term incentive plans at Riverwood were designed to provide a certain level of compensation to key employees who might lose their jobs in the event the Company was sold to provide funding to the Trust. It is important to reiterate that this compensation program was designed and implemented while the Company was (as it still is) controlled by one 81.5% shareholder; which shareholder in turn is controlled by its own 80% shareholder (the Trust) and while both principal shareholders were fully represented on the Riverwood Board of Directors.

[1] For some employees it is financially more attractive to voluntarily forfeit some "parachute" benefits in order to avoid Section 280G's punitive excise tax. Generally, employees whose benefits do not exceed 140 percent of 280G's "base amount" fare better by voluntarily forfeiting every dollar in excess of the base amount. Moreover, some companies negotiate "parachute" terms that compel recipients to forfeit benefits to the degree necessary for the company to avoid any loss of tax deductions that otherwise would be available. In such cases, real benefit payments to affected employees would be reduced substantially, and the 280G rules actually act to decrease taxable income. For these reasons, there is little likelihood that the U.S. Treasury would ever realize much in the way of payments attributable to the 280G excise tax.

Under the program as designed and approved, each one dollar of gross benefit was intended to deliver 55 cents of net-after-tax benefit to the recipient, at a cost to the company of approximately 60 cents after taxes. However, the golden parachute rules change all of that. In cases where the 280G rules are applicable, the 55 cents of intended net benefit drops to 38 cents, a 30 percent reduction; and the cost to the Company to deliver this benefit increases 55 percent to 94 cents.

Of course, the company could elect to "gross up" the employee by paying all or a portion of his/her excise taxes, and in this manner provide the full 55 cents net benefit that was intended. This protects the employee, but only at an unrealistic cost to the company and to the very real detriment of all shareholders. To deliver a 55 cent net benefit in this manner would cost the company $1.40 after taxes—more than double the cost in the absence of the 280G rules.

<u>Conclusions/Recommendations</u>

Regardless of one's views about the policy rationale underlying Section 280G, there is no reason that such rules should apply in the case of companies such as Riverwood, where one entity that is itself not widely held, owns a controlling interest in the company. The abuses which Section 280G purports to correct cannot occur in such situations because the shareholders that are intended to be protected are in control of the corporation.

Clearly, in Riverwood's case, the 280G rules have a broader application than Congress intended and interfere with the reasonable decisions of Riverwood directors and management to design compensation packages to retain key employees in their jobs during perilous financial times, and to reward them for shepherding the business through those difficult periods. For this reason, Riverwood believes that an additional exemption to the 280G rules is warranted. Consistent with the original policy rationale, this amendment would exempt compensation paid in "change of control" cases where one shareholder, that is not itself a publicly traded corporation, controls (directly or indirectly) more than 50 percent of the corporation and is not related to any officer receiving the compensation benefit. In such cases, the abuses which the §280G rules are intended to redress cannot arise.

We seek the Committee's strong support of this proposed revision to the tax laws. If Committee members have any questions regarding the company's views on this subject, we would be pleased to respond to them directly.

STATEMENT OF JAMES S. QUIRK
Senior Vice President
Memorial Sloan-Kettering Cancer Center

submitted on behalf of
MEMORIAL SLOAN-KETTERING CANCER CENTER, New York, NY

to the

Committee on Ways and Means
U.S. House of Representatives

July 11, 1995

Today we are asking the Committee on Ways and Means to consider an exclusion for employer-provider housing for academic health centers, the same as provided to other educational institutions. The change, embodied in H.R. 1685, introduced by Congressman Houghton, would afford the same safe harbor provision to academic health centers, and place them on equal competitive footing with colleges and universities.

In the 1986 Tax Reform Act, Congress enacted a safe harbor provision for college and university-owned housing provided to certain faculty and staff. Under the safe harbor provision, the difference between the fair market value and the actual rent for campus housing provided to employees of an educational institution is excluded from gross income to the employees. In the 1986 Act, academic health centers were not included in the safe harbor provision.

The proposed amendment would afford the same safe harbor provision to academic health centers, and place them in an equal competitive position with colleges and universities in their ability to recruit and retain highly qualified and skilled faculty and staff. The arguments that applied to the safe harbor provision for colleges and universities in the 1986 tax law are the same arguments that apply to an academic health center.

The benefits of providing faculty and staff housing enables the academic health center to attract and retain a full-time faculty and staff to fulfill the mission of the institution. For institutions located in high rent areas such as New York City, this provision is essential for the institution to carry out its missions of patient care, education, and research.

Second, many of the tenants of academic center-owned housing are pursing advanced degrees and training at the center and usually at substantial financial hardship. In addition, the faculty and staff of an academic health center are often living in the same building as faculty and staff of a neighboring university.

The proposed amendment would amend the definition of "educational institution" under section 119(d) of the Internal Revenue Code. The amendment would ensure that academic health centers, which are not a part of a college or university, but nevertheless are teaching institutions, would qualify for the section 119(d) special valuation rule. This change would correct the anomalous situation under current law where a qualified "educational institution" can use the rule and an academic health center cannot, even though the two institutions must hire and compete for the same highly qualified employees.

The proposed amendment narrowly defines "academic health center" to focus only on rectifying the competitive problem described above. Under the proposed amendment, the academic health center must:

(i) qualify as a tax exempt hospital or medical research organization eligible to receive charitable contributions (as defined under Code section 170(b)(1)(A)(iii)

(ii) receive graduate medical education federal funding, and

(iii) engage in and teach basic and clinical medical science and research with the organization's own faculty.

We believe that the proposed amendment will place academic health centers on an equal competitive playing field with colleges and universities in their ability to recruit and retain highly qualified and skilled faculty and staff.

We thank the Committee for consideration of our proposal.

TESTIMONY OF BERNARD M. SHAPIRO
PRICE WATERHOUSE

I. Introduction

We are pleased to submit this testimony in support of a measure which the Chairman has included on the list of miscellaneous tax reforms to be considered by this Committee: The treatment of certain securities transferred to ESOPs from terminated defined benefit plans. Reforming this provision of the tax code is essential to correct an apparently unintended adverse side-effect of legislation enacted in 1989 which sought to eliminate abuses in the administration of employee pension plans. That legislation inadvertently penalized some companies that had previously included leveraged ESOPs in their pension plans, as Congress had encouraged them to do in legislation enacted in 1986. This issue has been the subject of hearings by this Committee before; in 1992 this Committee reported corrective legislation with bipartisan support; and Congress passed this correction without opposition that same year. Unfortunately, for reasons completely unrelated to this issue, the measure was never signed into law.

The focus of our comments is the amendment Congress made in 1989 to I.R.C. Section 404(k) that limits the deductibility of dividends paid to employee stock ownership plans (ESOPs). The 1989 amendment was intended redress abusive activity by companies who had not established ESOPs as a pension benefit for their employees, but merely sought to exploit a tax preference for ESOPs. Unfortunately, as drafted, this amendment inadvertently retroactively penalized companies that followed a course of action which Congress had encouraged in 1986 to establish new retirement plans which included ESOPs. For reasons of clarity and equitable public policy, we urge Congress to correct this oversight and eliminate the unintended tax penalty which the 1989 legislation imposed on taxpayers that, as Congress intended, formed leveraged ESOPs for the benefit of their employees. This is just the sort of non-controversial, technical reform with broad-based bipartisan support that should be included in the Committee's miscellaneous tax reform package.

II. In 1986 Congress Encouraged the Establishment of Leveraged ESOPs.

In 1986, Congress enacted two provisions -- Section 4980(c)(3) and an amendment to Section 404(k) -- to encourage the transfer of pension plan assets into leveraged employee stock ownership plans (ESOPs).

Section 4980(c)(3) provided a specific exemption from the excise tax, which Congress imposed on pension reversions, for assets transferred from a defined benefit plan upon plan termination to an ESOP. The Senate Finance Committee explained that:

> The Committee believes it is appropriate to provide an exception to this tax in the case of certain transfers of excess assets to an ESOP . . . in order to encourage greater establishment of such plans to promote employee stock ownership.[1/]

Also in 1986, Congress amended Section 404(k) to permit a deduction for dividends paid on employer securities to the extent that those dividends are used to make payments on an ESOP loan. As noted by the Joint Committee on Taxation:

> Congress believed that it was appropriate to expand on the incentives that advance the idea of broader capital ownership and employee stock ownership in particular.

1/ Report of the Committee on Finance accompanying H.R. 3838, Report Number 99-313, page 636.

> Congress felt it appropriate to encourage corporations to borrow money in order to make a contribution of stock to employees' accounts . . .
>
> Further, in order to accelerate the repayment of ESOP loans, Congress found it appropriate to permit a deduction for dividends on employer securities if such dividends are used to make payments on an ESOP loan.[2/]

In permitting deductibility, Congress did not distinguish between dividends paid on employer securities purchased with the acquisition loan (i.e., "leveraged shares"), and dividends paid on other securities ("reversion shares").

III. Taxpayers Acted In Reliance on Section 4980(c)(3) and Section 404(k).

After 1986, relying upon Sections 4980(c)(3) and 404(k), a number of taxpayers terminated pension plans, applied for favorable IRS determination letters and initiated the process that ultimately would establish the ESOPs Congress had encouraged. For example, I will describe the experience of our client Merrill Lynch.

A. Taxpayers Terminated their Pension Plans Within the Window Provided by Congress.

To qualify for the Section 4980(c)(3) exception, an employer was required to terminate its pension plan by December 31, 1988. In compliance with 4980(c)(3), Merrill Lynch terminated its pension plan and transferred the assets necessary to meet the plan's termination liabilities to Metropolitan Life on December 30, 1988. Prior to that date, on October 24, 1988, Merrill Lynch filed a request with the Internal Revenue Service for a determination letter as to the qualified status of the pension plan upon its termination. Merrill Lynch was advised by counsel that it would be prudent to await receipt of a favorable determination letter before the transfer of residual assets to the ESOP and purchase of employer securities under the plan.

B. IRS Delay Effectively Prevented Completion of Transactions Before August 4, 1989.

At various times in 1989, Merrill Lynch urged IRS to expedite issuance of its determination letter.[3/] Even with regular prodding by Merrill Lynch throughout 1989, the determination letter, dated July 31, 1989, did not reach Merrill Lynch until August 4, 1989. Merrill Lynch counsel was advised by IRS officials who participated in the issuance of these determination letters that other taxpayers received favorable determination letters at about the same time, again after a lengthy delay.

C. The Transfer to the ESOP was Completed Shortly After Receipt of the IRS Determination Letter.

By expediting action after receipt of the IRS determination letter, Merrill Lynch transferred the residual assets to a newly established ESOP pursuant to I.R.C. Section 4980(c)(3) on September 15, 1988. On September 22, 1989, the ESOP used those assets to purchase 9.9 million shares of Merrill Lynch stock (the "Merrill Lynch reversion shares"), and on the same date, relying upon Section 404(k), Merrill Lynch caused the ESOP to borrow $70 million to purchase an additional 2.2 million shares of Merrill Lynch stock (the "Merrill Lynch leveraged shares").

2/ General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, May 4, 1987, p. 844.

3/ While IRS had imposed a moratorium on issuance of determination letters for terminating defined benefit pension plans, the moratorium was not applicable to the Merrill Lynch termination and should not have delayed issuance of a determination letter in that instance.

In financing this transaction, Merrill Lynch relied upon the ability, provided by Section 404(k), to repay the acquisition loan using deductible dividends paid on both the Merrill Lynch reversion shares and the Merrill Lynch leveraged shares.

IV. Congressional Action in November 1989 Retroactively Penalized Taxpayers That had Formed ESOPs as Congress had Previously Encouraged.

A. Congress Amended Section 404(k) to Address Abusive Activity Wholly Unrelated to Section 4980(c)(3) Transactions.

In the 1989 Omnibus Reconciliation Act (P.L. 101-239, Section 7302), Congress limited the deductibility under I.R.C. Section 404(k) of dividends paid to an ESOP and used by the ESOP to repay a loan incurred to acquire employer securities. Under Section 7302 as amended, to be deductible, dividends must be paid on employer securities purchased with the acquisition loan (i.e., "leveraged shares"). Dividends paid on other securities (i.e., "reversion shares") are no longer deductible, even if the dividends are used to repay the acquisition loan.

Congress amended Section 404(k) to redress an issue wholly unrelated to Section 4980(c)(3) transactions: abusive activity. In amending Section 404(k), Congress intended to eliminate the availability of the Section 404(k) dividend deduction for shares in existing profit sharing and stock bonus plans that were being converted into ESOPs in order to obtain the 404(k) dividend deduction for the employer. The amendment to Section 404(k) was not aimed at eliminating the deduction for dividends paid on shares that were acquired by an ESOP pursuant to a qualified Section 4980(c)(3) transaction, with respect to a termination occurring on or before December 31, 1988.

B. Congress Was Unaware of the Retroactive Penalty it Imposed on Taxpayers.

The amendment to Section 404(k), which Congress enacted in November 1989 -- two months after Merrill Lynch had completed its leveraged transaction -- imposed a severe retroactive penalty. Because the conferees' decision to choose August 4, 1989, as a retroactive effective date occurred at the close of the 1989 Congressional session, Merrill Lynch and other taxpayers had no opportunity to alert conferees about the unintended consequences of their action.

Because Merrill Lynch had completed its Section 4980(c)(3) plan termination on December 13, 1988, and had filed with IRS on October 24, 1988, for a determination letter that would have allowed Merrill Lynch to prudently transfer assets and acquire employer securities for its ESOP, Merrill Lynch's transaction and those of similarly situated taxpayers should have qualified for grandfathering. Unfortunately, delay by IRS in the issuance of Merrill Lynch's determination letter (coincidentally until August 4, 1989) prevented Merrill Lynch from satisfying either of the grandfathering criteria selected by conferees.

We are confident that, had conferees understood the delays occasioned by the IRS determination process, and that the limited criteria selected for grandfathering inadvertently would penalize leveraged Section 4980(c)(3) transactions (which Congress itself had encouraged), conferees would have provided that Section 4980(c)(3) transactions (particularly those for which timely completion was delayed because of the IRS determination process) should qualify under the August 4, 1989, effective date.

V. The 102nd Congress Adopted Legislation to Correct this Unintended Penalty and the 104th Congress Should as Well.

The 102nd Congress adopted non-controversial legislation to correct the penalty it inadvertently imposed on Merrill Lynch and similarly situated taxpayers with the 1989 amendment to Section 404(k). In July 1992 and with bipartisan support, the Ways and Means Committee reported free-standing legislation (H.R. 5641) to correct this inequity. The House adopted H.R. 5641 on suspension, without opposition, in August 1992. H.R. 5641 was later incorporated into H.R. 11, comprehensive tax legislation which passed both the House and Senate in October 1992 but which President Bush vetoed for reasons entirely unrelated to the Section 404(k) provision. But for the President's veto, the Section 404(k) provision would now be law.

The 102nd Congress sought to correct the unintended consequences of the 1989 Section 404(k) provision which inadvertently penalized taxpayers Congress had previously encouraged to form leveraged ESOPs (attached); we urge the 104th Congress to adopt identical legislation.[4/] This measure would make clear that the 1989 amendment to Section 404(k) shall not apply to employer securities acquired after August 4, 1989, pursuant to Section 4980(c)(3), with assets transferred from a defined benefit pension plan the termination of which was the subject of a determination letter from the Internal Revenue Service, in effect on August 4, 1989, and at all times thereafter before such securities are acquired.

* * * * *

For the reasons stated above, Congress should correct the Internal Revenue Code by eliminating the apparently unintended and inadvertent tax penalty that Section 404(k) imposes on taxpayers that followed a course of action which Congress previously specifically encouraged. We would like to thank the Committee for the opportunity to present this testimony on behalf of Merrill Lynch and other similarly situated taxpayers.

4/ Consistent with the Committee's criteria for the miscellaneous tax reforms currently under consideration, if the Section 404(k) provision is determined to result in a small revenue loss, we would be pleased to assist the Committee develop an appropriate revenue-raising offset.

American Medical Association
Physicians dedicated to the health of America

James S. Todd, MD
Executive Vice President

515 North State Street
Chicago, Illinois 60610

312 464-5000
312 464-4184 Fax

July 27, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

I am writing in regard to miscellaneous tax reform proposals which were brought before the Committee on Ways and Means in a series of public hearings held earlier this month. The American Medical Association (AMA) would like to offer its comments on one provision of particular interest to physicians in non-profit medical group practices.

As you know, Section 457 of the Internal Revenue Code governs deferred compensation arrangements between non-profit organizations and their employees. Under current law, the maximum annual amount which can be deferred is the lesser of $7,500 or 33 1/3 percent of the individual's taxable income. The AMA supports a limited exception to Section 457 which would allow eligible non-profit group medical practices to offer competitive deferred compensation arrangements for employees in a manner comparable to those allowed for profit groups under the tax code.

We believe the current limitation in the tax code places non-profit groups at a great disadvantage in recruiting talented physicians who are needed to deliver services to inner city and rural residents which these groups serve. In addition, these non-profit medical groups, such as those affiliated with the Mayo Clinic and the Henry Ford Health System, offer some of the finest medical education and training in the world and are leaders in medical research and quality improvement. As a matter of fairness, as well as good health care policy, non-profit group practices should be accorded similar treatment to for profit groups.

The AMA endorses the written testimony provided for the record by the American Group Practice Association on this issue and stands ready to work with you and other members of the Committee to address this important health policy concern.

Sincerely,

James S. Todd MD

James S. Todd, MD

NATIONAL ASSOCIATION OF GOVERNMENT
DEFERRED COMPENSATION ADMINISTRATORS

167 W. Main St., Suite 600, Lexington, KY 40507 • (606) 231-1931 • FAX (606) 231-1928

July 19, 1995

Chairman Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer,

I am sending this letter in response to the recent hearing on miscellaneous tax reform and request that this be included in the printed record.

The National Association of Government Deferred Compensation Administrators (NAGDCA) is pleased to present its views on the protection of compensation voluntarily deferred by the employees of America's state and local governments. By far the majority of these funds, some $40 billion dollars to date, have been deferred pursuant to Section 457 of the Internal Revenue Code. Section 457 plans are the only elective tax-deferred retirement savings arrangement available to millions of such employees.

NAGDCA is the official organization representing public administrators of Section 457, with 49 state members, 74 members representing individual cities and counties, and over 70 private firms providing financial services or products to the governmental plans. Through four institutional members (International City-County Management Association, Michigan Association of Counties, National Association of Counties, and the U.S. Conference of Mayors) over seven thousand additional local governments are represented by NAGDCA.

NAGDCA and its members have been participants in the creation and administration of public deferred compensation plans from the outset. The Association, itself, is an outgrowth of the coalition of governments which worked with the Ways and Means Committee to design Section 457 in 1978.

Recent developments in California have highlighted two peculiarities of Section 457 plans: plan assets are subject to the claims of third parties and, under certain circumstances, may be used for other purposes by the employer, itself. The recent bankruptcy filing in Orange County highlights the first concern; an earlier attempt by Los Angeles County to use $250 million of plan assets to balance its budget highlights the other.

The threat of invasion places these voluntary retirement savings at risk, causes needless worry and concern, and have neither purpose nor policy behind them.

Section 457 should therefore be amended to remove these unnecessary and undesirable side effects, and to add language reflective of the way most governments administer their plans today. Generally, most plans assets are held for the exclusive benefit of the employees whose savings create those assets. No other change in the statute, or current arrangement, structure, organization or administration of these plans is either intended or suggested.

Several attorneys general and county and city attorneys are currently working with NAGDCA to assist in drafting language which crafts narrow but effective solutions to these concerns. NAGDCA is also reviewing their suggestions in conjunction with organizations such as the National Governors Association, the U.S. Conference of Mayors, Government Finance Officers Association, and the AFL-CIO. We look forward to sharing language options with the Ways and Means Committee as soon as completed.

Thank you for this opportunity to participate in your consideration of the least intrusive, most effective way to protect the retirement assets of public employees and to preserve their faith in the integrity of investments made on their behalf.

Sincerely,

John E. Kozusko
President,
National Association of Government
Deferred Compensation Administrators

TESTIMONY OF
HOLIDAY INN WORLDWIDE
REGARDING A PENSION SIMPLIFICATION PROPOSAL
BEFORE
THE HOUSE WAYS AND MEANS COMMITTEE
JULY 11-12, 1995

SUBMITTED FOR THE RECORD BY
ANTHONY RODALAKIS
VICE PRESIDENT OF RISK MANAGEMENT
HOLIDAY INN WORLDWIDE

Mr. Chairman and Members of the Committee:

Holiday Inn Worldwide (Holiday Inn) appreciates the opportunity to comment on legislative proposals to simplify the administrative burden associated with correcting excess employee contributions to 401(k) plans. It is very important that employees are encouraged to save for retirement, and that mechanical rules in the Internal Revenue Code relating to 401(k) plans are designed to alleviate any unnecessary complexities. The mechanical rules for correcting excess contributions constitute an area that is in great need of simplification.

Holiday Inn has designed and proposed a mechanism for correcting excess contributions that is (i) revenue neutral, (ii) renders exactly the same tax, financial and plan results as mechanisms already approved by the IRS, (iii) provides maximum protection under ERISA for employees, and (iv) provides simplicity of administration for companies and employees. While this mechanism already is consistent with the current provisions of Code Sec. 401(k) and corresponding Treasury regulations, a legislative clarification appears necessary before the IRS will officially sanction this mechanism. We respectfully request that this clarification be made.

BACKGROUND

As required under Code Sec. 401(k)(3), 401(k) plans must satisfy certain nondiscrimination standards that are designed to ensure that the average deferral percentage (ADP) of the before-tax contributions made by highly compensated employees (that is, generally, those earning more that $66,000) does not exceed by too high a margin the ADP of the before-tax contributions made by nonhighly compensated employees. Any amounts exceeding this limit must be returned to the highly compensated employees.

Most employers, particularly those with a young or transient workforce, have not been able to satisfy the ADP test. The ADP test failures occur in spite of companies' best efforts to make their 401 (k) plans attractive to employees. These incentives often include high matching contributions (in Holiday Inn's case, a 100 percent matching contribution on the first 6 percent of compensation contributed by employees) and favorable loan and withdrawal features.
Failure to satisfy the ADP test requires a company to take corrective action or its plan will become disqualified. This corrective action often includes distributing the excess contributions during the year following the year deferrals are made.

These corrective distributions create added tax complexities for the affected employees. In general, the amounts of the distributions are "includible" in each employee's gross income in the year of deferral or the year of distribution, depending on the timing of the distribution. As a result, the employees must delay the preparation and filing of their income tax returns until the amount and timing of the distributions is known, or they must file amended returns. Further, the amounts of distributed excess contributions may not be reported to the employees on IRS forms until the beginning of the calendar year following the year of distribution (that is, 2 years after the year of deferral). Needless to say, this correction process creates confusion and needless additional expense.

CURRENT SOLUTIONS GENERATE UNNECESSARY COSTS AND COMPLEXITIES

Currently, a company can make the following corrective measures, all of which are overly burdensome and present other problems:

- It can implement a system to carefully monitor the contributions of all employees and determine when contributions are approaching calculated limits (which for many companies is prohibitively expensive and usually results in an artificial maximum on contributions that in the final analysis proves too high or too low). Interim ADP testing also has proven to be not only expensive and administratively burdensome, but also imprecise and ineffective.

- It can severely restrict the amount of compensation that highly compensated employees can contribute which hampers these employees' retirement savings. As with the first option, this will not work for employees who become highly compensated because of bonuses or other compensation that was not foreseen when the company advised highly compensated employees of the restrictions imposed on 401(k) contributions.

- It can make a correction under Code Sec. 401(k)(8)(A) by distributing the excess contributions to each eligible highly compensated employee before the end of the following plan year. This presents the administrative and tax compliance complexities discussed above.

PROPOSED SPILLOVER ARRANGEMENT

We respectfully request that Congress clarify Code Sec. 401(k) to specifically provide a means by which companies can avoid unnecessary and burdensome corrective distributions. We suggest that companies be able to adopt a spillover arrangement whereby highly compensated employees can contribute to a 401(k) plan that permits a "spillover" of any excess contribution amounts into a nonqualified plan so that there are no excess contributions.

We understand that the IRS recently issued a yet-to-be-published private letter ruling allowing employee contributions made to a nonqualified plan to spillover to a 401(k) plan. While the Holiday Inn proposal renders exactly the same revenue, tax, financial and plan results as this IRS-approved mechanism, the Holiday Inn proposal provides greater ERISA protection for employees and greater ease of administration. Thus, clarifying Code Sec. 401(k) to permit our proposal is a logical, reasonable step that will assist all parties.

The 401 (k)-plan-to-nonqualified-plan spillover arrangement will allow a company's 401(k) plan to work in tandem with a nonqualified deferred compensation plan. Highly compensated employees will be allowed to elect to defer the receipt and taxation of any amounts of excess contributions (plus investment interest allocable thereto) that are distributed from the 401(k) plan to satisfy the ADP test. Thus, any amount that is distributed from the 401(k) plan to satisfy the ADP test and that is subject to a participant's spillover election will be paid by the 401(k) plan to the company and will be payable to the participant pursuant to the terms of the nonqualified deferred compensation plan.

The highly compensated employees' elections to defer under both the 401(k) plan and the nonqualified deferred compensation plan will be made before the beginning of the calendar year in which the deferred compensation is to be earned, and these elections will be irrevocable. Each highly compensated employee will have the right to elect (i) to defer under the 401(k) plan or to take cash, and (ii) to have any excess contributions distributed directly to the participant in cash or be spilled over to the nonqualified deferred compensation plan. Thus at each level, participants will have the option to take cash in lieu of deferrals.

This spillover arrangement provides a reasonable method for correcting the ADP test. Because the same or greater levels of deferrals can be achieved through the operation of separate, unrelated 401(k) and nonqualified deferred compensation plans that the IRS routinely approves or through the nonqualified-plan-to-401(k)-plan spillover arrangement that the IRS recently

approved, the Holiday Inn proposed spillover arrangement will neither create any new mechanism for the deferral of compensation nor allow any loss of tax revenues to the government. The arrangement simply provides for a cost-efficient, coordinated effort that will operate with precision and predictability.

In summary, the Holiday Inn proposal provides for a tax simplification that is completely revenue neutral for the government, as it will not provide for any income tax deferrals, deductions or exclusions that cannot be achieved through a combination of programs already formally approved by the IRS. The arrangement will allow participants to maximize permissible deferrals under the 401(k) plan and will minimize the administrative burden on companies and participants.

TECHNICAL ANALYSIS

We understand the IRS position is that a spillover arrangement from a 401(k) plan to a nonqualified plan is not allowed under current law. As described briefly below, we disagree with the IRS's interpretation and believe that this type of arrangement is allowed under current law including both the Code and Treasury regulations. Therefore, we are requesting that Congress clarify that the proposed spillover arrangement is permissible.

1. Cash or Deferred Arrangement

To constitute a qualified cash or deferred arrangement under Code Sec. 401(k), a participant must be given the opportunity to elect to defer his compensation under the arrangement or to receive that compensation in cash.[1] Treasury Regulation Sec. 1.401(k) - 1(e)(2) makes it clear that this cash availability requirement will not be satisfied by offering a non-cash taxable benefit to the exclusion of a cash alternative. However, neither this nor any other provision of the Code or Treasury regulations requires that cash be the sole alternative to a Section 401(k) plan deferral election.

The spillover arrangement satisfies the cash availability requirement at all levels. The participant has the opportunity to elect (i) for his compensation to be paid in the form of cash or as a deferral into the 401(k) plan and (ii) for his distribution of excess contributions to be distributed in the form of cash or as a deferral into the nonqualified deferred compensation plan. Empirical data of Holiday Inn and other companies clearly demonstrates that many employees who have the opportunity to receive either cash or a deferral under a nonqualified deferred compensation plan in fact will and do select the cash option. Thus, the spillover arrangement constitutes a true cash or deferred arrangement.

2. Contingent Benefit

As a general rule, no other benefit may be conditioned on an employee making or not making before-tax contributions to a 401(k) plan.[2] However, Treasury Regulations Sec. 1.401(k) - 1(e)(6)(iv) provides in part that, "Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under Code Sec. 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent." All 401(k) plans specifically limit the amount of before-tax contributions by highly compensated employees to the level permitted under the ADP test and provide that all excess amounts must be distributed. Thus, conditioning a participant's spillover contributions to the nonqualified plan on his or her reaching the maximum before-tax contributions permitted under the 401(k) plan falls squarely within the nonqualified plan exception to the contingency rule.

3. Correction of ADP Test

Code Sec. 401(k)(8)(A) provides that the ADP test for a plan year will be satisfied if, before the end of the following plan year, excess contributions (and investment income allocable thereto)

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1 IRC Sec. 401(k)(2)(A); Treas. Reg. Sec. 1.401(k) - 1(e)(2).

2 IRC Sec. 401(k)(4)(A); Treas. Reg. Sec. 1.401(k)-1(e)(6).

are distributed from the 401(k) plan. There is no statutory or regulatory requirement that, as part of this correction method, the distributed excess contributions (or investment income allocable thereto) be included currently in the highly compensated employees' gross income.[3] We also note that neither the ADP test correction language in most IRS-approved 401(k) plans nor the IRS's ADP test correction language in its list of required modifications requires or otherwise mentions any specific method or timing of including distributed excess contributions in gross income.

CONCLUSION

The policy considerations weigh heavily in favor of permitting the 401(k)-plan to-nonqualified-plan spillover arrangement. While the arrangement will provide a cost savings and efficiency for companies and employees, it is revenue neutral for the government.

In fact, the tax consequences of the Holiday Inn proposed spillover arrangement are the same as will result under the nonqualified-plan-to-401(k)-plan spillover plan recently approved by the IRS in a private letter ruling. However, our requested arrangement provides a more efficient and economical approach for both companies and employees.

We respectfully request that the terms of Code Sec. 401(k) be clarified to specifically permit 401(k)-plan-to-nonqualified-plan spillover arrangements.

For a technical explanation of the proposed spillover arrangement please contact Don Mazursky at (404)607-9411 or John Harman of Coopers & Lybrand L.L.P. at (202)822-4406.

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[3] See, for example, Treas. Reg. Sec. 1.401(k)-1(f)(1), 4(i) and 4(v).

TESTIMONY IN SUPPORT OF CERTAIN COINS AND PRECIOUS METALS NOT BEING TREATED AS COLLECTIBLES

Submitted by

Mr. Joseph Battaglia
Chairman, The Coalition for Equitable Regulation and Taxation
Executive Vice President, Goldline International
Santa Monica, California

For The

HOUSE WAYS AND MEANS COMMITTEE
THE HONORABLE BILL ARCHER, CHAIRMAN

July 27, 1995

Chairman Archer and distinguished members of the Ways and Means Committee, it is my privilege to submit testimony and documentation in support of Section 104 of H.R. 682, which amends paragraph (3) of section 408(m) of the Internal Revenue Code of 1986, to except certain precious metals bullion and coins from the definition of "collectibles."

I am Executive Vice President of Goldline International of Santa Monica, California, a division of A-Mark Financial, one of the nation's largest dealers in precious metals and legal tender coinage. A-Mark Financial is ranked by Forbes as the 147th largest privately held company in America. I also currently serve as Chairman of The Coalition for Equitable Regulation and Taxation, an organization of banks, brokerage firms, trade organizations, and coin/precious metals businesses, which was formed to ensure the United States tax code is updated to reflect the investment stature of precious metals bullion and legal tender coinage.

Current Law

Section 408(m) of the Internal Revenue Code (Code), enacted as part of the Economic Recovery Tax Act of 1981 (ERTA), restricts the use of collectibles (including precious metals bullion and legal tender coinage) in individual retirement accounts (IRAs) and other self-directed accounts in qualified retirement plans. Congress enacted this restriction as a result of what the Department of the Treasury saw as increasing abuse of IRAs through the inclusion of collectibles in these accounts. While the concern may have been valid relative to certain collectibles as a whole (art, collector plates, antiques, rugs, etc.), unfortunately, precious metals bullion and legal tender coinage were included in this category. Subsequently, the Tax Reform Act of 1986 amended section 408(m) to **exclude** gold and silver U.S. American Eagle bullion coins, minted by the U.S. Mint, from the definition of collectibles, thus allowing them as investment vehicles in IRAs and other self-directed accounts without penalty.

Currently, gold and silver bullion and legal tender coins can be included in defined contribution pension and profit-sharing plans (both corporate and Keogh), and in other tax-deferred or tax-exempt entities. Therefore, it is both logical and equitable that these same assets should also be an investment option for individually directed retirement accounts (IDRAs).

Proposal

Representatives Thomas and Neal included language in their bill, H.R. 682, which would amend section 408(m) and correct the

definition of collectibles by excluding (1) any coin certified by a recognized grading service and traded on a nationally recognized electronic network, or listed by a recognized wholesale reporting service, and which is or was at any time legal tender in the country of issuance, or issued under the laws of any State, and (2) any gold, silver, platinum, or palladium bullion (whether fabricated in the form of a coin or otherwise) of a fineness equal to or exceeding the minimum fineness required for metals which may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission (CFTC) under the Commodity Exchange Act, if such coin or bullion is in the physical possession of a qualified trustee as defined by the Code.

At the time of section 408(m)'s enactment in 1981, lawmakers erroneously believed that investments in collectibles did not contribute to productive capital formation. In fact, investments in bullion and coins can be as productive as purchases of stock on a stock exchange. Sales of bullion and coins create jobs and generate income for those involved in the production of the asset as well as those consummating the sale. Further, most brokerage firms and investment advisors recommend that persons saving for retirement diversify their investment portfolios to include some percentage of counter-inflationary investments, including precious metals and coins. These assets traditionally tend to experience appreciation during periods of economic uncertainty and high inflation that otherwise diminish the value of other financial assets.

Dr. Raymond Lombra, Professor of Economics at Pennsylvania State University, recently published a study (copy attached) which examined the investment performance of portfolios that excluded and included precious metals and coins. His study found that "considered individually, stocks and coins had the highest rates of return over the last 20 years" and that "a detailed analysis of hypothetical portfolios reveals that over the 1974-93 period, a portfolio consisting of 5% coins, 5% gold and the rest stocks, Treasury bonds, and Treasury bills would have increased portfolio returns at the same time that it decreased overall portfolio risk, suggesting that holding 5-10% of an IDRA in gold and coins is both warranted and prudent." He continues, "Since coins and bullion are not consumed, but saved, their acquisition improves saving and therefore augments the pool of funds available to finance growth--enhancing investment spending. Since widening the range of choices within IDRAs encourages broader participation and thus increases savings, and since precious metals and coins improve the investment performance of IDRAs, discriminating against such investment options is counterproductive and especially unwarranted in a nation experiencing a significant savings shortfall."

Lawmakers also enacted ERTA restrictions on collectibles partly out of concern that the Code did not sufficiently prevent individuals from using collectibles held in tax-favored savings vehicles for non-investment purposes. The proposed amendment eliminates the potential for such abuse by requiring that bullion and coins be held in the custody of a qualified trustee as defined by the Code.

Bullion

The classification of gold as a collectible is particularly egregious. Gold is a time-tested medium of exchange, universally accepted worldwide. Nations still settle international debt between them with gold as the medium of exchange. Moreover, most western powers hold significant stores of gold today in reserve, with the U.S. Treasury the largest investor in gold bullion. To classify gold as a collectible is simply inappropriate.

Precious metals--gold, silver, platinum, and palladium--are

physical commodities which are produced both in bar and coin form for investment purposes and in a wide variety of commercial component forms for use in thousands of industrial applications the world over. Typically, commercial and investor market participants effect their purchase and sale transactions through one of two mediums: the regulated futures exchanges, or the "over the counter" physical market (also known as the "spot" or "cash" market).

In the United States, the New York Commodities Exchange (COMEX) is the primary market. Thousands of contracts for the future delivery of gold and silver are bought and sold each business day. The New York Mercantile Exchange (NYMEX) is the primary futures market for platinum and palladium deliveries.

On these markets, professional traders match the buy and sell orders of their customers using the "open outcry" method. This trading is conducted in a public forum to provide maximum liquidity and ensure fair pricing for all market participants. These Exchanges are regulated by the Commodities Futures Trading Commission, which was created as a result of the Commodities Exchange Act.

While individuals and commercial companies can buy for future delivery through the exchanges, they can purchase physical bullion for immediate delivery in the "cash" or "spot" market. This market is a well-organized network of thousands of dealers, brokers, banks and suppliers worldwide who continuously buy from and sell to one another on behalf of their customers. Prices resulting from these trades are instantly updated and broadcast globally through a multitude of commercial business reporting systems (i.e., Knight-Ridder, Quotron, Reuters, etc.). As a result, pricing on the bullion markets is among the most competitive anywhere and allows the bullion investor to enjoy very narrow bid/offer market spreads.

Sales to the retail investor in the U.S. are made through a distribution network consisting of retail securities brokers (Merrill Lynch, Paine Weber, etc.), a growing number of banks, and thousands of coin dealers who operate small businesses throughout the country.

__Legal Tender Coinage__

The Certified Coin Exchange (CCE) is a computerized trading network which allows sight-unseen trading of certified coins and serves as a price reporting mechanism to the entire investment community. Under the CCE trading rules, dealers participating on the network place "bids" and "asks" (prices at which they are prepared to buy or sell specific coins or categories of coins). A dealer placing a bid on the exchange is obligated to purchase at least one coin at his bid price, without the right to inspect or reject the coin(s). The result is to render coins traded on the CCE fungible (interchangeable) commodities.

Several hundred dealers across the country are regular traders on the CCE. They can place both a "bid" (buying price) and an "ask" (selling price) on any certified coin. Each coin can be accessed by a unique number and doing so displays the relevant trading screen (a copy of which is attached). The trading screen shows all current bid and ask prices for the specific coin, as well as the identification code of the dealer. Should a dealer wish to consummate a trade, he need only press a few buttons, and the posting dealer will be instantly notified that he has purchased or sold the coin(s) which he had posted on the Exchange. The trade may also be made via telephone. While not shown on the attached printout, the actual trading screen also indicates quantities of coins desired or offered by each dealer, as well as the amount and date of the last electronic trade for the coin.

While the CCE is presently the largest and most active of the

rare coin exchanges, a second network, the Certified CoinNet, is administered by Information Networks, Inc. Certified CoinNet's trading rules are similar to those of the CCE.

The Certified Coin Dealer Newsletter (CCDN) provides a weekly summary of current wholesale pricing from electronic networks, trade shows, and auctions, as well as spot precious metals prices. The investor can get supplemental pricing information from the two weekly trade newspapers, Coin World and Numismatic News.

Independent certification and sight-unseen trading over electronic trading networks have made legal tender coins fungible commodities. The electronic trading networks function precisely the same as the NASDAQ with a series of published bid and ask prices and last trades. Trades are entered on these electronic networks in the same manner as trades are entered on NASDAQ, with confirmations provided by the trading exchange. These transactions are binding upon the parties.

It is this concept of fungibility combined with a bona fide national trading network with published prices that most differentiates legal tender coins from collectibles. Moreover, as can be seen in the attached Exhibit, the differential (or spread) between bid and ask prices is consistent with the investment nature of other assets.

Since enactment of the ERTA restrictions, the market for coins has developed such that reliable and accessible pricing mechanisms exist for valuation. Coins are regularly subject to specific value determination by professional appraisers who are expert, experienced, and objective in valuing such assets. Further, the proposal only includes coins that are certified by a recognized grading service and traded on a nationally recognized electronic network, or listed by a recognized wholesale reporting service, ensuring that only those coins which are more frequently traded and consistently valued will be allowed as investment vehicles in self-directed plans. Thus, the true market value of these retirement investments will be able to be consistently established at the time of purchase and liquidation. Valuation systems also exist for gold, silver, platinum and palladium bullion.

Equity for Small Investors

Since precious metals and legal tender coinage can be included in defined contribution pension and profit-sharing plans, it seems equitable to provide such investment options for individually-directed retirement plans. Removing current restrictions would allow small investors, many of whose total investment programs consist of their IDRAs or other self-directed accounts, to select from the same "menu" of investment options currently available to more affluent investors.

On behalf of the Coalition for Equitable Regulation and Taxation and the millions of investors in precious metals and coins in the United States, I urge you to amend section 408(m) of the Code to make the distinction between investment quality precious metals bullion and legal tender coinage from collectibles.

Mr. Chairman, the Coalition would especially like to thank Representatives Thomas and Neal for their leadership in addressing the problem of our nation's insufficient savings rate. We praise their efforts and believe that H.R. 682, if passed into law, will have a significant positive effect, increasing individuals' rates of savings and making our economy stronger.

Thank you for the opportunity to bring this matter to your attention.

TYPE OF COIN

GTH 09146 CDS market for PCGS 09146 ST.GAUDENS$20 MOTTO 01/17/94 13:16:15

	45	50	55	58	60	61	62	63	64	65	66	67	68*
p	(93)	(281)	(1466)	(6880)	(6710)	(22942)	(71709)	(85402)	(41179)	(11724)	(1331)	(58)	(1)
b									QUOTE C45				
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b									570sK14	QUOTE C45			
b							442sK14		570 B48	900 G78			
b							448 H32		575 E34	960 D89			
b							450 G78		575 D14	975sK14	1800 B48		
b						434sK14	450 C54	496 B48	575/K79	975/K79	1820 E01		
b					422sK14	470 C54	460 E01	500 C45	575 D89	985 J01	1900sK14	4060 B48	
b				410 G78	436*A03	476 E34	480 E34	500 H13	575*A03	985sD14	2100sA03	5000 A51	
b	364*A03	374*A03	400*A03	410*A03	466 E34	478*A03	482 C45	500*A03	580 H13	985*A03	2150sE34	5500sA03	
b	420 C45	422 C45	430 C45	434 C45	468 C45	480 C45	482*A03	505 E34	580sD14	990sE01	2200/K79	8000/K79	
a						515 D89	500 C45	535 G78	595 K59	1060 E01	2500 E01	9250sB26	
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a									615 D16				
a									625sD16				
a									630 E01				

population, or number made

"S" indicates a "sight seen" bid

* indicates "your" bid

BIDS or "BUY" prices

Dealer's ID number

ASKS or "sell" prices.

EXAMPLES of HIGH BIDS AND LOW ASKS

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STATEMENT BY THE PRINCIPAL FINANCIAL GROUP TO THE COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES ON MISCELLANEOUS TAX REFORMS (PENSIONS AND EMPLOYEE BENEFITS) July 11, 12, and 13, 1995

THE ISSUE

Complex pension laws and regulations affecting the nation's voluntary employer-sponsored pension system are making plan compliance too costly for businesses of all sizes. This situation threatens the retirement security of millions of Americans. Studies have shown that pension plans are one of the few ways Americans save. The challenge is to find ways to encourage employers to establish and maintain pension plans.

Recently, President Clinton and several membrs of Congress have announced separate pension simplification proposals designed to encourage small employers to establish retirement plans.

BACKGROUND

Since the Employee Retirement Income Security Act of 1974 (ERISA), Congress has passed an average of one new law each year that significantly affected pension plans. In the past decade alone, Congress made 11 major changes to pension law, adding 80 pages of pension laws to the statute books and nearly 1,000 pages of Internal Revenue Service regulations to interpret the law. There is no consistent plan or policy behind these laws and regulations. In fact, there is often duplication and overlap, such as the combined Internal Revenue Code §415 limits and §416 top-heavy rules.

These rules require a whole array of lawyers, actuaries, accountants and consultants to help employers comply, which then increases the costs to administers these plans. Most affected are small companies, where such expenses become an unreasonable portion of plan costs.

Consider:

- The percentage of Americans now covered by pension plans is not much greater than it was before the 1974 passage of ERISA.
- When adjusted for inflation, the cost to administer a traditional defined benefit plan nearly tripled from 1981 to 1991 for small and large companies, according to a Pension Benefit Guaranty Corporation survey.
- According to IRS estimates, it takes an average plan sponsor with less than 100 employees more than 72 hours — nearly two weeks — to prepare *just* the plan's required annual report.

These complex rules hit smaller employers especially hard. They simply find it difficult to afford to sponsor a plan. For example, 73 percent of full-time employees of private companies with 1,000 or more employees are covered by a retirement plan. Only 24 percent of U.S. employees in firms with less than 100 employees are covered by a retirement plan.

RECENT SIMPLIFICATION PROPOSALS

The Principal Financial Group strongly supports the Pension Simplification Act (H.R. 2037) (S. 1006) introduced by Congressmen Ben Cardin (D-MD) and Rob Portman (R-Ohio) and Senators David Pryor (D-Ark) and Orrin Hatch (R-Utah). We also support the Clinton Administration's simplification proposal. We urge the 104th Congress and the Administration to work together closely in a non-partisan manner to enact as many of these changes as possible in 1995.

We have prepared the following side-by-side comparison of H.R. 2037/ S. 1006, the Clinton proposal and current law. We have included comments and suggestions that we believe can only make an excellent starting proposal all that much better. As a leader in providing retirement plan services to employers of all sizes — particularly to smaller employers — The Principal is in a unique position to provide its observations on the needs of smaller employers and their ability to provide retirement plans for their employees.

THE PRINCIPAL FINANCIAL GROUP
HIGHLIGHTS OF SEVERAL
PENSION SIMPLIFICATION PROPOSALS

SUBJECT	Current Law	Pension Simplification Act (H R. 2037)(S 1006)	Clinton Proposal	Comments by The Principal
IMPROVE AND EXPAND 401(k) PLANS				
▪ 401(k)/(m) tests	▪ No design based safe harbors ▪ Average deferral percentage (ADP)/average contribution percentage (ACP) for the highly compensated employees must be equal to or less than: 1) 125% of ADP for all eligible non-HCE or 2) lesser of (a) 200% of the ADP of all eligible non-HCE or (b) such ADP plus 2 percentage points ▪ Base current year HCE's average deferral percentage (ADP)/ average contribution percentage (ACP) on current year's non-HCE's ADP/ACP ▪ Corrective distributions made by reducing HCE with highest ADP first ▪ Corrective distributions must be made by end of next plan year. Refunds must be made within 2½ months after end of current plan year or employer is subject to 10% excise tax	▪ Design based safe harbors (plan wording requires this contribution to be made) **preclude testing, if met:** 1) 100% match of first 3% of deferrals, 50% of next 2% (to 5% total) or: 2) all eligible non-HCE's get 3% of compensation ▪ Written notice to employees about plan ▪ 100% vesting on match; restricted withdrawals ▪ No HCE can get higher match than any non-HCE ▪ No match over 6% of deferrals For non-safe harbor plans: ▪ Base current year HCE's average deferral percentage (ADP)/ average contribution percentage (ACP) on last year's non-HCE's ADP/ACP ▪ First year non-HCE ADP deemed to be 3% or actual ADP for year ▪ Corrective distributions made with highest dollar amounts first (not %)	▪ Two safe harbor plan designs available 1) 100% match of first 3% of deferrals, 50% of next 2% (to 5% total, and 1% nonelective contribution to all eligible non-highly compensated employees, or 2) 3% nonelective contribution to all eligible non-highly compensated employees ▪ 401(k) ADP and ACP tests eliminated ▪ 100% vesting on match; restricted withdrawals ▪ Written notice to employees about plan For non-safe harbor plans: 1) Base current year HCE's average deferral percentage (ADP)/ average contribution percentage (ACP) on last year's non-HCE's 2) Corrective distributions made with highest dollar amounts first (not %)	▪ Endorse the concept of a safe harbor match, and support the employer match requirements of 100% of first 3% and 50% of next 2%. ▪ Generally, support the concept of the additional 1% nonelective contribution; some concern that this will increase administrative costs for plans that will need to keep track of new, relatively small participant accounts. ▪ Support the proposals for non-safe harbor 401(k) plans
▪ Tax-exempt organizations	▪ Tax-exempt and governmental organizations are generally not allowed to have 401(k) plans unless established before 7/1/86.	▪ Allows non 501(c)(3) tax-exempt organizations to have 401(k) plans. State or governmental organizations and 501(c)(3) organizations are still prohibited	▪ Allows tax-exempt organizations, including Indian Tribes, to have 401(k) plans	▪ Generally support. Allowing all tax-exempt organizations, including Indian Tribes to have 401(k) plans is preferable, however

SUBJECT	Current Law	Pension Simplification Act (H R 2037)(S 1006)	Clinton Proposal	Comments by The Principal
SIMPLIFY PENSION PLANS FOR SMALL BUSINESSES				
National Employee Savings Trust (NEST) (A simplified pension plan for small businesses)	▪ No provision	▪ No provision	▪ Open to employers with 100 or fewer employees ▪ IRA-type arrangement ▪ Two safe harbor plan designs available: 1) 100% match of first 3% of deferrals, 50% of next 2% (to 5% total, and 1% nonelective contribution to all eligible non-highly compensated employees, or 2) 3% nonelective contribution to all eligible non-highly compensated employees ▪ Eligible employees are those age 21 or older with two years of service with the employer ▪ Nonelective contributions required only to those employees earning $5,000 or more per year ▪ 401(k) ADP and ACP tests eliminated ▪ Elective deferrals limited to $5,000 ▪ Employer nonelective contributions limited to 5% of pay (pay limited to $150,000 but no other deduction limits apply) ▪ Top-heavy rules eliminated ▪ Contributions 100% vested, withdrawals allowed after 2 years of plan participation. ▪ Can receive rollovers from qualified plans or other IRAs.	▪ Support the concept of the NEST We must simplify pension rules so more smaller employers can afford to sponsor them. ▪ We offer the following comments as a way to further improve this proposal so that more smaller employers will find it feasible: ▪ Change withdrawal and vesting on employer match to existing §401(a) qualified plan rules. many employers will not be able to afford NEST without these changes ▪ Allow loans from NEST accounts; employees view them as a necessary provision before they will sign up to make deferrals ▪ Clarify that employers that once had another plan, including a defined benefit plan, will still be able to have a NEST plan ▪ Employers must be able to make all NEST contributions to one financial institution. Otherwise payroll and administration concerns would burden the employer. Employer involvement results in higher employee participation. Voluntary programs do not have the same level of participation.

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▪ **Breaks for Small Businesses**	▪ No provision	▪ Employers with less than 50 employees that have not maintained a qualified retirement plan at any time during the immediately preceding two years, would be eligible for an income tax credit (up to $1,000) equal to the cost of establishing a qualified plan ▪ For small employers, no owners or employees would be treated as highly compensated unless they receives compensation in excess of $80,000 ▪ Salary Reduction Simplified Pensions (SARSEPs) may be established by employers with 100 or fewer employees, with no requirement that at least half of all eligible employees participate. ▪ Repeals top-heavy plan requirements where no employee makes over $80,000 (indexed) in the preceding year	▪ No provision	▪ Support these proposals
		SIMPLIFY PENSION RULES		
▪ **§415(e) Combined Benefit Limits**	▪ Applies an overall limit on benefits and contributions to a members in both a defined benefit and defined contribution plan of the same employer ▪ Require maintaining pay and contribution records for all years of service	▪ Repeals 415(e) combined limit	▪ Repeals 415(e) combined limit	▪ Support
▪ **§415 Compensation**	▪ Limits benefits to 25% of compensation ▪ In general, based on taxable compensation ▪ Excludes deferred compensation under 401(k), 457, and 125 plans	▪ Limits benefits to 25% of compensation ▪ Includes deferred compensation under 401(k), 457 and 125 plans	▪ No provision	▪ Support
▪ **Minimum participation rule**	▪ Applies to all plans ▪ Lesser of 50 employees or 40% of all employees ▪ For separate lines of business, each line passes participation if it has at least 50 employees	▪ Defined Benefit plans only ▪ Lesser of (1) 50 employees or (2) greater of (a) 40% of all employees or (b) 2 employees (1 if only 1 employee) ▪ For separate line of business rules, 50 employee requirement is not changed	▪ Applies only to Defined Benefit plans	▪ Support

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▪ **Required beginning date**	▪ Distributions must begin by April 1 of the calendar year following the year the member turns 70½	▪ Changes to later of age 70½ or date actually retired, unless 5% owner or IRA owner ▪ Actuarial increase required if retire after age 70½. Doesn't apply to church or governmental plans ▪ Changes uniform retirement age to Social Security retirement age	▪ Changes to later of age 70½ or date actually retired, unless 5% owner or IRA owner ▪ Actuarial increase required if retire after age 70½.	▪ Support
▪ **1/2 year**	▪ Many pension rules refer to the attainment of age 70½ or age 59½.	▪ No provision	▪ Eliminates ½ year requirements for qualified plans, to 59 and 70.	▪ Support
▪ **Highly compensated employees (HCE)**	▪ An employee is an HCE if: 1) at any time during the prior year, the employee (a) was a 5% owner, (b) earned more than $99,000, (c) earned more than $66,000 and was in the top-paid 20%, or (d) was an officer and earned more than $59,400; or 2) during the current year, the employee is (a) a 5% owner or (b) one of the 100 employees paid the greatest compensation for the year and (i) earns more than $100,000 (ii) earns more than $66,000 and is in the top-paid 20%, or (iii) is an officer and earns more than $60,000. (Dollar values indexed for inflation) ▪ At least 1 employee must be HCE ▪ Family aggregation rule applies to family members of a 5% owner or one of the top 10 highest paid HCEs	▪ 5% owner in current or prior year, or ▪ $80,000 (indexed) in prior year, or ▪ Was the most highly compensated officer in prior year and earned more than $75,000 (First and last criteria will not apply to employers with less than 100 employees.) ▪ Repeals all family aggregation rules	▪ 5% owner in current or prior year ▪ $80,000 (indexed) in prior year ▪ Repeals all family aggregation rules	▪ Support ▪ Support
▪ ***Lump Sum Averaging***	▪ Lump sum distributions from qualified plans are eligible for special 5-year forward income averaging ▪ 10-year forward income averaging available to those who attained age 50 before 1/1/86.	▪ Repeals 5-year lump sum averaging ▪ Retains 10-year lump sum averaging for grandfathered participants ▪ Allows one lump sum of up to $750,000 to be exempt from excise tax on excess distributions.	▪ No provision	▪ Support.

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▪ **Leased Employees**	▪ An employee is a leased employee if he has performed services for the employer on a substantially full time basis for a year, and the services are of the type historically performed by employees in the recipient's business field	▪ Replaces historically performed test with control of employee test	▪ No provision	▪ Support
▪ **Disabled participants**	▪ 415 limits may be violated if 'contributions made for disabled highly compensated employees	▪ OK to contribute for disabled participants without violating 415 limits	▪ OK to contribute for disabled participants without violating 415 limits	▪ Support
▪ **Self Employed Individuals**	▪ Special aggregation rules apply to plans maintained by owner employees	▪ Eliminates aggregation rules that don't also apply to other qualified plans	▪ Eliminates aggregation rules that don't also apply to other qualified plans	▪ Support
▪ **Plan Termination Rules for Substantial Owners**	▪ PBGC guarantee for a non-substantial owner is phased in over a 5-year period from the date of the plan's adoption or amendment. ▪ PBGC guarantee for substantial owner (more than 10%) is generally phased in over a 30-year period from the date the owner begins participation in the plan. Each amendment is separately phased-in.	▪ No provision	▪ 5-year guarantee phase-in period that applies to non-substantial owners also applies to a substantial with less than a 50% ownership interest. ▪ For a substantial owner with a 50% or more ownership, the phase-in period depends upon the number of years the plan has been in effect. Each amendment would not be separately phased-in. ▪ Majority owner's guaranteed benefit couldn't be more than the amount that would be guaranteed under the 5 year phase in for other participants	▪ Support
▪ **Partial Termination Rules for Multi-employer Plans**	▪ Upon a partial plan termination, all affected employees must become 100% vested in their accrued benefits. ▪ Occurrence is based on facts and circumstances	▪ No provision	▪ Eliminates the 100% vesting requirement upon plan termination for multi-employer plans.	▪ Support
▪ **Prohibited Transaction Exemption Procedures**	▪ Because of mandatory exemption procedures, it can take up to two years to obtain individual exemptions	▪ No provision	▪ Develops a prohibited transaction class exemption to allow the DOL to exempt all transactions that are substantially similar to previously granted individual exemptions. ▪ Class exemption would guarantee a DOL response within 45 days.	▪ Support

SUBJECT	Current Law	Pension Simplification Act (H R 2037)(S 1006)	Clinton Proposal	Comments by The Principal
▪ **Prohibited Transaction Exemptions for Self-Directed ERISA Plans**	▪ ERISA Section 404(c) reduces a plan fiduciary's liability (and exempts the participant from a prohibited transaction) when participants direct the investment of their accounts. ▪ Internal Revenue Code doesn't provide a similar exemption, so could still create a prohibited transaction .	▪ No provision	▪ IRS would issue a class exemption that would provide a prohibited transaction exemption for all transactions under ERISA 404(c) for which the DOL has granted a class exemption. ▪ The class exemption would provide an exemption for any ERISA 404(c) transaction for which the DOL has granted an individual exemption (but only if the IRS concurs).	▪ Support
▪ **Reversions for Government Contractors**	▪ If a pension plan terminates and excess assets revert to the employer, the reversion is subject to an excise tax. ▪ Government contracting regulations require that a portion of any reversion from a plan maintained by a government contractor be returned to the government. ▪ The portion paid to the government is subject to the reversion excise tax.	▪ No provision	▪ Exempts from excise tax the amounts that are required to be repaid to the government.	▪ Support
▪ **Church Plans**	▪ A church plan under ERISA is generally exempt for the ERISA Title I requirements. A church plan under the Internal Revenue Code is exempt from certain requirements. ▪ Under the Code, a church plan can make an election to be subject to ERISA. ▪ The definitions of a church plan under ERISA and the Code aren't identical, which can cause confusion	▪ No provision	▪ Amends ERISA to provide that a plan that satisfies the definition of church plan under the Internal Revenue Code would be exempt under ERISA ▪ Amend ERISA to allow a church plan that is a welfare benefit plan to elect ERISA Title I coverage if it makes a similar election for its pension plans.	▪ Support
▪ **Master and Prototype Plans**	▪ No existing statutory authority for IRS to define specifically the duties of master and prototype sponsors	▪ Authorizes IRS to define the duties of organizations that sponsor master and prototype plans, regional prototypes and other pre-approved plans. ▪ Purpose is to protect employers against loss of qualification in certain instances.	▪ No provision	▪ Support, but wary of IRS mandating restrictive requirements for M & P plan sponsors.
▪ **Plan Amendment Adoption Dates**	▪ Amendments must generally be made by the employer's income tax return due date for the employer's taxable year in which the change occurred.	▪ Extends plan amendment period to first day of plan year beginning after 1/1/97 (1/1/99 for governmental plans).	▪ Extends the amendment period (no specifics provided)	▪ Generally, support the concept of extending amendment periods.

SUBJECT	Current Law	Pension Simplification Act (H R 2037)(S 1006)	Clinton Proposal	Comments by The Principal
▪ **Alternative Full Funding Limits for Multi-employer Plans**	▪ Deduction limited to the amount by which 150% of the plan's current liability (or, if less, 100% of the plan's accrued liability) exceeds the value of plan assets. ▪ Annual actuarial valuations required for multi-employer plans.	▪ Eliminates 150% of current liability limitation for multi-employer plans ▪ Election to disregard 150% of current liability limitation if each plan in controlled group is not top-heavy and accrued liability of active participants for the 5 prior plan years is at least 80% of total plan accrued liability ▪ Treasury may reduce 150% limit for other plans (but not lower than 140%) ▪ Actuarial valuations every 3 years for multi-employer plans	▪ Eliminates the 150% current liability limitation for multi-employer plans ▪ Deduction limited to the amount by which the plan's accrued liability exceed the value of the plan's assets. ▪ Actuarial valuations every 3 years for multi-employer plans	▪ Support
▪ **Reports of pension and annuity payments**	▪ Amount of penalty varies depending on length of time before failure is corrected	▪ Support replacing the $25/day / $15,000 maximum penalty for each failure with the general information reporting penalties. Includes maximum $50 penalty on inadvertent failures and certain overall dollar limits. Would not require reports of pension and annuity payments of less than $10	▪ Support replacing the $25/day / $15,000 maximum penalty for each failure with the general information reporting penalties. Includes maximum $50 penalty on inadvertent failures and certain overall dollar limits. Would not require reports of pension and annuity payments of less than $10	▪ Support
▪ **Basis Recovery**	▪ Pro-rata basis applies, determined by the form of the payment.	▪ Portion of annuity payments exempt from tax determined on a pro-rata basis, similar to IRS Notice 88-118	▪ Portion of annuity payments exempt from tax determined on a pro-rata basis, similar to IRS Notice 88-118	▪ Support
▪ **Governmental plan 415 limits**	▪ 100% of compensation limit ▪ Compensation definition doesn't include deferrals ▪ 415 limits apply to survivor and disability benefits ▪ Public plans can't maintain excess benefit plans	▪ 100% of compensation limit doesn't apply ▪ 415 limits won't apply to survivor and disability benefits ▪ Public plans could maintain excess benefit plans (457 plan limits do not apply to excess benefit plan maintained by state or local governments) ▪ Adds various 457 plan changes	▪ 100% of compensation limit doesn't apply ▪ Compensation definition modified to include deferrals ▪ 415 limits won't apply to survivor and disability benefits ▪ Public plans could maintain excess benefit plans	▪ Support
▪ **Vesting in multi-employer plans**	▪ Multi-employer plans must comply with 10-year cliff vesting rules	▪ Requires multi-employer plans to comply with 5-year cliff or 7-year graded general vesting rules	▪ Requires multi-employer plans to comply with 5-year cliff or 7 year graded general vesting rules	▪ Support
STREAMLINE PENSION PLAN REPORTING AND DISCLOSURE				
▪ **ERISA Annual Report (Form 5500 Series)**	▪ Compliance with the Form 5500 annual reporting requirements is lengthy and complex ▪ IRS processing of reports is inefficient and costly	▪ No provision	▪ Revise the current Form 5500 to streamline or eliminate certain information ▪ Establish an automated filing system for receipt and processing of the Form 5500 Series data ▪ Develop computer software for filers	▪ Support

SUBJECT	Current Law	Pension Simplification Act (H R 2037)(S 1006)	Clinton Proposal	Comments by The Principal
▪ **ERISA Advance Notice of Benefit Reductions**	▪ Under ERISA Section 204(h), a plan must provide a written notice before reducing the rate of benefit accruals. ▪ Notice must be given to participants, alternate payees and any union representative. ▪ Notice must be provided after the amendment has been adopted by not less than 15 days before its effective date.	▪ No provision	▪ ERISA notice isn't required to be given to any individual who will be unaffected by the plan amendment. ▪ Notice isn't required when a plan covered by the PBGC issues a notice of intent to terminate. ▪ Notice is required only for reductions in benefit accrual.	▪ Support
▪ **Summary Plan Description (SPD) Requirements**	▪ Plan administrators must furnish each participant and beneficiary with a summary plan description (SPD) and summaries of material modifications (SMMs) to the SPD. ▪ SPDs and SMMs must be filed with the DOL.	▪ No provision	▪ Eliminates the requirement that SPDs be filed with the DOL. ▪ Authorizes the DOL to obtain SPDs from plan administrators to respond to participant requests or to monitor compliance.	▪ Generally support. Would encourage the DOL to actively monitor SPDs to ensure participants are given adequate information about their plans. Perhaps this can be done through electronic submission of the revised Form 5500.
▪ **PBGC Missing Participant Program**	▪ For terminating defined benefit plans insured by the PBGC, plan administrators must transfer a missing participant's benefit to the PBGC or purchase and insurance annuity for the participant. ▪ Plan administrators must also provide the PBGC with information about the participant.	▪ No provision	▪ Expands the missing participant program to non-governmental defined benefit plans not covered by the PBGC and to defined contribution plans.	▪ Support
National Commission on Private Pension Plans	▪ No provision	▪ Establishes a commission to identify long-term goals for private retirement savings. ▪ 18-member commission would include 6 members appointed by the President; 6 by the Speaker of the House, and 6 by the Senate Majority Leader	▪ No provision	▪ Support

Information About The Principal Financial Group

The Principal Financial Group is a family of insurance and financial services with assets of $48.2+ billion. It's largest member company, Principal Mutual Life Insurance Company, is currently the fourth largest life insurance company in the nation ranked by premium income. The Principal Financial Group serves 731,000 individual policy holders, 97,941 group employer clients, 31,345 pension contractholders and 189,192 mutual fund shareholder accounts. In all, 8.9 million customers (businesses, individuals, and their dependents) rely on the companies of The Principal Financial Group for their financial service needs.

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STATEMENT OF CONGRESSMAN TOBY ROTH
COMMITTEE ON WAYS & MEANS
HEARING ON MISCELLANEOUS TAX REFORMS
July 11, 1995

Mr. Chairman, thank you for holding hearings on these miscellaneous proposals. I am particularly concerned about a provision that will address the tax treatment of Indian tribal governments under section 403(b) and allow them to maintain tax-sheltered annuities.

This is a non-controversial change to the tax code, and it is my understanding that it will not require a fiscal offset. It's a small change to us, but it is an important one for tribal governments and their employees.

As we are all aware, Indian tribes have faced great difficulty in establishing strong economies. Extending 403(b) plans to the employees of Indian tribal governments will help provide long-term economic stabilization.

As you know, under present law, organizations that are tax exempt under Section 501(c)(3), as well as certain state and local government educational organizations, are permitted to maintain tax-sheltered annuity plans. For this purpose, Indian tribal governments are treated as states, so educational organizations associated with a tribe are eligible to offer such annuity plans.

The tribes themselves, however, though tax exempt, are not the type of organization permitted to maintain 403(b) plans.

Unfortunately, when the law was changed in 1982 to allow educational entities established by tribes to participate in 403(b) plans, the law was misinterpreted. Underwriters began to market plans as though all employees of the tribes would be eligible to participate. At least ten tribes became involved in 403(b) plans. Although they have all ceased making contributions to the plans, the investments remain in question.

Today, we have the opportunity to correct this problem. My district is home to a number of tribes. The Oneida Tribe, in fact, is one of the largest employers in the region. Yet, they are among the very few who cannot offer their employees (whether members of the tribe or not) any form of tax-sheltered annuity plan.

Mr. Chairman, this issue is one of simple equity. I urge you and your colleagues to extend 403(b) eligibility to Indian tribal governments.

Statement of the

American Public Power Association
to the
The House Ways and Means Committee on
Miscellaneous Tax Reforms

Submitted for the Record
July 11-13, 1995

The American Public Power Association (APPA) is pleased to comment on the various miscellaneous tax proposals currently before the Ways and Means Committee. APPA's written comments will primarily focus on a provision unique to public power issuers of tax-exempt bonds, however APPA also has attached information on several other proposals before the Committee that we strongly support that would significantly affect how federal, state and local governments raise capital. [3] (See attached Joint Signature Letter from eighteen state and local organizations supporting these other tax-exempt bond simplification provisions for more detail.)

APPA is submitting this statement for the hearing record on behalf of 1,750 local, publicly owned electric utilities throughout the United States. Collectively, public power systems provide electric service to one out of every seven Americans. Their sizes range from very large --such as the Los Angeles Department of Water and Power -- to very small. Several state public power agencies, such as the New York Power Authority, South Carolina Public Service Authority, and the Lower Colorado River Authority in Texas provide electric power to many communities within their states. In addition, APPA members include joint action power supply agencies and public power distributors. However, the majority of APPA member utilities are located in small and medium-sized communities in every state except Hawaii. In fact, three-quarters of all public power systems are in towns with populations of less than 10,000.

Public power systems are primarily entities of state and local governments. More than 2,000 public power systems serve 14 percent of all the kilowatt-hour (kWh) sales to ultimate customers in the U.S. Approximately 1,870 of these systems are cities and municipal governments that currently own and control the day-to-day operation of their electric utility systems. These public power cities and towns purchase nearly 70 percent of the power used to serve their ultimate customers. Traditionally, our federalist system of government has respected the right of state and local governments to pursue activities that are in the public interest and the interest of the citizens they serve. Congress has promoted and protected the right of government to issue municipal bonds for "government owned and operated projects and activities." Public power systems are just that -- governmentally owned and operated systems similar to other local infrastructure projects such as water systems, prisons, hospitals and transportation lines. Local communities, through the ballot box, decide if they wish to own and operate these systems. Municipal bonds, are the mechanism with which public power systems, as well as other publicly owned institutions, raise the capital to provide these services to their communities.

The remainder of this statement will focus on legislation, H.R. 677 introduced by Representative Richard Neal (D-MA) that would eliminate an inequity in the tax code

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[3] These provisions are included in the Joint Committee on Taxation Staff Description (JCS-19-95) of Miscellaneous Tax Proposals scheduled for hearings July 11-13 before the House Ways and Means Committee, issued July 10, 1995 (See pg. 287, #2, Bonds for output facilities) as well as some of the tax-exempt bond provisions included in H.R. 3419, the Tax Simplification and Technical Corrections Act of 1994.)

which discriminates against public power issuers of tax-exempt bonds. (See JCS-19-95, pg. 287, Bonds for output facilities for a description of the proposal.) H.R. 677 has bipartisan support and a negligible revenue impact ($11 million over 5 years.). During the 103rd Congress, the U.S. Treasury testified before this Committee indicating that there was no sound policy reason for treating issuers more harshly than other issuers of tax-exempt bonds. Moreover, last Congress, the same bill received bipartisan support from over 30 members of the House, 17 of whom were on the House Ways and Means Committee.

APPA commends Chairman Archer for his leadership in holding these hearings, and we appreciate the opportunity to comment on H.R. 677 as well as other miscellaneous tax-exempt bond reforms.

Background: Public Power and the 1986 Tax Reform Act

In the Tax Reform Act of 1986, Congress embarked on a dangerous path of differentiating between government issuers of tax-exempt municipal bonds based on the activities of the issuers rather that the broad criteria of ownership, control and operations. This path is ultimately destructive to the principals of federalism because it is based on the assumption that the federal government knows what is in the best interest of local communities. As such, it is inconsistent with the policies supporting the devolution of power in Washington and has the characteristics of centralized economic planning.

To ensure that the public at large rather than specific private entities receive the benefits of the lower cost of tax-exempt municipal financing, Congress in 1986 reduced the amount of benefit that individual private parties could receive from facilities financed by tax-exempt bonds from 25 to 10 percent. If applied uniformly to all issuers of tax-exempt bonds this would be a legitimate exercise of Congressional control over municipal financing. Unfortunately, it was not applied uniformly and an additional restriction was placed on public power issuers. Section 141(b)(4) of the code provides that the private use test for public power "output" facilities is to be **the lesser** of 10% **or $15 million.** Exceeding this $15 million amount of private use destroys the tax-exemption status of the bonds issued for such facilities. H.R. 677 eliminates this separate $15 million limitation, but keeps in place the current 10% private-use limitation applicable to all other issuers of tax-exempt bonds.[4]

Why Is The $15 Million Private Use Restriction Unfair?

There are neither fiscal nor public policy justifications for the $15 million private-use test imposed on public power. While limiting private use of publicly financed facilities from 25 percent to some lower amount was the subject of debate, this separate limitation was never explicitly considered. The limitation was not imposed for fiscal reasons since no revenue estimates were ever prepared. From a practical perspective, this restriction also causes public power systems to operate less efficiently, further complicates the tax code, and treats output facilities more harshly than other governmental facilities.

In 1989 the Anthony Commission on Public Finance, chaired by former Rep. Beryl Anthony (D-AR), issued a report entitled "Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing." The Commission observed that "there is no public policy reason to apply the private use restriction differently for different types of facilities....[T]o limit the private use portion of bonds issued to finance public power and other output facilities appears to be totally without merit."

The restriction affects any public power project with construction costs in excess of $150 million. Electric utility generation and transmission facilities are capital intensive - - many costing in excess of $500 million. For such projects the effective private use limit

[4] H.R. 677 does not address a 1987 provision included in the Omnibus Budget Reconciliation Act [P.L. 100-203] restricting the use of municipal bonds to acquire private output facilities. (i.e. the Rostenkowski Amendment).

may be 2 or 3 percent or less, not the 10 percent allowed for all other governmental facilities, because of the current, separate $15 million threshold..

This restriction imposes operational problems and inefficiencies. For example, generating facilities have long construction lead times and have useful lives of at least 30 years or more. They are sized to meet anticipated future power supply requirements, not the power requirements that exist at the time of construction or the time they are first brought into service. These facilities are, historically, designed to have the ability to generate more electricity than initially needed by the public power developer. Of course, this surplus capacity may sit idle until it is needed by the public power system. As such, it clearly makes sense, both economically and environmentally, to utilize that capacity by selling it to others in the early years. But because of the special $15 million limit imposed on public power, sales are restricted to de minimus amounts of electricity. Thus the plants may not be operated at maximum efficiency levels. Other ramifications also result, such as obliging investor-owned utilities to build more power plants rather than purchasing available power from existing public power generators.

On June 22, 1993, Leslie B. Samuels, Assistant Secretary for Tax Policy testified on behalf of the U.S. Department of Treasury before the House Ways and Means Select Revenue Subcommittee and said that "There does not appear to be any reason to treat output facilities more harshly than other facilities. As a practical matter, the $15 million output limit ... create[s] an incentive for public power to operate inefficiently."

Competition in the Domestic Energy Arena

The electric power industry is undergoing a significant shift away from a regulated private utility monopoly structure towards an open competitive structure, especially for power generation and wholesale power sales. In the most significant legislation affecting the power industry in over 50 years, the Energy Policy Act of 1992, P.L. 102-486 (the "EPAct"), among other things, generally deregulated power producers to encourage a competitive bulk power market.

In one of the most significant changes affecting public power systems, the EPAct granted to the Federal Energy Regulatory Commission ("FERC") the authority to mandate open access to transmission facilities for the transmission of wholesale electric power from power generators to retail distributors. These provisions are pushing the electric power industry forcefully towards treating transmission facilities as integrated networks that consist of many interconnected parts built and owned by many different entities and that are now made available to all on an equal basis, without discrimination in favor of transmission owners. These mandated wholesale "wheeling" provisions will have a significant effect on the competitive forces in the industry, especially between municipal systems who have been transmission dependent, and private power companies who historically have had monopolistic control.

At present, the electric utility industry in the United States is undergoing dramatic change. There is the potential for a new set of rules that will permit greater competition. The monopoly protections long enjoyed by investor owned utilities may soon be dissolved.

Municipal electric utilities, on the other hand. represent an efficient and attractive choice for consideration by communities that are considering how best to provide low-cost, reliable electric power supply to their citizens. As a result of these new choices, there is a competitive threat that a community may decide to establish a municipal systems rather than continue to grant a service franchise to a private regulated monopolist.

Unfortunately, however, private utilities are obsessed with seizing what may be their last chance to increase costs on their competitors, or better yet, drive them from the industry, so as to avoid the consequences of having to compete with more cost efficient alternative suppliers.

The fear of competition, has forced private power companies to aggressively attack municipal systems arguing that they are receiving a free ride because they pay no

federal income taxes and are eligible to issue tax-exempt bonds. Many times these private systems have gone so far as to question municipal systems very right to exist. These arguments are one-sided and often misleading. There is no mention of the fact that municipal systems pay no federal income taxes because they make no income since they are not-for-profit utilities. There also is no mention of the fact that municipal systems issue tax-exempt debt as entities of state and local governments, just as investor owned utilities are eligible to enjoy certain tax benefits by nature of their being private corporations.

Moreover, public power systems, because of their nature (not-for-profit, consumer-owned entities) have historically served as a check against monopolistic shareholder owned private power companies. Often public power rates are used as a "yardstick," helping to keep investor-owned rates at a more reasonable level than they would be otherwise.

More specifically, private power companies have used this new competitive environment to oppose H.R. 677 a bill which, if enacted would promote partnership arrangements between municipally-and investor-owned utilities to the benefit of both. When hearing arguments against this provision it is important to separate the rhetoric from the merits of the proposal. H.R. 677 does not give preferential treatment to public power utilities. As mentioned above, municipal utilities are entitled to issue tax-exempt bonds because they are part of state and local governments, just as investor owned utilities are eligible to enjoy certain tax benefits because they are private corporations. H.R. 677 does not make it easier for a municipal utility to compete outside its service territory. The bill has nothing to do with service territory. Decisions about service territory and who serves whom at the retail level are governed by state law, not federal tax policy. Congress also did not "deliberately" impose a special private-use test on public power because the industry operates in a competitive market. In fact, the industry does not, and will not, operate in a truly competitive environment so long as private power companies are guaranteed a rate of return as they are now. Many other services provided by state and local governments are also provided by private industry such as schools, police, water and road systems. These systems do not adhere to the special $15 million private use restriction.

Opposition to this bill by private utilities is based on a long-standing hostility toward public power, rather than the merits of the proposition. H.R. 677 is good for consumers. It simply eliminates a discriminatory provisions in the tax code that is not supported by any public policy justification and has little to do the competition between private power companies and publicly-owned systems.

Conclusion

Private use restrictions limiting the benefit available to private parties from publicly financed facilities are based on fiscal and public policy considerations. However, the restrictions should apply equally to all governmentally financed and operated facilities. The special and discriminatory $15 million private-use restriction that applies only to publicly owned electric and gas facilities is not supported by any public policy justification. It discriminates against communities that elect to provide their electric and gas utility services. It may force developers of electricity generation and transmission facilities to forego the most economic and environmentally beneficial uses of those facilities, particularly in the early years of their service. APPA strongly supports the inclusion of H.R. 677 in any tax bill considered by the Committee.

Attachment

ATTACHMENT

Airports Council International-North America (ACI-NA)
American Public Gas Association (APGA)
American Public Power Association (APPA)
American Public Works Association (APWA)
Association of Metropolitan Sewerage Agencies (AMSA)
Council of Development Finance Agencies (CDFA)
Council of Infrastructure Financing Authorities (CIFA)
Education Finance Councel (EFC)
Government Finance Officers Association (GFOA)
Municipal Treasurers' Association (MTA)
National Association of Counties (NACo)
National Association of Higher Educational Facilities Authorities (NAHEFA)
National Association State Treasurers (NAST)
National Association of Towns and Townships (NATaT)
National Council of Health Facilities Finance Authorities (NCHFFA)
National League of Cities (NLC)
National School Boards Association (NSBA)
U.S. Conference of Mayors (USCM)

May 18, 1995

Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

RE: Tax-exempt Bond Simplification Provisions

We are writing on behalf of our members who are state and local government officials who rely on the issuance of tax-exempt bonds to finance infrastructure and other public facilities.

You have recently indicated a willingness to develop tax legislation that would include miscellaneous reforms of a technical nature and simplification provisions. We urge you to include five tax-exempt bond provisions in this tax legislation that conform to the criteria you have established for consideration. These provisions, which are described below, have been the subject of Congressional hearings; have been seriously considered or approved several

times by Congress; and have broad support from state and local government officials, members of Congress, federal agencies, the municipal bond industry, and various study commissions.

Each year, approximately 10,000 tax-exempt municipal bond issues are sold. The changes we support in the bond area will benefit small and large issuers and issuers nationwide. These provisions are not wholesale changes to the municipal bond laws, but instead would modify or remove overly burdensome and costly regulatory requirements that stand in the way of efficient and cost effective municipal bond financings. These changes are an important first step in improving tax-exempt bond policies and mitigating the overly burdensome regulatory structure that serves no federal purpose, costs state and local governments billions of dollars in compliance costs, and benefits the array of consultants hired by state and local governments to interpret overly complex and intrusive tax law provisions. They are not comprehensive, complicated or controversial changes. They simply provide a modicum of relief for state and local governments that are charged with increased demand for essential public services.

We would welcome the opportunity to work with you and your staff on the following five key provisions:

1. <u>Increase the small-issuer arbitrage rebate exemption</u>.

The arbitrage rebate requirement was perhaps the most intrusive and ultimately costly provision for state and local governments included in the 1986 Tax Reform Act. Although the concept of "rebating" earnings on the investment of bond proceeds to the federal government may seem simple, its implementation indisputably is not. The small-issuer rebate exemption currently is $5 million and has not been increased since the enactment of the rebate on governmental and 501(c)(3) issuers in 1986. An increase from $5 million to $25 million was recommended by the Anthony Commission on Public Finance and would provide relief for a significant number of issuers not currently eligible at very little cost to the federal government. This occurs because a large number of issues (approximately 80 percent of the total) account for a small percentage of total tax-exempt volume (approximately 20 percent).

Such a change would give small state and local government issuers more flexibility to finance necessary public projects without cumbersome restrictions that were intended to prevent abusive transactions engaged in by other types of issuers. Moreover, an increase in the small-issuer rebate exemption has passed Congress on two separate occasions, but never

signed into law because of unrelated issues. It also was included in H.R. 3419, the Technical Corrections and Simplification Act of 1993 and H.R. 13, the Tax Simplification Act of 1993.

It is particularly important to provide small-issuer rebate relief because the present-law two year construction bond exception to the arbitrage rebate is too complex for small issuers and imposes overly harsh financial penalties if unanticipated events prevent an issuer from meeting spending targets.

2. Increase the small-issuer bank interest deduction limit.

Current law permits banks to take an 80 percent interest deduction for bonds issued by small government issuers and small 501(c)(3) issuers. Bonds issued by such issuers are eligible for the bank interest deduction if the issuer does not issue more than $10 million in volume on an annual basis. Prior to 1986, this deduction was available for all bonds held in banks' portfolios. This tax law change has significantly reduced bank demand for tax-exempt securities and resulted in higher borrowing costs for issuers, greater market volatility and less liquidity.

Increasing this small issuer exemption would provide relief for a large number of issues that account for only a small percentage of total volume in the market. The provision should also be changed to allow issuers to elect whether to apply the exemption at the issuer level or the borrower level. This $10 million limit has not been increased since enactment of the 1986 Tax Reform Act. The Anthony Commission on Public Finance called for the limit to increase to $25 million in 1989 and the provision has been included in three tax bills since that time, but because of unrelated concerns, those bills did not become law. In the interest of simplicity, this small-issuer limitation and the arbitrage rebate small-issuer exemption should be set at the same dollar amount.

3. Repeal of the five percent unrelated and disproportionate use rule.

This requirement apparently stems from Congressional concern that significant amounts of bond proceeds from governmental issues were being used to finance private activities unrelated to the public activity being financed with a governmental tax-exempt bond and for which Congress had not specifically authorized tax-exempt financing. Under current law, not more than five percent of bond proceeds may be used for facilities "unrelated' to the financed public facility. Additionally, the related use must also be proportionate to the governmental or public use financed with the bond proceeds.

Problems arise in applying this test because of (1) the unavoidable vagueness inherent in the concept of "relatedness" and the application of a "facts and circumstances" standard, (2) the infinite number of factual situations that arise, and (3) the problems of attempting to allocate mixed-use facilities between related and unrelated uses and governmental and private uses. There is also no demonstrable need for the imposition of the related-use requirement, particularly in light of the fact that the private loan financing test imposes a five percent limit on the loan of bond proceeds to a nongovernmental person.

This provision is a perfect example of an unworkable section of the code. It has never met its intended purpose and therefore leads to confusion and increases in legal fees. It has been included in three different tax bills, two of which were vetoed by President Bush for unrelated reasons. More recently, it was included in H.R. 3419 and H.R. 13.

4. Repeal $15 Million Private-Use Restriction on "Output" Facilities

In addition to the 1986 reduction of the private-use limitation from 25 percent to 10 percent, the federal tax code also provides that for certain output facilities--public power and public natural gas generation and transmission facilities--the private-use limit is the lesser of 10 percent or $15 million. Private use restrictions limiting the benefits available to private entities from publicly financed facilities are based on sound and appropriate public policy considerations. However, the restrictions should apply equally to all governmentally financed and operated facilities.

The special $15 million private-use limitation that applies only to publicly owned electric and gas facilities is not supported by any public policy justification. It may force local governments that provide generating and transmitting facilities to have their surplus capacity sit idle rather than having it sold to others in order to avoid the private-use limitation. This provision should be repealed because it is discriminatory and it encourages practices that are not environmentally or economically sound.

5. Modify Six-Month Rebate Exemption

Under current law, issuers are not required to rebate arbitrage earnings if bond proceeds are spent within six months of the date of issuance. However, the rebate exemption period may be extended to one year for proceeds held in a bona fide debt service fund or a reasonably required reserve or replacement fund and in other limited instances if the unspent portion does not exceed the lesser of five percent of the proceeds or $100,000. Modifying this

provision to eliminate the flat-dollar limit of $100,000 on unspent proceeds would remove the unwarranted penalty on larger issuers who should also be eligible to take advantage of the extension provided by current law.

If you or your staff have any questions concerning these issues, please do not hesitate to contact any of the organizational representatives listed below:

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John Harrington

STATEMENT OF NORTHEAST PUBLIC POWER ASSOCIATION ON H.R. 677

Submitted to
Committee on Ways and Means

July 27, 1995

The Northeast Public Power Association (NEPPA) welcomes this opportunity to state its views on H.R. 677, a bill introduced by Rep. Richard Neal to eliminate the $15 million cap on private use that applies to tax-exempt bonds issued by public power entities.

NEPPA is the regional service association that represents more than 70 public power systems, joint action agencies and rural electric cooperatives in six states of the northeastern United States. NEPPA member utilities serve approximately 1.5 million customers in Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, and Maine.

Issues relating to tax-exempt financing are of critical importance to the majority of NEPPA's members. Since 1980, NEPPA member utilities have issued over $1.7 billion in tax-exempt bonds, primarily for the construction of electric generating facilities.

NEPPA strongly supports H.R. 677, which would eliminate the arbitrary $15 million cap on private use that applies only to bonds issued by public electric and gas systems. As the Committee is well aware, the Tax Reform Act of 1986 reduced the private use test for tax-exempt bonds issued by all governmental entities from 25 percent to 10 percent. A separate provision of that Act imposed an additional private use limitation on public power bonds: the lesser of $15 million or 10 percent.

No abuses were identified as the rationale for this separate rule and no hearings were held on the limitation. No revenue estimate was made to determine the impact on the Treasury of the provision. In short, it appears to NEPPA that there is no sound public policy or financial justification for this discriminatory restriction.

The $15 million restriction limits public power's flexibility in developing, operating and using bond-financed facilities. In some cases, it causes less than optimum use of generating facilities because of the extremely small amount of surplus power that can be sold to non-exempt entities (including investor-owned and rural electric cooperative utilities) without jeopardizing the tax-exempt status of the bonds. NEPPA urges the Committee to adopt H.R. 677 and to move the measure as expeditiously as possible.

TESTIMONY OF EDWARD A. O'CONNOR, JR.
SPACEPORT FLORIDA AUTHORITY

INTRODUCTION

Mr. Chairman and members of the Committee, I thank you on behalf of the State of Florida and the Spaceport Florida Authority for the opportunity to submit this testimony.

The Spaceport Florida Authority (Spaceport Authority) was created by Florida's Governor and Legislature to provide a unified direction for space-related economic growth and educational development, to ensure a stable and dynamic economic climate, to attract and maintain space-related businesses and programs suitable to the state, and to further the coordination and development of Florida's space industry.

The Spaceport Authority is a public corporation and political subdivision of Florida's government. It was created as the sole regulator of commercial spaceports in the state, and is responsible for ensuring, through active cooperation with federal agencies, the space industry, and academia, that a supportive environment exists in Florida for the growth and continued development of space enterprise, including launch activities, other space business, research, and education. All non-shuttle launch complexes on Cape Canaveral (Cape) are included within the Spaceport Authority's state-legislated territory.

The Spaceport Florida Authority Act extends state sales and use tax exemptions for commercial launch vehicles, fuels, and payloads, and empowers the Spaceport Authority to issue bonds to finance the development of space-related projects. Section 331.301, Fla. Stat. (Supp. 1994). These are the nation's first municipal space bonds, and they may provide an attractive alternative for financing costly space programs, including infrastructure, launch support facilities, and ground stations. Bonds issued by the Spaceport Authority, and all instruments securing the bonds, are exempt from taxation by the state or any local government. Through separate federal legislation, the Spaceport Authority is seeking to attain tax-exempt status for bonds which finance the development of elements necessary to the operation of a spaceport--the same exemption currently extended to bonds used for airports and seaports.

With its focused charter and broad power the Spaceport Authority is capable of bringing together the resources, funding, and planning efforts of industry, state and federal government, and academia to maintain and improve our nation's capabilities to access space, and bolster the competitive position of the domestic commercial launch industry.

PART ONE

Florida has taken several steps to improve the space industry environment by increasing industrial involvement, providing tax incentives and financing assistance, and creating an advocacy organization specifically designed to assist space enterprise. The federal government has also taken steps to encourage space industry by developing space policies and legislation which encourage its agencies to procure commercial services and hardware when feasible.

In keeping with the intent of these federal policies, Florida is supporting various other initiatives in Washington aimed at encouraging space enterprise. This amendment would make spaceport facilities eligible for tax-exempt bond financing to the same extent as other transportation facilities, such as airports, docks, and wharves. The description of a "spaceport" is very similar to an airport. A spaceport includes facilities directly related and essential to servicing a spacecraft, enabling spacecraft to take off or land, and transferring cargo or passengers to or from the craft. The facilities must be located at, or in close proximity to the launch site to perform these functions.

PART TWO

I am pleased to submit the views of the State of Florida on the spaceport tax proposal. I respectfully request that this committee support tax-exempt bond financing of spaceports. This legislation to amend the Internal Revenue Code of 1986 to treat spaceports like airports is an important means of accomplishing the objectives of the Commercial Space Transportation Act. We must re-capture our competitiveness in the commercial launch industry to preserve our position of leadership in other space industry sectors. Our nation's commercial space launch industry needs support because it faces increasing competition from Europe, China, Japan, India, Australia, and the former Soviet Union. These governments fully appreciate the strategic and economic advantages of developing and operating their own launch systems.

The needs of U.S. space business can be served through proactive support from both State and Federal governments. Space companies are profit-motivated in an extremely competitive and costly industry; therefore, they are remarkably sensitive to the business environment that State and Federal Governments create. Technical assistance, tax policies, insurance requirements, and access to infrastructure can have an immediate impact on the industry's ability to respond to market needs, and to react to market fluctuations.

The future of international space industry will be driven by a commercial demand for a presence in space by high technology businesses for their products, services, and research needs. Those nations able to provide low-cost, reliable access to and from space will control an industry destined to expand and mature well into the next century. Accordingly, the U.S. must maintain its leadership in space by encouraging, supporting, and improving our commercial space transportation capability. To compete internationally, we must provide for the development and modernization of the infrastructure required to improve our commercial launch capabilities. Consequently, extending spaceports tax-exempt bond status will enable this necessary improvement.

PART THREE

There is an immediate and growing need for improvement and modernization of our nation's existing space transportation infrastructure and capabilities. Although the Cape is perceived by many to exemplify the state-of-the-art in U.S. technology, today's commercial launch operators are increasingly concerned about the Cape's ability to meet launch commitments due to near-obsolete support infrastructure and equipment. This legislation will allow investments in developing and improving our commercial space infrastructure. We will be able to provide cost-effective, reliable transportation to space. Without such access to space, we will lose

profitable and prominent business in the marketplace and lose an industry in which we have led the world. The Spaceport Florida Authority and the State of Florida strongly support the proposed amendment to the Internal Revenue Code of 1986 for the tax exemption of spaceport bonds, and urge you to support such legislation.

The Spaceport Authority is committed to establishing a more competitive environment where space businesses have:

- Easy and economical access to launch and launch-support facilities.
- Enhanced capabilities for infrastructure and systems modernization.
- Access to facilities for payload development and preparation.
- Access to financial assistance and alternatives for infrastructure development.
- A mechanism for forming partnership arrangements with the government and universities.
- An experienced pool of engineers, scientists, and other support personnel.
- Easy access to universities and research centers.
- Access to business incubators for small and entrepreneurial space-related firms.
- Strong support from federal, state, and local governments.
- Assistance and support for safety and environmental issues.
- An advocacy organization dedicated to providing support and assistance to the space industry.

Together with industry, universities, and the federal government, the Spaceport Authority hopes to form lasting partnerships to satisfy mutual needs and, through teamwork and innovation, increase our effectiveness in the world marketplace .

The international market for space transportation is expected to expand dramatically from 1995 through 2000. During this time, the U.S. satellite industry is currently projecting the need to launch more than 300 satellites. Although a smaller number of launches is actually expected to occur, the U.S. space transportation capability must be pushed beyond its current limits to meet this demand. The alternative is the continued erosion of the U.S. market share

The State Governments and Industry are now willing to work with the Federal Government to turn the tide and reclaim the nation's market share of the space transportation industry. No longer is it necessary for the Federal Government to continue fully funding the infrastructure that is necessary to support our nation's space transportation system. Instead, State Governments, including Florida's, are willing to share the burden by investing in space transportation infrastructure. The reason that State Governments are willing to make this investment is to keep and to create high-paying, high-tech jobs, as well as preserve American dominance in space transportation systems.

Because our nation's space launch capability is out-of-date and costly to maintain, the U.S. will lose both revenue and jobs to our international competitors unless we begin immediately to modernize. State Governments, including Florida, have already begun to invest in the nation's space transportation capability. During the past five years, Florida has invested more than $5 million in programs aimed at improving U.S. competitiveness in space transportation. Other states, such as Virginia, Alaska, California, and New Mexico are making similar investments. But the States cannot continue to invest and improve without the Federal Government as a partner.

Industry has also begun to invest in our nation's space transportation system as well. For example, Minnesota's Honeywell Corporation has made $90 million worth of investments in avionics systems to be used in existing and new launch vehicles. Thiokol Corporation of Utah has invested more than $40 million to develop a new rocket motor, the Castor 120. Companies like Orbital Sciences Corporation, EER, and others have also invested millions to enter the U.S. space transportation industry. This proposed legislation is an action that will directly benefit the several states in which space transportation infrastructure is or may be located -- including Florida, Virginia, New Mexico, Alaska, and California. Depending on developments in launch technology and system performance, other states, including Texas, Hawaii, Alabama, Mississippi, and Arizona may establish launch sites at some point in the future and are, therefore, strong supporters of this legislation. This legislation is an action that, if passed, will also benefit the

states in which no infrastructure is located, but in which space transportation hardware is built -- including Michigan, Minnesota, Texas, Colorado, and Utah.

In part because of our aging infrastructure, U.S. satellite manufacturers increasingly turn to foreign launchers to transport their products to orbit. Growing numbers are petitioning for permission to use Chinese, Russian, and Ukrainian rockets.

Lastly, this proposed legislation will greatly assist us in upgrading our nation's commercial space infrastructure at a minimal cost to the federal government. A 1993 revenue estimate by the staff of the Joint Committee on Taxation put the tax revenue impact of this measure at only $19 million over a five-year period. This impact would be greatly offset by the job creation projects funded by the bonds. It would simply allow the states' spaceports to be eligible for the same exempt facility bond financing already extended to airports. It would also encourage private investment in our nation's space launch infrastructure. Most U.S. launch facilities are in a deteriorated condition, and therefore there exists a potential for safety problems and scheduling slips. These safety problems and scheduling slips put a large cost burden on commercial launch companies that are trying to offer a competitively priced service.

Florida and several other states recognize the importance of maintaining a cost-effective means for U.S. access to space to maintain competitiveness. Cost-effective transportation to (and from) orbit is a prerequisite to the continued growth of all sectors of the space industry. Commercial space is a $4.7 billion industry in the U.S., represents thousands of jobs, and is one of the few industries where our nation has remained strong.

In closing, State Governments and industry need to unite with the Federal Government to successfully implement our program of infrastructure improvement. On behalf of Spaceport Florida Authority and the State of Florida, I ask for this committee's full support of the amendment to the Internal Revenue Code of 1986 to extend the tax-exempt bond financing capability to spaceports. If we can launch more rockets at a reduced cost, then more satellites and rockets can be built, and more research and development can be conducted -- cementing the continued dominance of the U.S. in the international realm of space transportation.

Thank you.

STATEMENT OF ROBERT C. KELLY
CO-CHAIRMAN OF THE MANAGING BOARD OF
AMOCO/ENRON SOLAR

before the
COMMITTEE ON WAYS AND MEANS
U.S. House of Representatives

July 27, 1995

My name is Robert C. Kelly and I am Co-Chairman of the Managing Board of Amoco/Enron Solar, a joint venture of subsidiaries of Amoco Corporation headquartered in Chicago, Illinois, and Enron Corp., headquartered in Houston, Texas. I very much appreciate the opportunity to submit this statement for inclusion in the Committee hearing record and to share my thoughts from a private sector perspective on the use of existing tax exempt private activity bond mechanisms in the commercialization of solar energy technology by U.S. companies in multi-megawatt grid connected solar power projects in the United States.

The Importance of Solar Energy to the U.S.

Let me begin by emphasizing the importance of the development of solar energy to the national interests of the United States in three key areas:

- ***economic***
- ***environmental***
- ***energy security***

In the ***economic*** area, we see a significant potential for U.S. jobs and in particular exports because of the growth in demand for electric power in the developing world. In meeting global power requirements there is an intense interest in renewable energy, particularly in solar power, as a means of providing a long term electric supply without creating significant environmental effects and without having to resort to significant fuel imports.

Major foreign competitors in Germany, Japan, and other countries are looking to compete for a share of this market. Given our technology, we believe we have a two to four year lead in capturing a large share of the international market, but our competitors are not standing still and will make every effort to cut into our lead. We can maintain or extend that lead by accelerating our commercialization efforts with support by Congress for legislation on tax exempt private activity bonds.

U.S. companies can lead the market in sales to these growing international markets by demonstrating to foreign buyers the commercial viability of multi-megawatt solar farms in U.S. projects, such as the Amoco/Enron proposal for the Nevada Solar Enterprise Zone and similar projects in other states with excellent solar energy resources such as California, Arizona, Texas, New Mexico, Hawaii, and Florida. These projects can be extremely competitive and can be financed in the private sector if they are given access to existing tax exempt private activity bond funding mechanisms that currently support development of many other similar projects.

In the ***environmental*** area, fostering the development of commercially viable solar power will be a major constructive step which the U.S. government can take towards meeting its obligations under the Rio Treaty. The ever escalating growth in carbon dioxide emissions has caused concern among many of the world's governments that steps need to be taken to stabilize or reduce carbon emissions. Here solar power has a clear advantage over other technologies currently in use, but there is no market or regulatory mechanism that gives any incentive to use solar power rather than other greenhouse gas emitting technologies.

One method of accounting for these external effects would be to foster the development of solar energy projects with the existing tax exempt private activity bond funding mechanisms that are currently in place.

Energy security is the third major reason why the development of solar energy is important. We need to further develop our domestic energy resources in the U.S. and reduce dependence on energy imports. The development of the huge solar energy resource in the United States could help offset our growing dependence on energy imports

Tax Exempt Private Activity Bonds and Solar Electric Projects

The cost of money is a critical element in the competitiveness of a solar electric project because solar electric power is capital intensive. Tax exempt private activity bonds such as exempt facility bonds reduce debt costs by up to 40% and make commercial scale solar electric projects more competitive.

A good example of how changes in legislation on exempt facility bonds can promote solar electric power is illustrated by the Amoco/Enron Solar proposal for the Nevada Solar Enterprise Zone. The Solar Enterprise Zone (SEZ) concept was launched in the FY 1992 Defense Reorganization Act which called for a feasibility study on the use of the Nevada Test Site, an excellent location in terms of the solar resource, for the development of solar technologies.

In May 1994 the D.O.E. requested proposals from the private sector on how to utilize the SEZ to commercialize solar power. In response to that RFP Enron's solar development group, which is now part of Amoco/Enron Solar, proposed that the SEZ be developed through a sale of 100 megawatts of power to the D.O.E. at a competitive price. The proposal was based on three major conditions:

- A Long Term Power Sales Contract to the D.O.E. at Competitive Prices
- The Availability of a Site at Nominal Cost to the Project
- Tax Exempt Private Activity Bond Financing

The advantage of this proposal is that it allows for the successful development of the SEZ with private sector financing. In our initial proposal to the D.O.E., we estimated the capital cost for the Solar Farms in Nevada between $150-200 million in 1994 dollars over 15 years. The D.O.E. has set up an entity to further develop the concepts of the SEZ, an RFP has been issued, and site and market issues are being worked out.

Constraints on Use of Tax Exempt Private Activity Bonds in SEZ Type Projects

We believe that competitively priced solar power can be sold to the D.O.E. and other government agencies if solar developers have access under current private activity bond programs to tax exempt financing.

There are two changes to current laws that would enable the private sector to develop the SEZ or other multi-megawatt solar projects using private funds:

- ***Legislation to add bonds used to finance a solar generation facility to the list of exempt facility bonds.*** This legislation is necessary because solar generation facilities are not currently included in any existing category of private activity bonds that can be issued on a tax exempt basis. The closest existing category is "exempt facility bonds" which includes, among other things, "facilities for the local furnishing of electricity". However, the "local furnishing of electricity" has been defined as providing electricity in the county where it's produced or an adjacent county, and it's probable that some or all of the electricity produced by the Solar Farm in the SEZ will be wheeled to serve power needs in other areas.

- ***Legislation to add bonds used to finance a solar generation facility to the list of exceptions from the general rule that bonds cannot be tax exempt if they are***

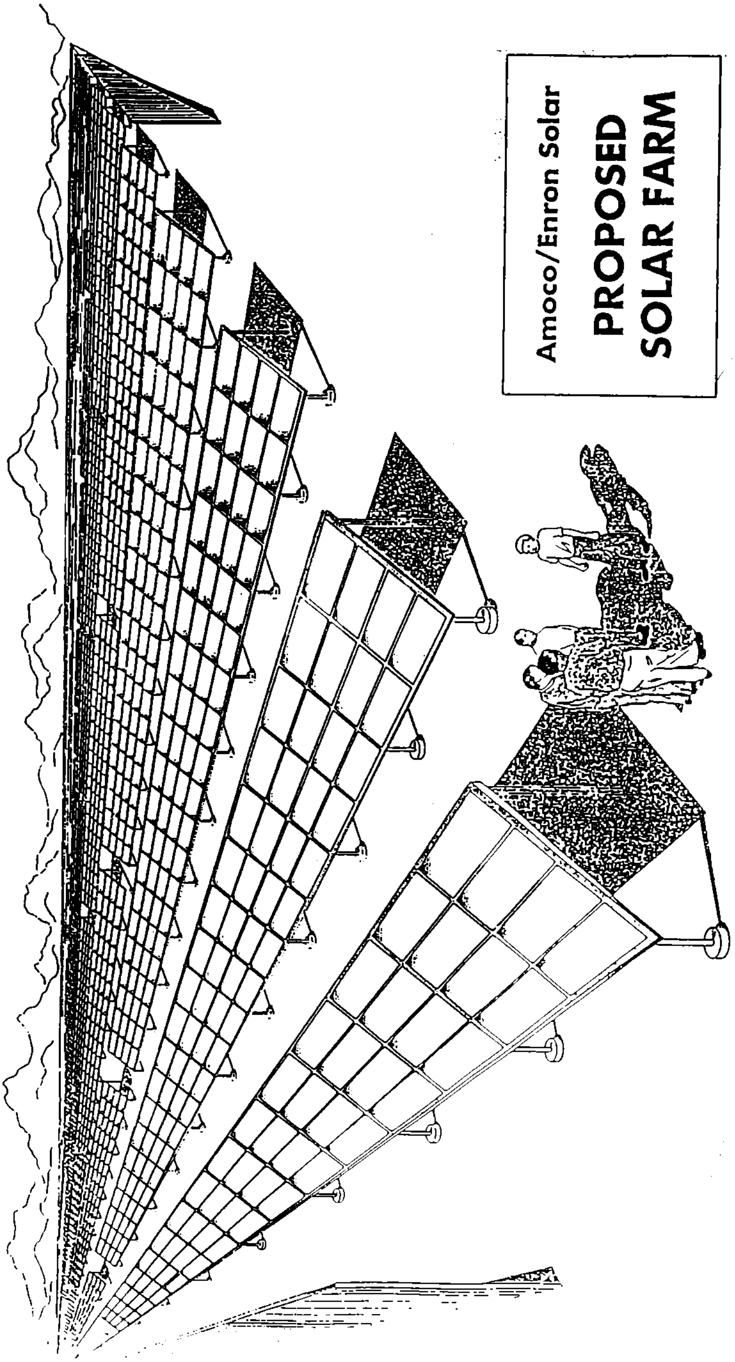
"Federally guaranteed". This legislation is necessary because there is case law holding that a purchase commitment from a federal government agency is a "Federal guarantee", and it is likely that a federal government agency will be committing to purchase the power generated by the Solar Farm in the SEZ.

Implications of Legislation

The proposal does not ask for an increase in the bond cap that each state receives from the federal government, or that solar generation facilities be given access to tax exempt financing without use of the limited bond cap available. The proposal only seeks to allow state and local governments to use some of their limited bond cap, if they choose to do so, to provide tax exempt financing for solar power generation projects. State and local governments can already use their bond cap to provide tax exempt financing for nuclear and fossil fuel power generation projects where the power will be consumed locally.

The solar generation projects the proposal would promote will, over their lifetime, provide tax revenues to the government and pollution reduction benefits which will further reduce the social costs of electricity.

In conclusion, we recommend that Congress pass the proposal to allow solar electric power projects that sell power to the federal government or other purchasers access to tax exempt private activity bonds under current state bond caps.


Amoco/Enron Solar
PROPOSED
SOLAR FARM

TESTIMONY OF WILLIAM R. SNELL
ALASKA INDUSTRIAL DEVELOPMENT AND EXPORT AUTHORITY

ALASKA INDUSTRIAL DEVELOPMENT AND EXPORT AUTHORITY

ALASKA ENERGY AUTHORITY

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July 19, 1995

VIA FACSIMILE (202) 225-0425

The Honorable Donald E. Young
House of Representatives
2331 Rayburn Building
Washington, D.C 20510-0201

RE: Purchase of Snettisham Facilities From Alaska Power Administration

Dear Congressman Young:

The purpose of this letter is to emphasize and clarify the reasons for the need to amend section 147(d) of the Internal Revenue Code (the "first use" requirement applicable to tax-exempt private activity bonds) in connection with bonds expected to be issued by AIDEA to finance the acquisition of the Snettisham facilities from the Alaska Power Administration.

The acquisition, including the price to be paid to the United States, is structured on the basis that bonds issued to finance the acquisition will be tax-exempt private activity bonds. As set forth in detail in the enclosed letter provided to AIDEA by bond counsel, the bonds will be private activity bonds not only because their proceeds will be used to acquire output property from the federal government, but also because AIDEA will enter into a take or pay Power Sales Agreement with Alaska Electric Light & Power Co. (AEL&P), the investor-owned electric utility that serves the City and Borough of Juneau. AEL&P will purchase all of the power produced by the Snettisham facilities and will be obligated to make payments for the power sufficient to pay all of the debt service on the bonds and operating and maintenance costs of the facilities.

Unless the "first use" requirement of section 147(d) of the Internal Revenue Code is amended, it will be impossible as a practical matter for AIDEA to issue tax-exempt private activity bonds to finance the acquisition because to satisfy the requirement it would be necessary to make rehabilitation expenditures in addition to paying the purchase price of the facilities, in an amount equal to 100% of the bond proceeds used to acquire the facilities. Otherwise, the bonds could not be tax-exempt, and Alaska citizens would be asked to shoulder an unacceptably large increase in electric rates.

Therefore, section 147(d) of the Internal Revenue Code must be amended either in a manner that makes that provision inapplicable to any private activity bonds issued by AIDEA to finance the acquisition of the Snettisham facilities, or by providing that the "first use" of the Snettisham facilities shall be deemed to occur pursuant to the acquisition of those facilities by or on behalf of the State of Alaska.

Sincerely,

John B. Olson

for William R. Snell
Executive Director

Enclosure

cc: Senator Ted Stevens
Senator Frank H. Murkowski
John Katz, Office of the Governor

WRS:DRS:ks

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July 17, 1995

William R. Snell
Executive Director
Alaska Industrial Development and
Export Authority
480 W. Tudor Road
Anchorage, AK 99503

Re: Snettisham Acquisition Financing

Dear Riley:

At your request, our firm has reviewed the federal tax requirements under current provisions of the Internal Revenue Code of 1986, as amended (the "Code"), that would be applicable to tax-exempt bonds expected to be issued by the Alaska Industrial Development and Export Authority ("AIDEA") to finance the purchase by the State of Alaska (the "State") of the Snettisham hydroelectric facilities (the "Snettisham facilities") from the federal Alaska Power Administration ("APA"), an agency of the U.S. Department of Energy. We are nationally recognized bond counsel, and AIDEA has designated us to serve as bond counsel in connection with the issuance of the bonds.

Background. AIDEA has provided us with documents and information showing that, as an integral part of the acquisition of the Snettisham facilities by the State, AIDEA will enter into a wholesale "take or pay" Power Sales Agreement with Alaska Electric Light & Power Co. ("AEL&P"), an investor-owned electric utility. Under the take or pay Power Sales Agreement, AEL&P will be obligated to take or pay for all of the electric energy produced by the Snettisham facilities beginning on the date the Snettisham facilities are purchased by AIDEA and continuing for the entire term of the bonds issued by AIDEA to finance the purchase. AEL&P will be obligated to make payments under the Power Sales Agreement sufficient to pay all of the debt service on the bonds (net of certain interest earnings) and the costs of operation and maintenance of the Snettisham facilities, among other items.

[illegible]

Bonds to Acquire Nongovernmental Output Property. Bonds issued by AIDEA to finance the purchase of the Snettisham facilities will be treated as private activity bonds under two separate provisions of the Code. First, under section 141(d) of the Code, the term "private activity bond" includes any bond that is part of an issue if the amount of proceeds of the issue that are to be used (directly or indirectly) for the acquisition by a governmental unit of nongovernmental output property exceeds the lesser of 5% of the proceeds or $5 million. "Nongovernmental output property" means any property that before its acquisition was used by a person other than a governmental unit in connection with an output facility. Because all of the proceeds of the bonds will be used to acquire the Snettisham facilities (output property) from APA (an agency of the federal government that is not treated as a governmental unit pursuant to section 150(a)(2) of the Code), the bonds will be treated as private activity bonds under section 141(d) of the Code.

Bonds Treated as Private Activity Bonds Because of Take or Pay Contract With Investor-Owned Utility. In addition, under section 141(b) of the Code and Treasury Regulations § 1.103-7(b)(5), the bonds will be treated as private activity bonds because the Power Sales Agreement with AEL&P will have the effect of transferring to AEL&P the benefits of ownership of the Snettisham facilities and the burdens of paying debt service on the bonds issued to finance the acquisition of the Snettisham facilities, thus causing the private business use and private security or payment tests of section 141(b) of the Code to be met. (The result would be the same under Proposed Treasury Regulations § 1.141-7 because the take or pay contract with AEL&P would cause the benefits and burdens test to be met.) Therefore, even if the bonds were not treated as private activity bonds under section 141(d) of the Code, the bonds still would be treated as private activity bonds under the special private business tests of section 141(b) of the Code applicable to output facilities.

Exempt Facility Private Activity Bonds for the "Local Furnishing" of Electric Energy. Bonds issued by AIDEA to finance the purchase of the Snettisham facilities nevertheless may be treated as tax-exempt private activity bonds if certain other requirements of the Code are met. Under section 141(e)(1)(A) and section 142(a)(8) of the Code, bonds issued to finance facilities used for the local furnishing of electric energy are treated as qualified exempt facility private activity bonds (and therefore tax-exempt, except for application of the alternative minimum tax to the interest on such bonds) if other applicable requirements of the Code are satisfied. The Snettisham facilities are expected to be used for the "local furnishing" of electric energy because AEL&P's service area is limited to the City and Borough of Juneau,

Alaska, and AEL&P is obligated to provide electricity to any person within its service area who desires service. (Treasury Regulations § 1.103-8(f)(2)(iii).) It also is expected that AIDEA will receive an allocation from the State's private activity bond cap for bonds issued to finance the acquisition of the Snettisham facilities as required by section 146 of the Code.

Need for Exception to "First Use Requirement" of Section 147(d) of the Code. Bonds also will satisfy the requirements of section 147 of the Code, except for section 147(d) of the Code, which provides in paragraph (1) that:

> a private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the net proceeds of such issue is to be used for the acquisition of any property (or an interest therein) unless the 1st use of such property is pursuant to such acquisition.

This provision of the Code prohibits using proceeds of qualified private activity bonds to acquire existing facilities unless certain rehabilitation requirements are met, which, in the case of structures other than buildings (such as the Snettisham facilities), would require the making of rehabilitation expenditures with respect to the structures in an amount equal to at least 100% of the cost of the structures financed with net proceeds of the issue.

The provisions of section 147(d) of the Code (sometimes called the "first use requirement") are not made inapplicable to the bonds by section 141(d)(5) of the Code. Section 141(d)(5) of the Code provides that:

> In the case of a bond which is a private activity bond solely by reason of this subsection [141(d), which treats bonds used to acquire nongovernmental output property as private activity bonds]--
>
> > (A) subsections (c) and (d) of section 147 (relating to limitations on acquisition of land and existing property) shall not apply, and
> >
> > (B) paragraph (8) of section 142(a) shall be applied as if it did not contain "local".

(Emphasis ours.) Thus, if the bonds to be issued for the acquisition of the Snettisham facilities were private activity bonds solely because their proceeds will be used to acquire output property from APA, the foregoing provision would make the "first

use requirement" inapplicable to those bonds. However, because the bonds also will be private activity bonds by reason of the take or pay contract with AEL&P, section 141(d)(5) of the Code by its terms does not make the first use requirement of section 147(d) of the Code inapplicable to the bonds.

Conclusion. Therefore, unless the first use requirement of section 147(d) of the Code is made inapplicable to any qualified exempt facility private activity bonds used to finance the acquisition of the Snettisham facilities (whether those bonds are treated as private activity bonds because they are used to acquire nongovernmental output property, or because they meet the private business tests applicable to output facilities with respect to which a private utility has entered into a take or pay contract, or otherwise), bonds issued by AIDEA to finance the acquisition of the Snettisham facilities could not be issued as tax-exempt private activity bonds. Alternatively, section 147(d) of the Code should be amended to provide that, in the case of any private activity bonds issued to finance the acquisition of the Snettisham facilities, the first use of those facilities shall be deemed to occur pursuant to their acquisition by or on behalf of the State of Alaska.

Very truly yours,

William G. Tonkin

William G. Tonkin

STATEMENT[1] BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

Submitted for the Record
July 27, 1995

On behalf of Broward County, Florida, I am pleased to provide this written testimony. My name is Phillip C. Allen and I serve as the Director of Finance and Administrative Services for Broward County, Florida. I have served as the County's Director of Finance for nine years and have accumulated over twenty-two years of experience in the issuance of tax-exempt bonds for two other governmental units.

Congressman E. Clay Shaw has shown leadership and sensitivity to the needs of local governments by bringing this matter forward for Committee consideration. As a former Mayor of the City of Fort Lauderdale in which a significant portion of Port Everglades lies, Congressman Shaw is extremely knowledgeable of both the problems that the former Port Everglades governmental unit exhibited as well as the very vital role the activities supported at the Port provides to the local economic community.

While the reference citation below specifically names Port Everglades, Florida, the draft of a suggested amendment to the Tax Code we have provided and enclosed as Exhibit I does not contain such a specific targeting of the application of our proposed correction. We believe the facts surrounding the acquisition of Port Everglades by Broward County if matched by similar circumstances by other governmental entities calls for the broader corrective actions we have provided in the suggested amendment. The issue is one essentially of equitable and fair treatment of tax-exempt governmental issuers.

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[1]This statement provides comment on a proposal before the Ways & Means Committee as outlined in Committee release FC-8 dated June 30, 1995 and summarized in Joint Committee on Taxation Staff Description of Miscellaneous Tax Proposals (JCS-19-95, July 10, 1995). The specific proposal being commented upon herein is listed as item #9 under the heading <u>Tax-exempt bonds</u> as Bonds related to the transfer of Port Everglades, Florida.

BACKGROUND

Broward County, Florida (the "County") is a chartered home rule county, created pursuant to the Florida Constitution and Chapter 125, Part II, Florida Statutes. The Port Everglades Authority (the "Authority") was created by the Florida Legislature in 1959, pursuant to Chapter 59-1157, Laws of Florida, which granted to the Authority the power to independently own and operate the assets comprising the seaport and harbor facilities within the Port Everglades District.

Port Everglades, located 23 miles north of Miami, has emerged as a major transportation hub for cargo and cruise operations. This evolution started in the late 1970s when the Port Everglades Authority decided to diversify from the seaport's traditional role as a bulk petroleum transfer facility and sought to secure new commodities and regain its share of a growing cruise industry. Today Port Everglades is ranked as the 12th busiest container Port in the United States, second busiest cruise port in the world, the United States Navy's favorite liberty Port, is the second largest non-refinery petroleum facility on the east coast, is home to Florida's largest operating Foreign Trade Zone, and has a thriving bulk (recyclable metal, gypsum, and cement) and break bulk (lumber, recyclable paper, and steel) operation.

This seaport boasts several marketing advantages. As the deepest harbor south of Norfolk, Virginia, Port Everglades can accommodate most deep draft vessels currently in operation or planned for future use. This has allowed us to attract to Port Everglades approximately 100 vessel calls annually by the United States Navy, United States Coast Guard, and the NATO fleet. With our harbor depth, we can accommodate all vessels in the fleet including Nimitz class aircraft carriers. The seaport also has the straightest and shortest entry channel of any coast Port. Transit time from the sea lanes is approximately 30 minutes. South Florida's proximity to the Caribbean has proven beneficial not only from a cargo perspective (United States exports to the Caribbean are particularly strong) but to the cruise industry as well.

Port Everglades is poised to become a gateway facility with the additional container capacity at its Southport Container Complex. That added capacity combined with the exceptional highway connections (I-595 has its eastern terminus at the seaport's entrance) and the proximity of the Florida East Coast Railway's intermodal yard bodes well for the seaport's continued growth as a transportation hub, or gateway facility, for containerized cargo.

However, further highway and railroad access improvements are necessary if the seaport's growth is to be ensured. Port Everglades is geographically situated to take advantage of the historically strong east/west trade between the United States and Europe, and the north/south trade between Canada, the United States, and Latin America.

Over the past five years, the seaport has invested over $135 million in capital improvements to meet the needs of the maritime industry. That investment has had a dramatic impact on our local economy. According to a study utilizing an economic impact kit provided by the United States Maritime Administration, Port Everglades provides an annual economic impact of $3.5 billion to our surrounding communities. The growth experienced at the seaport also has a positive effect for the United States Customs Service. Port Everglades operations in 1993 generated $47 million in United States Customs collections which go directly to the United States General Treasury.

During the 1980's, however, there were frequent allegations in the media and ongoing investigations that the Authority was rife with corruption, self dealing and personal benefit to Authority Commissioners and their friends. There was substantial public concern, so much so, that in 1991, the voters of the County voted in an informal straw ballot referendum in favor of abolishing the independent Port District and the Authority, and transferring control of the Authority assets to the County.

In response to that vote, the Florida Legislature enacted a special act providing that if the County's voters approved by a majority vote in a formal referendum to be held on March 11, 1992, the Authority was to be dissolved as of November 22, 1994, and its assets and liabilities transferred to the County. The voters of the County did again vote in favor of that transfer and the acquisition of the port assets by the County did take place on November 22, 1994.

STATEMENT OF THE PROBLEM BEING FACED BY BROWARD COUNTY

As a result of the mandated transfer, the County now finds itself owning all of the Authority's assets and the County has become the obligor on the Authority's bonded indebtedness it did not issue and had no part in structuring.

The mandated assumption of the Authority's outstanding debt by the

County has placed on the County the burden of a bonded indebtedness structure not of its making and that is not in the best interests of the County. There are strong public purpose reasons why the County desires to restructure this debt, all related to better operation and management of the port assets, through effective debt management. Here are only a few of the reasons why the County needs to restructure the Authority's debt:

a. Levelize annual debt service and improve debt coverage ratios. Current debt service is higher in some years than in others through 2000. This has an adverse impact on future revenue financings because rating services and investors analyze the ratio of revenues from Port operations to maximum debt service on Port debt. Reducing annual debt service would also have the effect of increasing coverage ratios, improving the County's credit picture with respect to Port operations, and relieving potential stress on the County's revenue stream from Port operations.

b. Replace the Authority's cumbersome two-lien debt structure with a single lien. The two-lien structure was necessary in 1989 due to the Authority's financial picture at that time. The improving financial performance of Port operations, coupled with the transition to County management should improve market access to bond insurance with a single lien for the debt related to Port operations.

c. Updating and modernizing the Authority's bond indenture, and making it more consistent with the "A" credit rating that we expect the County's debt to receive in the future and to provide for financial flexibility. This will lower the County's future borrowing cost. A new indenture can only effectively be put in place if all outstanding debt of the Authority is redeemed or defeased.

d. Increase debt capacity for new projects. Reducing debt service and increasing coverage ratios would also have the effect of increasing the County's capacity to support new projects for the Port.

e. Fully fund a bond reserve account. A significant structuring mistake was made by the Port Everglades Authority in the previous bond issue which will require

> Broward County to place an additional $4.7 million deposit to the debt reserve fund within the next five years. This could be resolved in a new bond issue.

Under federal tax law, the existing bonded indebtedness created by the Authority and now assumed by the County cannot be advance refunded, since the last permitted advance refunding of the Authority's prior debt was in 1989. Certain portions of the Authority's bonds are non-callable. But, if the proposed new financing by the County is deemed to be an acquisition financing, as opposed to a refunding, the County could accomplish its needed restructuring of port debt.

In 1993, the IRS adopted Reg. §1.150-1(d)(2)(v) (the Regulations), known as the "integrated transaction rule," which provides that if, within six months before or after an entity assumes (including taking subject to) obligations of an unrelated entity in connection with an "asset acquisition," and the obligations assumed are refinanced, the refinancing issue is not treated as a refunding issue. Based on this IRS regulation, any refinancing by the County of the Authority's debt within six months before or after November 22, 1994, should not have been treated as a refunding, but rather as acquisition debt. Our facts fall squarely into the integrated transaction rule.

In July, 1994, the County asked the IRS to so rule. On May 25, 1995, the Internal Revenue Service ruled[2], however, that we do not fall within this rule, although the facts are squarely in our favor. The IRS ruled that the Authority and the County were not unrelated parties as required by the Regulations since the Authority ceased to exist at the time of transfer[3]. This is somewhat like being told that since your mother is now deceased she is no longer your mother. In today's spirit within the Congress to address the sometimes inappropriate power of regulatory entities such a revisionist approach by IRS calls for further review by Congress.

In order to remedy the current situation faced by Broward County and its taxpaying citizens, the requested amendment to the Tax Code is appropriate.

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[2]Letter from the Department of the Treasury, Internal Revenue Service, dated May 25, 1995, reference CC:DOM:FI&P:5/TR-31-1858-94.

[3]November 22, 1994.

Governmental entities should be encouraged to merge those functions that are duplicative and serve to perpetrate the inefficiencies of the past. Taxpayer concerns evident by ever increasing calls for less government at all levels support such positive actions taken within Broward County to enhance local governmental services and increase the efficient use of limited tax dollars.

Under limitations contained in local law[4], dollars saved from the proposed acquisition financing must be dedicated to further expansion of Port infrastructure and thereby provides for even greater economic activity and tax receipts.

According to economic models promulgated by the United States Maritime Administration and actual experience, the Port supports direct and indirect economic activities at a multiplier of one hundred times of its revenue base. Further, investments at the Port have created a thirteen to one leverage of capital investment to revenue.

This analysis supports the premise that for every dollar saved from defeasing the current ineffective bond indenture requirements and reinvested into further Port assets, the economy will grow by almost eight dollars annually[5]. Such economic activity will more than cover any potential revenue loss estimate provided by the Joint Tax Committee staff. We would like to formally respond at a later date to the determinations made by the Committee staff.

SUMMARY

Broward County is saddled with a restrictive and poorly constructed bond indenture that according to current interpretation of the Internal Revenue Service cannot be advanced refunded through the issuance of tax-exempt bonds under the existing Tax Code. The County needs to defease the existing Indenture yet cannot do so because the IRS has adopted a very narrow and restrictive interpretation of a Regulation that would otherwise permit the County to issue the proposed debt.

We ask for your support of the proposal now in front of your Committee through the fine efforts of Congressman E. Clay Shaw, an active and knowledgeable community leader.

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[4]Ch91-346(10) Laws of Florida.

[5]Actually $7.69.

We would be pleased to provide any further testimony the Committee or staff may wish.

Attachment

EXHIBIT I

PROPOSED AMENDMENT TO TAX CODE

When a governmental entity possessing substantial police, eminent domain, and taxing power acquires substantially all of the assets and assumes (or takes subject to) substantially all of the liabilities and obligations of another governmental entity (regardless of whether that acquisition is achieved by merger, liquidation, acquisition of assets or otherwise), any obligations issued by the acquiring entity within two years after such acquisition at least 95% of the net proceeds of which are used to pay debt service (including call premium) on obligations of the acquired entity, shall be treated, for all purposes of the Code, as new money acquisition obligations and not as refunding bonds or hedge bonds, and the proceeds of such obligations used to pay debt service (including call premium) on such obligations of the acquired entity shall be considered spent for all purposes of the Code on the date such proceeds are so used or are deposited in an irrevocable escrow to be so used, whichever is the first to occur. The yield on any investment assets acquired with the proceeds of obligations issued by the acquiring entity, directly or indirectly, shall not exceed the yield on the obligations being defeased.

Testimony on Qualified Mortgage Bond Financed Home Improvement Loans
House Committee on Ways and Means

Katherine G. Hadley
Commissioner, Minnesota Housing Finance Agency

July 25, 1995

Thank you for the opportunity to submit testimony concerning the need for an increase in the home improvement loan limits under the mortgage revenue bond program.

The Minnesota Housing Finance Agency (MHFA) has been addressing Minnesota's basic housing needs and helping build strong communities since 1971. Since its inception, MHFA has provided $3.8 billion in housing loans and subsidies. Over 172,000 Minnesota households have received help to buy a home, move into newly constructed apartments in short supply, make their housing more affordable, improve its condition or quality, or make it more energy efficient. Over 89,400 below market interest rate home improvements and energy loans totaling $454,200,000 have been purchased by MHFA over the past 20 years.

Section 143(k)(4) of the Internal Revenue Code of 1986 provides that the maximum allowable home improvement loan financed by tax-exempt mortgage revenue bonds is $15,000. This limitation was established in 1981 and has remained unchanged. The limitation presents problems for MHFA programs for the rehabilitation and preservation of existing homes. MHFA urges the committee to increase the home improvement loan limit to $25,000 and to index the limit to inflation.

Minnesota is one of nine states that use mortgage revenue bonds (MRB) to finance home improvement loans. In 1993, Minnesota made almost one-half of the MRB funded home improvement loans in the country. 1,140 loans for a total value of $10,221,816 were made in Minnesota in 1993 out of 3091 loans nationwide with a total value of $21,746,615.

The MHFA home improvement loan program financed with MRB proceeds targets low and moderate income households. The median income of households served in Minnesota's MRB funded home improvement loan program was $25,583 for FFY'94. $25,500 is 50% of the HUD established median income for the Minneapolis/St. Paul area. The tax exemption of interest on MRBs plus the state appropriations provides loans under this program with interest rates between 2% and 8%, depending on household income. These loans particularly help low and middle income homeowners who have not owned their homes long enough to accumulate equity to maintain their homes and preserve this important asset.

Improvements that increase the livability and energy efficiency of existing housing are eligible for financing under this program. In Minnesota, 55% of the dollar value of loans made under the program were used for interior and exterior finishing, roofing, or insulation and energy conservation. Loans for luxury or recreational improvements such as fireplaces, decks, and swimming pools are prohibited under this program. Only residences with less than 4 units are eligible.

The $15,000 limit no longer realistically reflects the costs of home repairs and improvements. Since 1981, construction costs have increased 51% nationally. The average dollar amount of an MHFA home improvement loan has increased by 32% since 1981.

In 1992, the FHA Title I maximum home insurance amounts were increased from $15,000 to $25,000. The 1981 legislation establishing the MRB limits intended that this loan limit be consistent with the FHA maximum insurance amount. While Minnesota no longer participates in the Title I insurance program for home improvement loans, the increase in this limit is a recognition by Congress of the need for an adjustment.

Efforts to revitalize the center cities and first ring suburbs of the state are hindered by the low loan limit. In the State's largest communities, more than 60% of all the owner occupied residences are at least 45 years old. These older homes need more extensive and therefore, more expensive improvements. An increasing number of the loans made in the Minneapolis, St. Paul area are at the cap. The $15,000 cap limits communities' ability to engage in rehabilitation and preservation that attracts and retains middle class families in the center cities and first ring suburbs.

The State's health care policy of maintaining elderly and disabled persons in the community and delaying institutionalization is undermined by the low loan limits. MHFA is seeing an increasing need for accessibility modifications to homes. These modifications are often critical to maintaining someone in their own home. The opportunity to make necessary accessibility modifications also offers senior citizens the freedom to choose where they will live. Accessibility modifications are, as a rule, expensive. Adjusting the loan limits will increase the usefulness of this tool in preventing institutionalization and thereby lowering long term care costs.

An increase in the home improvement loan limit will have only a negligible impact on the Treasury. The increase would not require an increase in the per capita amount of tax exempt bond authority; it simply gives the states greater flexibility in the use of their bonding authority. It is unlikely that states without a home improvement program now and unused bonding authority would start one if the loan limit were raised. The risk involved and need to convince participating lenders that the program wouldn't compete with existing loan products is one obstacle to starting a program. The cost of buying down the interest rates and servicing the rather small loan amounts makes the program rather expensive to operate and is another significant obstacle to starting a new program. States such as Minnesota with a long history of operating a financially sound program are in the best position to make use of higher loan limits.

Home improvement loans are an effective tool in preserving our existing housing stock. Maintenance and preservation of existing housing is a much less costly means of providing affordable housing than new construction. Increasing the allowable limits for home improvement loans is one way of removing barriers imposed by federal law that prevent states from fully using existing tools to further important state policies.

We urge the Congress to improve the usefulness of this important tool by increasing the loan limit to $25,000 and indexing it to inflation.

Thank you again for this opportunity to submit testimony.

STATEMENT OF

JON A. MANGIS, DIRECTOR
OREGON DEPARTMENT OF VETERANS' AFFAIRS
STATE OF OREGON

BEFORE THE

SUBCOMMITTEE ON MISCELLANEOUS TAX REFORMS
COMMITTEE ON WAYS & MEANS

SUBMITTED FOR THE RECORD
WITH RESPECT TO LEGISLATION AFFECTING

QUALIFIED VETERANS MORTGAGE BONDS

July 19, 1995

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

For the record, my name is Jon Mangis, and I am the Director of Veterans' Affairs for the State of Oregon.

I am submitting written testimony, in lieu of requesting a personal appearance, on behalf of veterans living in Alaska, California, Texas, Wisconsin, and my home state of Oregon . My testimony is submitted to support Oregon and the four other states currently authorized to issue "Qualified Veteran Mortgage Bonds".

Prior to the 1984 Tax Reform Act, each of these states provided low interest mortgage loans to veterans residing within their boundaries. The Oregon Veterans Loan Program began with encouragement from the U.S. Congress, as a "thank you" to those men and women serving this Nation during World War II. It was to be a short-lived program. But America went to Korea, and Oregonians amended their constitution to make these brave men and women eligible for state veteran home loans. Then it was Vietnam, and Oregonians once again voted to change its Constitution to make Vietnam veterans eligible.

Then came 1984, and Congress legislated tax reform, stating that any qualified veteran must have entered the service prior to 1977 or they cannot benefit from the proceeds of "Qualified Veteran Mortgage Bonds".

But, American servicemen and women did not go away in 1977. Americans went to Central America; Grenada; Lebanon and four years ago, the Middle East, Somalia and they now wear blue helmets in the former Yugoslav Republic.

Americans, Oregonians, have worn the uniform of this great Nation since 1976. Yet, according to paragraph (4) of Section 143(l) of the Internal Revenue Code of 1986, these men and women are not veterans because they entered military service after 1976.

Your colleagues in the House of Representatives and the U.S. Senate amended 38 U.S.C. establishing veteran status for post-Vietnam veterans. Yet, if you live in Oregon, Alaska, California, Texas or Wisconsin you are not considered a veteran because of a tax code provision that limits veteran status to those who served prior to 1977.

The Oregon program, and I am sure the other state Veteran Home Loan Programs, are questioned daily as to why a post-Vietnam veteran cannot obtain a state veteran home loan. This situation recently made more confusing when Congress extended federal V.A. home loan eligibility to the reserve military and naval forces (PL 102-590).

The Oregon program has provided major economic impact in my home state by providing low interest loans to our veterans. During Desert Storm, our Oregon Legislative Assembly was ready to submit legislation to Oregon voters to extend eligibility to post-Vietnam veterans, until I asked them to table it.

I explained to our Legislature that until the United States Congress changed the eligibility status in the Federal Tax Code, their action would only create more confusion and hard feelings among Oregon veterans.

Historically, individual states have provided recognition for their veterans since the very beginning of this Nation. States have provided small bonuses for service, small educational programs, state veteran nursing homes and a few veteran home loan programs, all in existence prior to the tax code changes made in 1984. Most of these programs were created with the encouragement of your colleagues in 1944 and 1945 as they worked on a federal G.I. Bill of Rights. Almost every state in this Nation responded with a variety of programs. For us, it was a state Veteran Home Loan Program.

These programs are important to the economic well being of the five affected states Through the process of the building, sale, and purchase of single family residences, they generate millions of taxable dollars to the state and federal treasuries It appears that this is not taken into consideration by the staff of the Joint Committee when they do their revenue cost estimates.

I am asking you to:

A. Eliminate the requirement of Section 143(l)(4)(A) so as to allow veterans who commenced active duty service on or after January 1, 1977 (post '76 veterans) to be eligible to obtain mortgage-loan financing from proceeds of tax exempt Qualified Veteran Mortgage Bonds

B. Eliminate the requirement of Section 143(l)(4)(B) -- (the 30-year requirement), to allow veterans to apply for financing more than 30 years after leaving active service.

As the past President of the National Association of State Directors of Veterans Affairs, I asked for and received their support in this issue. Many of you probably have received letters from your home state.

Today, we have national resolutions supporting these changes by the American Legion, AMVETS, Disabled American Veterans, the Veterans of Foreign Wars of the United States and the Vietnam Veterans of America. Other organizations taking this issue under consideration are the Paralyzed Veterans of America, Military Order of the Purple Heart and the Marine Corps League.

This year, the Legislative Assembly of the State of Oregon passed Senate Concurrent Resolution 9 which asks you, the Congress of these United States, to amend Section 143 (l) (4)(a)(b) of the Internal Revenue Code to allow post 1976 veterans to be eligible to benefit from the proceeds of Qualified Veteran Mortgage Bonds.

In reference to the Joint Committee on Taxation Print, Description of Miscellaneous Tax Proposals (for hearings scheduled July 11-13, 1995) and dated July 10, 1995, I urge you to read page 294 (Description of Proposals Regarding Qualified Veteran Mortgage Bonds). The five states who issue Qualified Veteran Mortgage Bonds support, as a group, the third proposal. This proposal phases in, over time, the use of Qualified Veteran Mortgage Bond proceeds for post-1976 veterans.

Thank you for your past support of veterans and consideration of my statement.

Jon A. Mangis, Director
Oregon Department of Veterans' Affairs
700 Summer Street N.E.
Salem, Oregon 97310

68th OREGON LEGISLATIVE ASSEMBLY--1995 Regular Session

Enrolled

Senate Concurrent Resolution 9

Sponsored by Senator WALDEN, Representative MARKHAM

To the Senate and House of Representatives of the United States of America, in Congress assembled:

We, the Sixty-eighth Legislative Assembly of the State of Oregon, in legislative session assembled, respectfully represent as follows:

Whereas men and women of the State of Oregon continue to serve in the Armed Forces of the United States of America; and

Whereas many of the uniformed Oregonians have been injured or have died in service to their country; and

Whereas federal law prevents these loyal Americans from being eligible to use the Oregon home loan program for veterans because they entered the Armed Forces of the United States after December 31, 1976; and

Whereas federal law does not recognize veterans who served in Lebanon, Grenada, the Persian Gulf, Somalia, Haiti, Panama and other military actions undertaken by the government of the United States; and

Whereas all veterans' organizations in Oregon support eligibility for these veterans and, along with their national counterparts, have passed resolutions calling for correction of this inequity; now, therefore,

Be It Resolved by the Legislative Assembly of the State of Oregon:

(1) The Congress of the United States is respectfully urged to amend section 143(l)(4)(a) and (b) of the Internal Revenue Code to allow veterans who entered the Armed Forces of the United States after December 31, 1976, to become eligible for Oregon home loans for veterans using the proceeds of qualified veteran mortgage bonds.

(2) Copies of this resolution shall be sent to the President of the United States, the Speaker of the House of Representatives, the Majority Leader of the Senate and to each member of the Oregon Congressional Delegation.

Adopted by Senate April 20, 1995

Judy Hall

Secretary of Senate

Gordon Smith

President of Senate

Adopted by House May 17, 1995

Beverly Clarno

Speaker of House

RESOLUTION NO. 128 OR

SUBJECT: HOME LOAN PROGRAM EXTENDED TO LEBANON, GRENADA, PANAMA AND PERSIAN GULF VETERANS

WHEREAS, The States of Oregon, Alaska, Wisconsin, California, and Texas have established veterans' home loan programs; and

WHEREAS, The States of Oregon, Alaska, Wisconsin, California, and Texas have authority in the Federal Tax Code to issue Qualified Veteran Mortgage Bonds to finance their respective veteran home loan programs; and

WHEREAS, Veterans' eligibility under current federal tax law restricts the eligibility to veterans who served on active duty prior to January 1, 1977; and

WHEREAS, The Directors of Veterans Affairs of the states of Oregon, Alaska, Wisconsin, California, and Texas are desirous of extending their respective veteran home loan programs to include the men and women of the United States of America dispatched to participate in the conflicts in Lebanon, Grenada, Panama, and Southwest Asia (Persian Gulf); and

WHEREAS, Veterans of these aforementioned conflicts should receive benefits consistent with the benefits available to veterans of previous armed conflicts; and

WHEREAS, Those veterans have been qualified for eligibility into congressionally chartered veterans' organizations by prior acts of the Congress of the United States, now, therefore, be it

RESOLVED, By The American Legion in National Convention assembled in Chicago, Illinois, August 25, 26, 27, 1992, that the Congress of the United States be urged to amend Paragraph 4 of Section 143(1) of the Internal Revenue Code of 1986 to read: "Qualified Veteran.-- For the purpose of this subsection, the term 'qualified veteran' means any veteran who meets such requirements as may be imposed by the state law pursuant to which qualified veterans' mortgage bonds are issued."

RECEIVED AND RECORDED RESOLUTIONS

RESOLUTION NO 406 MO

SUBJECT: RE-ESTABLISH ECONOMIC COMMISSION POLICIES AND POSITIONS

Joseph J. Frank

Joseph J. Frank (MO)
Chairman

Robert W. Vincelette

Robert W. Vincelette (VT)
Secretary

Resolution No. 711 APPROVED

AMEND INTERNAL REVENUE CODE

WHEREAS, the States of Oregon, Alaska, Wisconsin, California, and Texas have established veteran home loan programs; and

WHEREAS, the States of Oregon, Alaska, Wisconsin, California, and Texas have authority in the Federal Tax Code to issue Qualified Veterans Mortgage Bonds to finance the Veteran Home Loan Program; and

WHEREAS, veterans eligibility under current Federal Tax Law restricts the eligibility to veterans who served on active duty prior to January 1, 1977; and

WHEREAS, the Directors of Veterans Affairs of the States of Oregon, Alaska, Wisconsin, California, and Texas are desirous of extending their respective veteran home loan programs to include the men and women of the United States of America dispatched to participate in the conflicts in Lebanon, Grenada, Panama, and Southwest Asia (Persian Gulf); and

WHEREAS, veterans of these aforementioned conflicts should receive benefits consistent with the benefits available to veterans of previous armed conflicts; now, therefore

BE IT RESOLVED, by the 94th National Convention of the Veterans of Foreign Wars of the United States, that the Congress of the United States be urged to amend Paragraph 4 of Section 143(l) of the Internal Revenue Code of 1986 to read: "(4) Qualified Veteran--Fore purposes of this subsection, the term qualified veteran means any veteran who meets such requirements as may be Re imposed by the State law pursuant to which qualified veterans' mortgage bonds are issued."

Submitted by Department of Oregon

To Committee on VETERANS SERVICE RESOLUTIONS

STATE VETERAN HOME LOAN PROGRAM

E-15-93

Issue:

Veterans with military service prior to January 1, 1977 residing in Alaska, California, Oregon, Texas, and Wisconsin have access to state-run veteran home loan programs. Participation by any other veteran is denied due to Internal Revenue Service (IRS) code which defines eligibility.

Background:

Prior to the 1984 Tax Reform Act, each of these states provided low interest mortgage loan to veterans residing within their boundaries. These programs began as a "Thank-You" to those men and women who honorably served their country. Adjustments were made to amend state statutes for the inclusion of Korean Veterans and Vietnam Veterans.

This new generation of veterans created by activities in Central America, Grenada, Lebanon and the Middle East are denied access only due to congressional legislation (through a tax reform), which states any qualified veteran must have entered the service prior to 1977 or they cannot benefit from the proceeds of "Qualified Veteran Mortgage Bonds". VVA has consistently endorsed benefits being extended to all veterans, equally, regardless of the military action in which they participated.

Position:

Vietnam Veterans of America, Inc., at its National Convention in Norfolk, Virginia, August 4-8, 1993 seeks legislation to amend Section 143(L)(4) of The Internal Revenue Code deferring to state law the determination of veterans eligibility for the purpose which qualified veterans' mortgage bonds are issued.

RESOLUTION 58

SUBJECT: QUALIFIED VETERAN MORTGAGE BONDS

WHEREAS the States of Oregon, Alaska, Wisconsin, California and Texas have established veteran home loan programs; and

WHEREAS the States of Oregon, Alaska, Wisconsin, California and Texas have authority in the Federal Tax Code to issue Qualified Veteran Mortgage Bonds to finance the veteran home loan program; and

WHEREAS veterans eligibility under current Federal Tax Law restricts the eligibility to veterans who served on active duty prior to January 1, 1977; and

WHEREAS the Directors of Veterans' Affairs of the States of Oregon, Alaska, Wisconsin, California and Texas are desirous of extending their respective veterans home loan programs to include the men and women of the United States of America dispatched to participate in the conflicts in Lebanon, Grenada, Panama and Southwest Asia (Persian Gulf); and

WHEREAS veterans of these aforementioned conflicts should receive benefits consistent with the benefits available to veterans of previous armed conflicts; now therefore

BE IT RESOLVED that AMVETS urges the Congress of the United States to amend paragraph 4 of section 403(l) of the Internal Revenue Code of 1986 to read: "*(4) Qualified Veteran.--For purposes of this subsection, the term 'qualified veteran' means any veteran who meets such requirements as may be imposed by the State law pursuant to which qualified veterans' mortgage bonds are issued.*"; and

BE IT FURTHER RESOLVED that the above change apply to obligations issued after the date of the enactment of the amendment.

History of Primary Federal Tax Law Requirements/ Changes Affecting Qualified Veterans' Mortgage Bonds

Description	Primary Requirements/Changes
Mortgage Subsidy Bond Tax Act of 1980 (Section 103A)	* Bonds must be in registered form.
	* No Advance Refunding of Mortgage Subsidy Bonds permitted.
	* No refinancings of existing mortgage loans permitted.
	* Bonds must be General Obligations of the State.
	* "Substantially all" (90%) of the Bond proceeds must be used to provide residences to veterans.
Tax Reform Act of 1984	★★ **Definition of "Qualified Veteran" provided.**
	★★ **Eligibility must be used prior to 30 years from date of separation from active service.**
	* Establishment of Federal Bond Issuance Cap.
	* State Veteran Program needed to be in existence prior to June 22, 1984.
Temp. Reg. 1.103 A-2	* Informational Reporting Requirements to be filed with the IRS.
Tax Reform Act of 1986	* 95% or more of the net proceeds must be used to provide residences to veterans.
	* Permitted yield on veteran loans reduced from 1.5% to 1.125%.
	* No yield on "nonpurpose" investments can be retained above the yield of the bonds (rebate to Federal Government or borrowers).
1989 Tax Exempt Bond Arbitrage Regulations	* Specifies methodology for computing rebates (future value calculations).
1990-1992 Unsuccessful attempts at Congressional Law Changes (101st & 102nd Congress)	* S. 777 and H.R.1250 opened eligibility criteria to the authority of the individual States.
1993 - H.R. 1289 (unsuccessful)	* Definition of "Qualified Veteran".

STATEMENT OF MR. GARRY MAURO
TEXAS LAND COMMISSIONER AND
CHAIRMAN OF THE TEXAS VETERANS LAND BOARD
TO THE COMMITTEE ON WAYS & MEANS
HEARINGS ON MISCELLANEOUS TAX REFORMS

July 26, 1995

Mr. Chairman and Members of the Ways & Means Committee:

Thank you for the opportunity to express my support for a proposed amendment to section 143(l)(4) of the Internal Revenue Code (the "Code"). As you are aware, section 143(l)(4) of the existing Internal Revenue Code makes veterans who did not serve on active duty some time before January 1, 1977 ("post-76 veterans") ineligible to receive low-interest home mortgage loans from the proceeds of tax-exempt qualified veterans mortgage bonds. There are currently proposals before the Committee that would amend section 143(l)(4) to make all post-76 veterans eligible to receive mortgage loans funded with tax-exempt qualified veterans mortgage bonds regardless of when they commenced active service.

I earnestly solicit your support of allowing younger veterans to participate in this housing finance program. At stake is whether thousands of younger veterans who have honorably served their nation will be able to afford and obtain safe, decent housing.

Texas has a long history of rewarding veterans for protecting our freedoms and democratic ways. In the early days, when the frontier stretched for seemingly endless miles, veterans were given grants of land. Today, we continue that tradition with a program of low interest land and housing loans. This program generates an enormous amount of economic activity, furnishing crucial jobs in low-income rural areas as well as the larger metropolitan areas.

When I was first elected land commissioner in 1982, I acted at the request of veterans organizations and sought to add a housing component to what was then solely a land program. The Legislature and the voters agreed in a State-wide election, and now Texas veterans are able to buy a home as well as purchase land by participating in this program.

In 1983, the voters approved $500 million in general obligation bonding authority to finance the housing program, and the Legislature put the full faith and credit of the state behind it. In 1985 and 1993, because of the popularity of the program, it became necessary to seek an additional $500 million in bonding authority. That also was overwhelmingly approved by the voters.

With interest rates down and home loans being made at a record pace in recent months, we must go to the voters once again. Earlier this year, the Legislature approved another $500 million in constitutional authority, and the voters are expected to give their strong endorsement in a November 7 amendments election.

But the program is being inexorably squeezed, and this is where we need your help. Because of language in the 1984 federal tax law, we are limited in our ability to serve our youngest veterans -- those who served in the Grenada, Panama and Desert Shield/Storm actions and those now in Somalia and other troublesome, often dangerous, places around the world. The law narrowed loan eligibility to those veterans who had served before 1977.

In 1984, Congress could not have anticipated the need for continued U.S. military presence in so many foreign hot spots and surely would not have intended to exclude the nation's younger veterans from benefits that include affordable housing. We view our program as a way of paying a debt that we owe.

Our veterans have earned this benefit. Texas and four other states have veterans housing programs. We respectively ask that you support an amendment to the Code to make post-76 veterans eligible for this housing-finance assistance so that we may continue to assist veterans and their families who simply want their own homes.

On page 294 of the Joint Committee of Taxation Print,Description of Miscellaneous Tax Proposals (for hearings scheduled July 11-13, 1995) dated July 10, 1995, there are four proposals set forth regarding post-76 veteran eligibility. The states whose issue qualified veteran's mortgage bonds support, as a group the third proposal, which phases in, over time, the use of Qualified Veteran Mortgage Bonds proceeds for post-76 veterans. The States believe that the federal revenue consequences of this proposal will be insignificant.

We also note our opposition to the second proposal which would place qualified veterans mortgage bonds under the State volume cap applicable to private activity bonds generally. This cap which has been in place for almost ten years is already inadequate to meet state and local government needs and to bring another category of bonds under that cap would only exacerbate the problem.

VETERANS AFFAIRS

STATE OF WISCONSIN, DEPARTMENT OF VETERANS AFFAIRS

30 West Mifflin Street, P. O. Box 7843, Madison, WI 53707-7843
Tommy G. Thompson, Governor
Raymond G. Boland, Secretary

July 24, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
1102 Longworth House Office Building
WASHINGTON DC 20515

RE: Wisconsin Support of Amendment to Internal Revenue Code Provision Governing Qualified Veterans Mortgage Bonds.

Dear Mr. Moseley:

The Committee on Ways and Means has been asked to consider amending section 143(1) of the Internal Revenue Code to include within the definition of "qualified veteran" those veterans who have entered active duty since January 1, 1977. This proposal is included among the miscellaneous tax reforms on which the Committee held hearings on July 11-13.

Wisconsin has provided primary mortgage home loans funded by tax-exempt bond proceeds to its veterans since 1974. The home loan program has been of tremendous benefit to Wisconsin veterans, allowing thousands of them to become homeowners. Those home sales generated business for Wisconsin's construction contractors, mortgage lenders and real estate brokers and salespersons. And those new homeowners in turn provided a significant boost to the state's general economy.

Because of the current I.R.C. definition of "qualified veteran", Vietnam veterans are the last to benefit from the program. This is not fair. Those serving their country since Vietnam, including the men and women who served in Panama, Grenada, Lebanon and the Persian Gulf, are every bit as entitled to the benefit.

The sole reason for denying the benefits of the program to those veterans is that the issuance of tax-exempt bonds to fund the home loans has an adverse effect on the U.S. Treasury. But Wisconsin can provide the benefit to its post-1977 veterans without exceeding the bond volume limitation set by Congress at the time it adopted the restrictive definition of "qualified veteran". Furthermore, Wisconsin and the other affected states have proposed legislation to the Committee which would further hold down costs to the Treasury by imposing a subcap on the amount of qualified mortgage bonds that can be used for veterans not currently eligible.

In any event, the cost to the Treasury would be small. The benefits which could be extended to post-1977 veterans upon amendment of the law would be great.

Wisconsin respectfully requests passage of an amendment to the definition of "qualified veteran" in section 143(1) of the Internal Revenue Code to include veterans whose active service has occurred since January 1, 1977.

Sincerely,
DEPARTMENT OF VETERANS AFFAIRS

Charles B. Hoslet

CHARLES B. HOSLET
Executive Assistant

cc: The Honorable Gerald Kleczka, U.S. House of Representatives

Statement of John L. Fiegel, Executive Director of the Council of Development Finance Agencies, Before the Committee on Ways and Means Hearing on Miscellaneous Tax Provisions, July 11-12, 1995.

Thank you Mr. Chairman for the opportunity to present these written comments on behalf of the Council of Development Finance Agencies (CDFA). The Council represents over 100 of the country's most active and involved state and local industrial development authorities and economic development finance departments. These agencies are the ones charged with issuing small-issue industrial development bonds, as well as utilizing numerous other financing mechanisms, to assist small manufacturers and other businesses.

All too often new or expanding small manufacturers are unable to secure necessary capital at affordable costs. The use of tax-exempt industrial development bonds makes this expansion and job growth possible. There are a number of modest changes in the tax law which would improve the effectiveness of the small-issue bond program outlined below in the Council's tax agenda. Our members are grateful for the opportunity to present these ideas as they impact the creation and expansion of small manufacturing businesses and jobs.

Congressman English is currently preparing legislation incorporating many of the Council's recommendations which he will submit in the near future that will improve the effectiveness of the small-issue industrial development bond program. Congressman English understands the importance of this program to the state of Pennsylvania and the jobs created over the years from such bond issuance. His leadership is critical to efforts to spur economic development. The Council has been, and will continue to, work closely with the Congressman in developing this legislative initiative.

Small-Issue Industrial Development Bonds: Background

State and local government agencies may issue tax-exempt private activity bonds on behalf of private borrowers if 95 percent of the net proceeds of the bonds is to be used to finance manufacturing facilities. These bonds enable small business borrowers to have access to capital at affordable rates for new plant construction, expansion, and modernization. To issue a qualified small-issue bond, the issuer must receive an allocation from the state private activity volume cap. Each state's volume cap is the greater of $50 per capita or $150 million. Each bond issue is subject to a public approval process. Interest on the bonds is subject to the alternative minimum tax.

No manufacturing project may receive more than $10 million in tax-exempt financing. In addition, total capital expenditures associated with a bond-financed project may not exceed $10 million during the period beginning three years before the date of issue and ending three years after the date of issue of the bonds. No borrower may have more than $40 million in qualified small-issue bonds outstanding.

Up to 25% of the costs of the bond-financed project may be for facilities that are directly related and ancillary to a manufacturing facility. In general the bonds may not be used to finance the acquisition of existing property unless rehabilitation expenses equal at least 15% of the purchase price and in the case of used equipment (off-site) at least 100% of the purchase price. Certain uses (such as country club facilities and retail food services) are prohibited.

After several years of uncertainty and temporary provisions, the small-issue industrial development bond program was permanently extended as part of the 1993 tax law. The permanent extension provided needed stability and has allowed small businesses to address long-term planning concerns. The Council recommends several improvements to the program that would encourage even greater use of this low-cost, high-results program.

Recommendations:

1. Increase the capital expenditure limit from $10 million to $20 million.
In order to be eligible for tax-exempt financing, a small manufacturer must have less than $10 million in total capital expenditures, including the project financed with tax-exempt bonds, in the six-year period beginning three years before the bonds are issued and ending three years after the bonds are issued. If a business is successful as a result of the project financed with tax-exempt bonds and wants to expand within three years after issuing the bonds, it may be forced to choose between limiting its expansion to stay within the $10 million capital expenditure limitation or having the tax-exempt bond retroactively become taxable.

Increasing the limit would permit more capital-intensive companies (particularly those using sophisticated, high technology equipment) to qualify for tax-exempt financing while retaining the emphasis on smaller manufacturers. The current $10 million limit on tax-exempt bond financing would be retained. All regions of the country would benefit from this modest change.

(The limit was last raised from $5 million to $10 million in 1978 during the Carter Administration. In 1992, Congress approved an increase in the capital expenditures limit as part of H.R. 11 but was vetoed by President Bush.)

Congressman English has written you, Mr. Chairman, to deal with this issue at the first opportunity possible. This issue is important solely because of the passage of time. There should be no impact on revenue from raising the $10 million capital expenditure limit.

2. Restore bank interest deductibility with a $5 million limit.
Prior to the Tax Reform Act of 1986, banks were permitted to deduct 80 percent of the interest expense paid for borrowing funds to finance a small-issue (manufacturing) industrial development bond. Before this legislation, local banks were major purchasers of small-issue industrial development bonds. With the elimination of bank interest deductibility (cost of carry), banks have substantially reduced their presence in this market. As a result, bond issuance, which was relatively straightforward prior to 1986, has become significantly more complicated. In general, industrial development bonds now are placed in the public market requiring underwritings, trustee arrangements, letters of credit, and other complicating structures. The problem is particularly acute for small bond issues, where their size and the financial sophistication of a small local company makes the transaction infeasible. The result is that industrial development bond financing is largely unavailable to smaller companies and for smaller transactions.

Restoring bank deductibility for these smaller issues (bonds of less than $5 million) would make it financially more attractive for banks to acquire and hold bonds, as they did prior to 1986, and allow many of these small manufacturing projects to proceed, financed with industrial development bonds. Because small-issue industrial development bonds are contained within the state-wide volume caps on private activity bonds (which is at or near capacity in many states), this proposal should have little or no impact on federal revenues, but would allow small manufacturing companies access to this type of capital and would have an almost immediate impact in creating new jobs and economic growth.

3. Relax the 25% rule to permit greater flexibility for including research and development activities and on-site warehousing where those activities are ancillary to the manufacturing activity.
In many cases manufacturing operations are more efficient when the appropriate research and development work is conducted at the plant site. In other cases it is more efficient for the manufactured product to be stored at the factory before being shipped to off-site distribution centers and ultimate purchasers. In many instances where the finished product is large, this warehousing/storage activity constitutes a major component of the factory operation. The current law limiting these research and development or warehousing activities to no more than 25% of the bond amount artificially and unrealistically limits the effective and rational operation of the plant site. So long as the primary activity at the site remains manufacturing, these related and ancillary activities should be permitted without regard to artificial percentage limits.

Mr. Chairman, we thank you for the opportunity to address these issues. The members of the Council look forward to working with you on these important issues and would be glad to work with your staff in that effort. We appreciate the subcommittee's support and your efforts to address and respond to the particular needs and concerns of America's small manufacturers.

We hope the Committee favorably considers Congressman English's proposed legislation, particularly his request to raise the $10 million capital expenditure limit.

COUNCIL OF INFRASTRUCTURE FINANCING AUTHORITIES

TESTIMONY OF
THE COUNCIL OF INFRASTRUCTURE FINANCING AUTHORITIES
SUBMITTED FOR THE WRITTEN RECORD OF
THE HOUSE COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISCELLANEOUS TAX BILLS
July 11-12, 1995

The Council of Infrastructure Financing Authorities (CIFA) appreciates the opportunity provided by the Committee to provide testimony on tax provisions of concern to its members. CIFA is a national non-profit association representing nearly 50 state, regional, and local infrastructure financing agencies in 34 states and the Commonwealth of Puerto Rico. These agencies issue tax-exempt bonds to build public infrastructure for a range of needs, including health, education, energy facilities, and environmental facilities for water pollution, water supply, and solid and hazardous waste management.

CIFA members provide low-cost financing to local governments through State Bond Banks, Revolving Loan Funds, and other arrangements. Through these financing structures, CIFA members provide small communities with the economies and efficiencies of tax-exempt bond financing which they could not access on their own. Larger communities also enjoy the benefits of financing through state-enhanced issues. These arrangements result in the construction of facilities that protect and enhance public health, safety, and well-being; environmental quality; and local economies.

Unfortunately the current tax code, particularly provisions added in the Tax Reform Act of 1986, makes it much more difficult than it otherwise would be for CIFA members to perform these functions. Issuers are hindered both by restrictions on how bond proceeds can be used and by provisions in the tax code that make their securities less attractive to potential investors.

One of these is the restriction on the ability of financial institutions to deduct the interest on debt incurred to acquire or hold tax-exempt bonds, referred to in shorthand as "bank deductibility." Up until 1982, such interest was fully deductible for these institutions. The Tax Equity and Fiscal Responsibility Act of 1982 lowered deductibility to 80%, and the Tax Reform Act of 1986 virtually eliminated it.

This change (along with a similar change in the treatment of tax-exempt bond investment by property and casualty companies) seriously affected the municipal bond market. Banks, along with property and casualty companies, had been a major purchaser of tax-exempt bonds. This was especially true in small communities which, lacking access to the larger capital market, relied heavily on local banks to purchase their bond issues.

Recognizing this fact, the 1986 provision included an exception to the bank deductibility disallowance for small issuers. Under this exception, an issuer which does not reasonably anticipate issuing more than $10 million in non-private activity bonds may designate up to $10 million in such bonds as "qualified bonds" the interest costs of which will be 80% deductible by banks that purchase them. The credit markets reward such "bank qualified" bonds with a lower interest rate, thereby lowering finance costs for the small issuer. For this purpose, an issuer and all its subordinate entities are treated as a single issuer, even if the other entities are substantially controlled by another entity. For example, if a county creates a sewer authority to issue bonds for wastewater treatment, the total bonds issued by the country, the sewer authority, and all other subordinate entities cannot total more than $10 million.

While this exception is helpful, in its current form it conflicts with another mechanism that has been created to assist small local governments in financing their infrastructure needs. Many

small issuers pool their issues and sell them through a state bond bank or similar entity. The bond bank will issue bonds of its own and use the proceeds to purchase the pooled bonds of the smaller issuers. This allows the small issuers to lower their administrative and insurance costs, and to avail themselves of the expertise of the bond bank managers, which may be lacking at the local level. However, by doing this, they lose the bank deductibility of their bonds, as the $10 million limit is applied at the level of the pool, not of the separate issuers. This deprives them of the lower interest rates that would have been available had they not pooled their bonds.

CIFA therefore strongly supports the proposal before the Committee that would allow an issuer such as a bond bank, the proceeds of whose issues will be used to finance loans, to apply the bank deductibility limitation separately to each borrower. This would allow local governments to pass their bank deductibility through to the bond bank, achieving the cost savings provided by using the pool as well as the interest savings of bank deductibility.

This change in the tax code is non-abusive and a very appropriate one for this Congress to make. The use of bond banks and other pooling mechanisms is an important means for these small governments to finance needed infrastructure, particularly environmental facilities that are required by federal law, and should be encouraged by the federal government. The cost efficiencies achieved by these pools result in fewer dollars being spent on costs of issuance and lower debt service carrying costs. This in turn means that fewer bond proceeds are needed to cover these costs, reducing the amount of tax-exempt issues.

Moreover, at a time when Congress is trying to reduce direct spending by the federal government on the types of facilities financed by these bonds (and reduce federal interference in the affairs of state and local governments), it should encourage any mechanism that assists small local governments in funding infrastructure on their own. Small issuers have been increasingly caught between the rising costs of federal mandates and their own desire to upgrade their infrastructure, and the declining amount of direct appropriations at both the federal and state level available to finance these improvements. While there are many other things that this Committee and Congress as a whole could do to alleviate this situation--most importantly, ease the "private activity" restrictions so as to facilitate public-private partnerships in financing infrastructure and cut back on some of the complexity of the arbitrage rules--allowing small issuers to retain bank deductibility when they participate in bond pools would be an important first step.

CIFA also strongly supports the tax-exempt bond provisions of the tax simplification bill (H.R. 3419, passed by the House in the 103rd Congress) and urges that this legislation be included in any tax bill that is passed this year. While the changes that these provisions would make are fairly small, they would be of some help in easing the complexity and administrative burden that now plague issuers at every level. These provisions not only were passed by the House in 1993, but were approved twice by Congress as part of larger bills that were vetoed by the President for reasons unrelated to the simplification provisions. These changes make sense, and it is time that they were enacted.

We appreciate the Committee's consideration of these issues. While they may not seem to be major issues in the greater scheme of national affairs, we can assure you that they are of vital importance to small localities in the state of every Committee member. CIFA and its members will be happy to provide any information or assistance that the Committee might require in its deliberations on these matters.

TESTIMONY OF
THE NATIONAL COUNCIL OF HEALTH FACILITIES FINANCE AUTHORITIES
BEFORE THE
FULL COMMITTEE ON WAYS AND MEANS

July 27, 1995

The National Council Of Health Facilities Finance Authorities (NCHFFA) appreciates the opportunity to provide testimony in support of the proposal to enhance the ability of small 501(c)(3) health organizations to obtain needed funding by modifying the rules for deductibility of interest costs for the purchase of tax-exempt debt by financial institutions.

The NCHFFA was created in 1987 to represent the collective interests of state health care financing authorities (representing twenty-three states and the City of Philadelphia) that issue tax-exempt bonds on behalf of public and nonprofit hospitals. NCHFFA does not represent specific hospitals or health care institutions. Rather, NCHFFA focuses its efforts on issues that directly affect the availability of tax-exempt financing to client institutions of NCHFFA's members.

Members of NCHFFA have traditionally been the principal providers of capital for health care facilities and thus play an integral role in America's health care system. Many 501(c)(3) health care institutions do not have sufficient cash flow to fund capital needs and must therefore access the tax-exempt markets through government issuers. Tax-exempt financing generally represents the lowest cost of capital for 501(c)(3) health care borrowers. Access to the capital markets on a federal tax-exempt basis is an important factor in an institution's ability to adjust to the changing health care market. As the need to downsize the current health care system increases, there is greater pressure on health care providers to find innovative ways to serve consumers in an efficient and cost-effective manner. In order to facilitate the consolidation process and to encourage the innovation of alternative health care programs, NCHFFA supports modification of various restrictions on tax-exempt financing.

Many small hospitals and health care facilities, such as community-based clinics and rural and inner-city hospitals, are often deprived of access to affordable financing or are paying unnecessarily high interest costs and costs of issuance due to current tax law which sharply limits incentives for banks to purchase tax-exempt debt. Private placements with bank lenders often represent the only affordable financing option for small tax-exempt issues. A public tax-exempt issue of less than $5 million (when that is even possible) generally is too costly for small health care borrowers. For these small issues, private placement of the debt with banks afford substantial cost savings. Access to bank lenders can mean a difference between a successful project and having delayed delivery of necessary services.

Many of these not-for-profit entities have need only occasionally for tax-exempt financings in small amounts which are unattractive to the public market or large investment bankers. Traditionally, local community banks have been interested in purchasing this debt in order to be supportive of important community health facilities. However, since 1986 banks and other financial institutions generally have been denied a deduction for the portion of their interest expense that is attributable to investment in tax-exempt bonds. The only exception to the disallowance rule is for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that

issue no more than $10 million of such bonds during the calendar year (the "small issuer exemption").

The Council supports a broader effort by public finance groups to expand the exemption from $10 million to $25 million so that it may apply to more issuers. However, as a practical matter many small health care facilities cannot take advantage of the exception because they borrow through statewide or regional authorities authorized by the state statute to issue bonds on behalf of a number of providers, thereby exceeding the $10 million limit. The "small issuer" limit makes it difficult for the issuers to carry out a key function for which they were created under state statute, ie., to assist small rural and inner city health care providers to reduce their cost of borrowing funds through the use of private placements. A solution to this problem would be to allow as an election the measure of the $10 million exemption at the borrower level for nonprofit health care organizations or similar entities. This would focus the exemption on small entities who need special assistance for access to capital and allow our Authorities to better serve them through reduced costs and reduced risk of defaults.

State issuers like our council members possess the expertise needed to evaluate the availability of potential projects and design tax-exempt offerings which meet industry standards for safety and soundness. They have a staff of qualified finance experts who can assist in selecting the appropriate financing option, negotiate covenants and confirm pricing for each financing. They can also standardize the financing process with a high level of quality, making sure that small borrowers and projects receive good representation. State issuers can also do one financing for all projects a borrower may have within the state, thereby reducing financing costs. These issuers are also knowledgeable about new financing techniques which they in turn offer their constituent borrowers, and they remain involved with projects whenever problems may develop after a financing is in place.

One result of health care reform that is certain is the acceleration of the need to down-size the acute care system, with hospitals and other health care providers consolidating, to reduce in-patient capacity while filling other gaps in the system (such as continuing care for the elderly). The goal of this "re-tooling" is to find innovative ways to serve consumers more efficiently such as ambulatory care centers to reduce costly in-hospital stays or community health centers to reduce the use of emergency rooms as primary care facilities.

The revision to the bank deductibility restriction will assist many small health care institutions make these needed investments, become more cost efficient and deliver better health care to their local communities. This needed reform is in many cases essential for them to be able to compete effectively or even survive in today's competitive managed care environment. At a time when Washington is returning more and more of the administrative and economic responsibilities of health care reform to the state and local level, it is imperative that they also be given the important economic tools necessary to carryout these responsibilities. Therefore, we strongly urge the Committee to improve access to affordable financing for small non-profit hospitals and health care facilities by adopting these much needed reforms to interest deductibility.

TESTIMONY OF
TIMOTHY G. GREENE
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL
STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE)

HOUSE COMMITTEE ON WAYS AND MEANS
HEARINGS ON MISCELLANEOUS REVENUE ISSUES

SALLIE MAE'S SPECIAL EXEMPTION FOR PURPOSES OF
SECTION 265(a)(2) OF THE INTERNAL REVENUE CODE

JULY 11, 1995

Sallie Mae is pleased to provide written testimony to the House Committee on Ways and Means as part of the committee's examination of a number of tax-related issues. Its purpose is to provide background and information relating to the repeal of an exemption currently available to Sallie Mae regarding the treatment of interest expense attributable to investments in certain tax-exempt bonds. This provision is a companion to legislation currently being considered in Congress (H.R. 1720) to recharter Sallie Mae as a fully private corporation (i.e., privatization).

PRIVATIZATION

Sallie Mae, with the support of the Administration and Congressional leadership, is actively pursuing a legislative path towards privatization. On June 8, H.R. 1720, which includes amendments authorizing the rechartering of Sallie Mae, received bipartisan approval from the House Committee on Economic and Educational Opportunities, which has jurisdiction over Sallie Mae's Congressional charter. The bill may be considered by the full House this month. More recently, the Senate Subcommittee on Education, Arts, and Humanities held a hearing on the privatization of Sallie Mae. There is general recognition that Sallie Mae has achieved the objective for which it was created -- assuring that private loan capital is made available to support the Federal Family Education Loan Program (formerly the Guaranteed Student Loan Program) -- and that a Government Sponsored Enterprise (GSE) is no longer necessary to stimulate the marketplace for these loans. H.R. 1720 provides for the orderly phase-out of the GSE and the establishment of a holding company structure including both the wind-down GSE and new fully private subsidiaries.

As part of any such privatization, Sallie Mae expects to relinquish the special benefits bestowed upon it by the Congress in an orderly fashion. One such benefit is related to the tax treatment of the tax-exempt bonds held by Sallie Mae in

support of its mission to support the FFELP and to help colleges and universities obtain financing for the construction and renovation of campus facilities.

SALLIE MAE'S TAX-EXEMPT PORTFOLIO

In 1986, Congress was concerned that colleges and universities that did not enjoy superior credit ratings were having a difficult time finding investors willing to buy their tax-exempt bonds. Small schools with no credit ratings or poor credit ratings had particular difficulties financing the construction or renovation of campus facilities. Congress also determined that there was a benefit in expanding Sallie Mae's ability to support the FFELP by purchasing tax-exempt student loan revenue bonds. To remedy this situation, Congress amended Sallie Mae's charter and authorized Sallie Mae to buy tax-exempt bonds issued to finance the purchase of student loans or to finance the purchase, construction or renovation of educational facilities. Congress required 75% of Sallie Mae's educational facility bonds to carry credit ratings below the top three tiers (i.e., below investment grade). This restriction was modified slightly in 1992.

PURPOSE OF SALLIE MAE'S 265(a)(2) RULE

Under Section 265(a)(2) of the Internal Revenue Code, interest expense attributable to the purchasing or carrying of tax-exempt bonds is generally not deductible for Federal income tax purposes. Most corporations only lose interest deductions to the extent that debt can be traced directly to purchases of tax-exempt bonds. If debt cannot be traced directly to tax-exempt bonds, the IRS will not infer that a corporation incurred interest to carry tax-exempt debt unless the tax-exempt bonds represent more than 2% of the corporation's assets.

In order to make it economically possible for Sallie Mae to invest substantial amounts in exempt education bonds, Congress created a special rule under which Sallie Mae is deemed to use its stockholder's equity to purchase or carry exempt education bonds before any debt issued by Sallie Mae is determined to have been issued or continued to purchase or carry exempt education bonds. Thus, under current law, interest expense incurred by Sallie Mae is only subject to Section 265(a)(2) to the extent that the average basis of Sallie Mae's exempt education bonds for a year exceeds Sallie Mae's average stockholders' equity for the year.

REPEALING SALLIE MAE'S 265(a)(2) RULE

The proposal would repeal Sallie Mae's statutory exemption from Section 265(a)(2) as of the date Sallie Mae reorganizes as a private company. Furthermore, the proposal would also prohibit the GSE from using the 2% safe harbor available to other corporate taxpayers. The proposal excludes from section 265(a)(2), however, the tax-exempt bonds that Sallie Mae either owned or contractually committed itself to purchase before the effective date of Sallie Mae's reorganization.

This second component, the grandfathering of the current portfolio, is key to Sallie Mae's ability to phase out its tax-exempt portfolio in an orderly manner. Without this transitional rule, Sallie Mae would have to sell a significant portion of these securities in a limited period of time. The market for the tax-exempt bonds held by Sallie Mae is limited because of the size and terms of these issuances.

In this light, the effective date for the repeal of the exemption is a crucial component of the amendment. H.R. 1720 provides for a "reorganization effective date" on which the privatization would be effective, following its approval by Sallie Mae's shareholders. Because the exemption repeal is linked with the finalizing of the corporation's reorganization, linking the repeal of the exemption with this date is the most logical course. Therefore, we suggest that the Committee adopt the "reorganization effective date," as specified in H.R. 1720, as the effective date for the exemption rather than the date of December 31, 1995 referred to in the Joint Committee on Taxation's description of the proposal (as seen on page 297 of JCS-19-95). At this time, the "reorganization effective date" is anticipated to be December 31, 1996. If that expectation holds, the exemption would then be repealed for taxable years beginning on or after January 1, 1997, coincident with the establishment of the fully private Sallie Mae.

We understand that an earlier version of this proposal was estimated by the Joint Committee on Taxation to generate approximately $19 million in revenue over the seven-year budget horizon.

CONCLUSION

Sallie Mae believes that the orderly wind-down of its tax-exempt portfolio is an important component of its privatization. The Ways and Means Committee should review and be the source of legislation to eliminate Sallie Mae's exemption from section 265 (a)(2). We have discussed this provision with the staff of the Committee and appreciate their assistance in this matter. It is our hope that the Ways and Means Committee will consider this legislation at its first appropriate opportunity.

Please do not hesitate to contact me if you have any questions or need additional information. Thank you for your consideration.

Citizens for a Debt-Free America

July 25, 1995

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 1442
Check-off for Our Children Act

Those Americans who recognize that the ultimate responsibility for the national debt lies with the American people, thank the committee for considering this way to make it easier to exercise our obligation. At the present, people must go to considerable effort to make their contribution. It should not be so difficult to be a responsible citizen.

Fairness dictates that those who incurred the debt have an obligation to pay it, rather than impose perpetual bondage of debt service on generations that did not benefit. It is not a question of patriotism-rather a matter of honor.

Sincerely,

Kay M. Fishburn

Kay M. Fishburn
National Coordinator

Jack Fields

THE UNITED STATES OLYMPIC CHECKOFF ACT

BY THE HONORABLE JACK FIELDS

8TH DISTRICT, TEXAS

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

MR. CHAIRMAN, IT IS WITH WITH GREAT PLEASURE THAT I HAVE INTRODUCED THE UNITED STATES OLYMPIC ACT OF 1995.

THIS IMPORTANT LEGISLATION, WHICH I FIRST INTRODUCED OVER A DECADE AGO, HAS BEEN ENTHUSIASTICALLY SUPPORTED AND CO-SPONSORED BY A BIPARTISAN GROUP OF MEMBERS OF THE HOUSE OF REPRESENTATIVES.

WITH THE 1996 OLYMPIC GAMES QUICKLY APPROACHING, I BELIEVE IT IS IMPORTANT THAT WE PROVIDE OUR AMATEUR ATHLETES WITH THE FINANCIAL RESOURCES THEY NEED TO EFFECTIVELY PARTICIPATE IN INTERNATIONAL COMPETITION.

THE UNITED STATES OLYMPIC CHECKOFF ACT IS DESIGNED TO PROVIDE BADLY NEEDED FINANCIAL SUPPORT BY ALLOWING EVERY AMERICAN TAXPAYER AN ADDITIONAL OPPORTUNITY TO CONTRIBUTE DIRECTLY TO THE UNITED STATES OLYMPIC COMMITTEE.

THIS OPPORTUNITY WOULD BE AFFORDED BY ALLOWING AN INDIVIDUAL TO CHECK OFF A BOX ON HIS OR HER YEARLY 1040 TAX FORM INDICATING THE DESIRE TO CONTRIBUTE $1 TO THE USOC.

ALTHOUGH THIS CHECKOFF WOULD BE SIMILAR TO THE EXISTING PRESIDENTIAL CHECKOFF, THE KEY DIFFERENCE, WHICH I EMPHASIZE, IS THAT UNDER THIS LEGISLATION INDIVIDUALS WOULD HAVE TO CONTRIBUTE OR DEDUCT FROM THEIR REFUND A DOLLAR OF THEIR OWN MONEY AND NOT THE FEDERAL GOVERNMENT'S IN ORDER TO ASSIST THE USOC.

IN ADDITION, THIS LEGISLATION STIPULATES THAT ALL REASONABLE ADMINISTRATIVE COSTS INCURRED BY THE TREASURY DEPARTMENT WHILE IMPLEMENTING THIS PROGRAM WOULD BE DEDUCTED FROM THE PROCEEDS COLLECTED FOR THE USOC.

THIS LEGISLATION, THEREFORE, WILL NOT COST THE FEDERAL GOVERNMENT ANY MONEY WHATSOEVER BUT WILL PROVIDE AN IMPORTANT NEW FUNDING MECHANISM FOR AMATEUR ATHLETICS IN THIS COUNTRY.

AS A RESULT OF THE AMATEUR SPORTS ACT OF 1978, THE USOC BECAME THE COORDINATING BODY FOR ALL AMATEUR SPORTS IN THIS NATION. WHILE I BELIEVE THE USOC HAS MET THAT CHALLENGE WITH DISTINCTION, THE USOC'S NEW ROLE CONSTITUTES A SIGNIFICANT CHANGE IN ITS HISTORICAL RESPONSIBILITIES WHICH WERE LIMITED TO SENDING TEAMS TO THE PAN AMERICAN AND OLYMPIC GAMES. TODAY, THE USOC CONDUCTS A BROAD RANGE OF PROGRAMS THAT ATTEMPTS TO REACH THE NOVICE COMPETITOR AS WELL AS THE OLYMPIC LEVEL PARTICIPANT. IN FACT, ONLY 14 PERCENT OF THE USOC'S 1976-1980 BUDGET WAS USED TO SEND U.S. TEAMS TO THE PAN AMERICAN AND OLYMPIC GAMES.

IN ORDER TO FULFILL THE PURPOSES OF ITS FEDERAL CHARTER, HOWEVER, THE USOC NEEDS MORE FUNDS TO REACH ATHLETIC PERFORMERS OF ALL AGES AND ABILITIES, WITH NEW EMPHASIS ON THE HANDICAPPED, MINORITIES AND WOMEN.

I BELIEVE THAT AS A NATION WE MUST PROVIDE OUR ATHLETES WITH THE PROPER RESOURCES TO EFFECTIVELY COMPETE IN INTERNATIONAL COMPETITION. FOR TOO LONG, AMERICA'S ATHLETES HAVE PARTICIPATED IN OLYMPIC GAMES WITH ONE HAND TIED BEHIND THEIR BACKS BECAUSE OF POOR FACILITIES AND LACK OF TRAINING FUNDS. WHILE I AM NOT SUGGESTING DIRECT FEDERAL APPROPRIATIONS TO THE USOC, WE SHOULD PROVIDE THE AMERICAN PEOPLE WITH ADDITIONAL OPPORTUNITIES TO FINANCIALLY SUPPORT OUR OLYMPIC MOVEMENT.

ONE EXCELLENT MECHANISM FOR THIS SUPPORT IS CONTAINED WITHIN THIS LEGISLATION I AM INTRODUCING TODAY WHICH WILL ALLOW AMERICANS TO GIVE OF THEMSELVES TO THESE AMATEUR ATHLETES WHO SPEND ENDLESS HOURS TRAINING FOR THE CHANCE TO REPRESENT OUR NATION.

ADDITIONALLY, THIS LEGISLATION IS PARTICULARLY TIMELY IN LIGHT OF THE FACT THAT THE 1996 SUMMER GAMES WILL BE HELD IN THIS COUNTRY, IN ATLANTA, GEORGIA; AND THE 2002 WINTER GAMES WILL BE IN SALT LAKE CITY, UTAH.

WITH THIS IN MIND, I BELIEVE THAT OLYMPIC GREAT EDWIN MOSES BEST CHARACTERIZED THE NEED FOR THIS LEGISLATION IN HIS PREVIOUS TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE. IN HIS TESTIMONY, MR. MOSES NOTED THAT "OUR CHOICES ARE THREE: FIRST, WE CAN QUIT INTERNATIONAL SPORTS, SAYING THAT WE CAN'T COMPETE EFFECTIVELY AGAINST SOCIALIST SYSTEMS; SECOND, WE CAN CONTINUE TO CONTEST THESE COUNTRIES IN THE HAPHAZARD WAY OF THE PAST; OR THIRD, WE CAN RESPOND TO THE CHALLENGE."

I BELIEVE WE MUST RESPOND TO THIS CHALLENGE, THAT WE MUST PICK UP THIS OLYMPIC TORCH AND THAT WE MUST PROVIDE THE OPPORTUNITIES FOR THE USOC AND ALL AMATEUR ATHLETES IN THIS COUNTRY TO FULFILL THEIR DREAMS OF ATHLETIC EXCELLENCE.

WHILE MUCH HAS BEEN WRITTEN ABOUT THE PROBLEMS OF TEENAGE DELINQUENCY, IT IS MY FIRM BELIEF THAT THIS LEGISLATION OFFERS A RARE POSITIVE OPPORTUNITY TO EFFECTIVELY DEAL WITH SOME OF THE PROBLEMS FACING AMERICA'S TROUBLED YOUTH. FROM MY OWN OBSERVATIONS, I HAVE WITNESSED THE POSITIVE EFFECTS OF ATHLETIC COMPETITION AND FEEL ATHLETICS PROVIDES A REAL ALTERNATIVE TO TEENAGE CRIME AND OFFERS THESE INDIVIDUALS HOPE FOR A PRODUCTIVE FUTURE.

UNFORTUNATELY, TIME IS SHORT, FOR THE NEXT OLYMPIC GAMES ARE ONLY A YEAR AWAY AND THE USOC FACES AN EVER GROWING NEED TO REACH A GREATER NUMBER OF POTENTIAL ATHLETIC PARTICIPANTS EACH YEAR. I THEREFORE, AM EXTREMELY HOPEFUL THAT THE WAYS AND MEANS COMMITTEE WILL AGREE TO HOLD HEARINGS ON THIS IMPORTANT LEGISLATION AT THE EARLIEST OPPORTUNITY AND THAT THIS ENTIRE BODY WILL BE ABLE TO DEBATE THE MERITS OF THIS PROPOSAL THIS YEAR.

FINALLY, MR. CHAIRMAN, I WOULD LIKE TO EXPRESS MY DEEP APPRECIATION TO THE MEMBERS OF THIS BODY WHO HAVE AND WILL YET, JOIN WITH ME AS SPONSORS OF THIS LEGISLATION. TOGETHER, I BELIEVE WE IN THIS CONGRESS CAN PROVIDE THE UNITED STATES OLYMPIC COMMITTEE WITH THE FINANCIAL RESOURCES, AT NO GOVERNMENTAL COST, FOR NOT ONLY THE 1996 OLYMPIC GAMES BUT FOR THE FUTURE ATHLETIC PROGRAMS FOR MILLIONS OF AMERICANS.

THANK YOU, MR. CHAIRMAN. I URGE THE SWIFT ADOPTION OF THIS LEGISLATION, THE UNITED STATES OLYMPIC CHECKOFF ACT OF 1995.

104TH CONGRESS
1ST SESSION

H. R. 1996

To amend the Internal Revenue Code of 1986 to provide a mechanism for taxpayers to designate $1 of any overpayment of income tax, and to contribute other amounts, for use by the United States Olympic Committee.

IN THE HOUSE OF REPRESENTATIVES

JUNE 30, 1995

Mr. FIELDS of Texas introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to provide a mechanism for taxpayers to designate $1 of any overpayment of income tax, and to contribute other amounts, for use by the United States Olympic Committee.

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

SECTION 1. SHORT TITLE.

This Act may be cited as "United States Olympic Checkoff Act of 1995".

SEC. 2. DESIGNATION OF OVERPAYMENTS AND CONTRIBUTIONS FOR UNITED STATES OLYMPIC TRUST FUND.

(a) IN GENERAL.—Subchapter A of chapter 61 of the Internal Revenue Code of 1986 (relating to returns and records) is amended by adding at the end the following new part:

"PART IX—DESIGNATION OF OVERPAYMENTS AND CONTRIBUTIONS FOR UNITED STATES OLYMPIC TRUST FUND

"SEC. 6097. AMOUNTS FOR UNITED STATES OLYMPIC TRUST FUND.

"(a) IN GENERAL.—With respect to each taxpayer's return for the taxable year of the tax imposed by chapter 1, such taxpayer may designate that—

"(1) $1 of any overpayment of such tax for such taxable year, and

"(2) any cash contribution which the taxpayer includes with such return,

be paid over to the United States Olympic Trust Fund.

"(b) JOINT RETURNS.—In the case of a joint return showing an overpayment of $2 or more, each spouse may designate $1 of such overpayment under subsection (a)(1).

"(c) MANNER AND TIME OF DESIGNATION.—A designation under subsection (a) may be made with respect to any taxable year only at the time of filing the return of the tax imposed by chapter 1 for such taxable year. Such designation shall be made on the first page of the return.

"(d) OVERPAYMENTS TREATED AS REFUNDED.—For purposes of this title, any overpayment of tax designated under subsection (a) shall be treated as being refunded to the taxpayer as of the last date prescribed for filing the return of tax imposed by chapter 1 (determined without regard to extensions) or, if later, the date the return is filed."

(b) CLERICAL AMENDMENT.—The table of parts for subchapter A of chapter 61 of such Code is amended by adding at the end the following new item:

"Part IX. Designation of overpayments and contributions for United States Olympic Trust Fund."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of enactment of this Act.

SEC. 3. ESTABLISHMENT OF UNITED STATES OLYMPIC TRUST FUND.

(a) IN GENERAL.—Subchapter A of chapter 98 of the Internal Revenue Code of 1986 (relating to trust fund

code) is amended by adding at the end the following new section:

"SEC. 9512. UNITED STATES OLYMPIC TRUST FUND.

"(a) CREATION OF TRUST FUND.—There is established in the Treasury of the United States a trust fund to be known as the 'United States Olympic Trust Fund', consisting of such amounts as may be appropriated or credited to the United States Olympic Trust Fund as provided in this section or section 9602(b).

"(b) TRANSFER TO UNITED STATES OLYMPIC TRUST FUND OF AMOUNTS DESIGNATED.—There is hereby appropriated to the United States Olympic Trust Fund amounts equivalent to the amounts designated under section 6097 and received in the Treasury.

"(c) EXPENDITURES FROM TRUST FUND.—

"(1) IN GENERAL.—The Secretary shall pay, not less often than quarterly, to the United States Olympic Committee from the United States Olympic Trust Fund an amount equal to the amount in such Fund as of the time of such payment less any administrative expenses of the Secretary which may be paid under paragraph (2).

"(2) ADMINISTRATIVE EXPENSES.—Amounts in the United States Olympic Trust Fund shall be

available to pay the administrative expenses of the Department of the Treasury directly allocable to—

"(A) modifying the individual income tax return forms to carry out section 6097,

"(B) carrying out this chapter with respect to such Fund, and

"(C) processing amounts received under section 6097 and transferring such amounts to such Fund."

(b) CLERICAL AMENDMENT.—The table of sections for such subchapter A is amended by adding at the end the following new item:

"SEC. 9512. United States Olympic Trust Fund."

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TESTIMONY BEFORE THE WAYS AND MEANS COMMITTEE

DATE	JULY 27, 1995
NAME	LUCILE E. MCCONNELL, ESQ. EXECUTIVE DIRECTOR
ORGANIZATION	THE FUND TO END THE DEFICIT 725 15TH STREET, NW SUITE 502 WASHINGTON, DC 20005
COMMITTEE	COMMITTEE ON WAYS AND MEANS THE U.S. HOUSE OF REPRESENTATIVES
DATE OF HEARINGS	JULY 11-12, 1995
TOPIC	THE MISCELLANEOUS TAX BILL THE CHECK-OFF FOR OUR CHILDREN ACT HR 1442 CoSponsors: Rep. D. Minge (D-MN) Rep. J. Meyers (R-KS) Rep. P. DeFazio (D-OR) Rep. T. Fowler (R-FL) Rep. L. Payne (D-VA) Rep. P. Schroeder (D-CO) Rep. J. Hefley (R-CO) Rep. A. Hastings (D-FL) Rep. P. English (R-PA) Rep. G. Poshard (D-IL) Rep. E. Torres (D-CA Rep. S. Bishop (D-GA) Rep. G. Condit (D-CA) Rep. J. Fox (R-PA) Rep. E. Furse (D-OR) Rep. P. Geren (D-TX) Rep. D. Kennelly (D-CT) Rep. W. Luther (D-MN)

INTRODUCTION

Mr. Chairman, I am greatly moved to have this opportunity to raise up a single voice to encourage the work of Congress. This important work is beyond politics - to create a point of access for the people of America to participate in meeting a great challenge facing our Nation - to forge a Partnership for America's Future to retire our national debt. My name is Lucile McConnell. I am the Director of The Fund to End the Deficit.

The Fund to End the Deficit is a national, nonpolitical, charitable grassroots organization, which has two goals: (1) to make citizens aware of the impact of the deficit and the debt on our lives, the lives of our children and the future of our Country; and (2) to pool the voluntary contributions of citizens and businesses under P.L. 87-58 to directly reduce our national debt NOW. Thousands of citizens in thirty states are working with The Fund to take voluntary action to retire our debt.

MOVEMENT ACROSS THE NATION

Mr. Chairman, many people over the years have complained about the apathy of the American people. We have been called "optimists in denial." But I'd like to tell you of more recent examples of how Americans across the land are willing and eager to take control of their lives and their futures - not waiting for the government to take action and not wanting to be recognized or applauded.

These are stories of living examples of actively participating citizens. People voluntarily accepting personal responsibility for the condition of our nation and our common future. Ordinary citizens who want to do their part for America.

Representative of every American age group, these citizens are part of a voluntary debt retirement movement that is growing every day. This positive tide of spontaneous citizen action is sweeping across our nation:

- On May 27, 1993, Eskimo Pie Corporation, of Richmond, Virginia, gave over $72,000 to the Bureau of the Public Debt to reduce the national debt. This contribution represented a donation of 5 cents from every box of Eskimo Pies sold between March 8, 1993 to April 14, 1993.

- In May 1993, Frank Mirizio's senior government class of Corona Del Sol High School in Tempe, Arizona raised $16,000 by selling t-shirts and stickers and by having car washes to reduce the national debt.

- During fiscal year 1994, the Bureau of the Public Debt received over $20 million in citizen contributions to retire the national debt. This represent 40% of all donations since 1961 in just one year.

- April 1995, high school students at Good Counsel High School (Wheaton, Maryland) participating in the National Penny Parade raised $500 in pennies to retire the debt.

- May 1995, fifth grade students at Pine Forest Elementary School

(Mauelle, Arkansas) sold pickles to get Uncle Sam out of the pickle of the national debt and raised $390 to retire the debt.

Citizens are voluntarily giving their hard-earned dollars to help solve a monumental problem: Our Nation's Ballooning I.O.U. These citizens have made a smart decision - to take charge of America's future now. They are not waiting for the inevitable crisis that will be imposed upon us by the spiralling interest costs of the national debt and the soaring debt principal.

What is the basis of this voluntary debt retirement movement? A little known 1961 federal statute, P.L. 87-58, which empowers all citizens to directly reduce our national debt through voluntary contributions. And by the terms of the statute, these funds can only be used to pay down the debt principal, unlike tax dollars and trust funds.

It would be easy to dismiss these citizen efforts to tackle the debt, except when you look at the numbers: over the last 30 years, citizen contributions to debt retirement have totaled over $50 million, with over $25.8 million or over one-half of these contributions coming over the last 18 months!

THE FIRST QUESTION

I have been travelling across the Country talking with citizens of all ages. I have found a willingness, even an eagerness, in the heart of America to change America's future. Invariably people ask me "Why don't we have a check-off box on the tax return to allow us to make a direct contribution to retire the debt?"

Such a groundswell of energy is the genesis of The Check-Off for Our Children Act, HR 1442. HR 1442 creates a Partnership for America's Future with American citizens working along with Congress - doing our part - doing what Congress cannot do - retiring the principal of the debt while Congress works on getting the spending under control.

The question is how do we get to surplus? We, the American people, can bring the government to surplus right now by creating a cash infusion (without raising taxes) that can only be applied to retire the debt principal. The Check-off for Our Children Act creates a simple mechanism to allow direct citizen participation to renew our greatness and to restore our faith in government.

This bill builds on the foundation established by P.L. 87-58 over thirty years ago to engage every American, regardless of age, in our government by giving citizens the decisive role to play in creating a new future for America. Because of P.L. 87-58, Americans now have the opportunity to exercise each individual's stewardship responsibility, as a part of citizenship, and give something back to the Country that has given so much to us. Because of H.R. 1442, this opportunity to participate is made accessible and simple - just check off a box on the federal tax return and indicate the amount of the refund that should be directed to retire our debt.

MECHANICS OF THE CHECK-OFF FOR OUR CHILDREN ACT

Currently at tax time, citizens who wish to contribute monies to retire our national debt must send a separate check along with their tax return. Since 1983, the federal tax form instructs citizens who want to participate in debt retirement to write an additional check to the Bureau of the Public Debt and indicate P.L. 87-58 on the face of the check. The

notation of P.L. 87-58 on the face of the check is critical to direct the contribution to retire the debt and to ensure that it is not added to the general fund. For tax year 1993, citizens contributed over $200,000 for debt retirement through this means.

However, for both tax year 1993 and 1994, in several cases the Internal Revenue Service (IRS) returned these contributions with interest to citizens living in Texas, Louisiana, and Florida. These citizens were frustrated because they were unable to participate by making this contribution. To highlight the confusion that the current debt retirement contribution mechanism creates, we simply have to note that the IRS returned citizen voluntary contributions with interest, thereby expending additional federal funds instead of collecting them.

In other cases, the IRS may inadvertently credit these debt retirement contributions to the general fund to be spent for current expenses and not applied to bring down the debt. Some citizens send their checks for debt retirement to the White House or to Members of Congress. What we need is a simple and clear mechanism to allow the people of this Country to exercise the responsibility they already feel for retiring our debt. This mechanism is created by the Check-Off For Our Children Act.

This legislation will give each citizen the opportunity to choose to contribute a portion (or all) of his/her tax refund on the condition (under P.L. 87-58) that it can only be used to retire the national debt principal. The choice is created through a check off box on the federal income tax return that allows each citizen to designate a portion (or all) of his or her federal income tax overpayment to be directly applied to retire the principal of the national debt.

The federal government already has in its possession the monies to be refunded to citizens. The IRS must presently verify all refund amounts before sending back the refund checks. To add one step to simply transfer on paper the disposition of these refunds would be less expensive and cumbersome than processing additional checks as we do now and less costly than issuing refund checks to those citizens who desire to participate.

The federal government refunded $74,000,000,000 for tax year 1993. Even if citizens only contributed 1% of this amount, it would generate an immediate $740,000,000 to retire our debt. Most likely citizens would contribute more. Recently, The Wall Street Journal reported that over the last 12 months, citizen contributions for debt retirement are at all time high.

The Federal Election Commission reports that the administrative costs of the check-off for the presidential campaign fund were $470,000 for tax year 1988 and the amount contributed $32,462,979. This is only 1.5% of the funds citizens contributed for administration. For the Check-Off For Our Children Act, the administrative costs would probably be less because no new agency would have to be created, the Bureau of the Public Debt already oversees citizen contributions to retire the debt and the transfer of funds could be done by bookkeeping entries.

The Check-Off For Our Children is only the beginning of citizen participation in debt retirement. Once Americans find out about P.L.87-58, citizens will be requesting additional mechanisms to allow all us to make this dedicated contributions. And an impact will be demonstrated on the budget side of the equation because for every dollar we pay down debt principal, we will generate on the average a 6 cent interest savings on budget side. Citizens truly can work with Congress to reduce our budget deficit by reducing the interest on the debt,

which is now the second fastest growing component of our budget. Last year we would not have had a $203 billion deficit but for our $203 billion interest payment on our national debt.

CONCLUSION

America is at a crossroads in history. The next twenty years will be determinative as to our continued role as a world leader, as well as the continued existence of the American Dream of opportunity for our children. The continued growth of our economy, the continued creation of meaningful jobs, the continued revitalization of our infrastructure and the continued preservation of our environment for future generations all depend upon our ability to own up to our collective past decisions and face the challenge of reducing our national debt. We have all benefitted, and now we must look the Piper in the eye and pay up.

If we want to pass on a Country whose government no longer meets its commitments under the social contract executed by our Founding Fathers, if we merely want to transform the government into an organization whose function is to transfer tax dollars to pay interest on the national debt, then following our current course of inaction will meet these goals. But if we have a different vision, a larger vision, then we must take responsibility for our future and for our Country. The Check-Off For Our Children Act will begin to give that greater vision of a renewed America life and substance.

The American people are demonstrating that we want to participate in retiring the national debt. The greatest principle of democracy is that we each have a choice. The Check-Off for Our Children Act, in conjunction with P.L. 87-58, gives each of us a choice to turn back to the principles underlying our democracy: the principles of individual responsibility, individual participation and individual citizenship.

Citizenship is about choices. The choices we make individually and collectively set the course to our common future. The Check-Off For Our Children Act is the spark to ignite the Country - to demonstrate that we can be the masters of our economic destiny. We have it within our power today to engage individuals in government and create a personal involvement in our democracy. There are no quick fixes to the national debt problem - there is only a continuous commitment by each one of us to take responsibility for our Country and our future. Specifically, the Check-Off for Our Children Act will ensure that every American taxpayer has the opportunity to exercise his or her choice to make a direct contribution to retire the national debt.

As we pay down the national debt principal, our generation will realize at least four immediate benefits: we will reduce the risk of inflation as excess cash is applied to debt retirement, we will stabilize interest rates and we will ensure that the federal government has the flexibility to respond to national crises, such as natural disasters. And importantly, because we will reduce the amount we must spend on interest every year, we will reduce overall Federal budget requirements. The benefit to future generations go far beyond these four - the benefit to our children is the inheritance of a renewed America.

The national debt is a giant overshadowing our future. But a greater giant is awakening - a lot of little people cooperating. Wake up America! Our future is our choice!

Resectfully submitted,

Lucile McConnell
Executive Director
The Fund to End the Deficit

THE POWER TO GIVE IS THE POWER TO CREATE.

ABOUT THE FUND TO END THE DEFICIT

- **The Fund to End the Deficit**, is a national nonpartisan, charitable (501(c)(3)) grassroots organization. The Fund has two goals: (1) to make citizens aware of the everyday impacts of the deficit and the debt upon our lives and upon the future of our children and our Country; and (2) to reinvolve citizens in our government by pooling the voluntary contributions of citizens under P.L. 87-58 to increase public participation in reducing our national debt NOW.

- **Over thirty years ago in 1961, a federal statute, P.L. 87-58, was passed that empowers all citizens to make contributions to the Bureau of the Public Debt** on the condition that these contributions only be used to reduce our national debt, **unlike tax dollars and trust funds.** The Bureau of the Public Debt, under this 1961 statute, must use citizens' contributions to buy back the bonds early which finance the government's operations to produce an interest saving.

- **The Fund to End the Deficit** staff is totally volunteer; therefore, 100% of all contributions from businesses and citizens that we collect go to a separate bank account to be paid over to the Bureau of the Public Debt to retire our national debt. Our goal is to reinvolve citizens in our government and to rekindle the flame of citizenship that once burned so brightly in our Country that it illuminated the whole world.

- **Our current national debt totals over $4.7 trillion. The debt increases at approximately $10,000 per second. Even with the deficit reduction legislation passed in 1993, the debt is expected to increase another $1 trillion by 1999. Our tax dollars do not go to retire the debt; tax dollars only pay interest on the debt. Over 20% of all person income tax paid goes to make interest payments on the debt. We each work six weeks out of the year just to pay our share of the interest on the debt.**

- **THE CITIZENS DEBT RETIREMENT PLAN of The Fund to End the Deficit has four components: (1) a check off box on the 1040 tax form to donate a portion of our refund to retire our debt and a payroll deduction plan for adults ("Citizens to Change America's Future"), (2) an active civics curriculum for students ("Change America's Future"), (3) a corporate contribution campaign ("Say Yes to America's Tomorrow") and (4) a legislative/advocacy agenda under our sister corporation, STAND (Society to Take Action on the National Debt). The goal of the Citizens Debt Retirement Plan is to promote a national voluntary citizen movement under P.L. 87-58 to retire our national debt today!**

- **Call our office (202) 628-4455 or THE FED LINE 1-800-795-9469 to JOIN FORCES WITH THE FUND TO END THE DEFICIT AND SAY "YES!" TO AMERICA'S TOMORROW! JUST SAY "YES!" SAY WE CAN!**

The Fund to End the Deficit, Inc. is a charitable, nonprofit corporation registered to solicit contributions in Maryland, Virginia and the District of Columbia (D.C. License #29309500 September 1, 1994 - August 31, 1995). Copies of our current financial statements are available upon request.

The Fund to End the Deficit, Inc. P.O. Box 34796 Washington, DC 20043 1-800-795-9469

TESTIMONY BEFORE THE WAYS AND MEANS COMMITTEE

DATE JULY 27, 1995

NAME Charles Isley

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

TOPIC THE CHECK-OFF FOR OUR CHILDREN ACT
HR 1442 Sponsored by Congressman Minge

CoSponsors:
L. Payne (D-VA)
Poshard (D-IL)
Pat Schroeder (D-CO)
Torres (D-CA)
Bishop (D-GA)
Condit (D-CA)
DeFazio (D-OR)
P. English (R-PA)
Fowler (R-FL)
Fox (R-FL)
Furse (D-OR)
Geren (D-TX)
A. Hastings (D-FL)
J. Hefley (R-CO)
Kennelly (D-CT)
Luther (D-MN)
Meyers (R-KS)

INTRODUCTION

Mr. Chairman, I appreciate this opportunity to speak on behalf of my constituency at Indiana University Northwest and as a member of "Generation X". I am the Student Body President at a small commuter campus in Gary, Indiana. My constituency is a rather culturally and age diverse Student Body. The largest age group I represent are "non-traditional" college students. My constituency both young and old, Republican or Democrat, Christian or Muslim, all agree that something needs to be done about the national debt today.

As a representative of "generation X," I strongly believe that we must take action today. I was recently asked to volunteer my services to an organization named The Fund To End The Deficit, Inc. The Executive Director, Lucile McConnell asked me to serve as the National College Campus Coordinator for this organization. In this capacity I will be speaking at college campuses throughout both Indiana and America. I hope to organize college campuses across America join the National Penny Parade.

The National Penny Parade is the first step to getting citizens to join with Congress to retire our national debt under PL 87-58. We hope to make every American aware that we can each do our part to retire our debt under this 30-year old federal statute.

Public Law (PL 87-58) is the most beneficial piece of legislation I have ever had the pleasure of reading. I sincerely agree with the sentiments of President Kennedy at the time he signed this bill into law. During times of prosperity we must pay off the debts we incur in times of crisis. This will allow us to have resources available to deal with future crisis situations when they do occur.

The United States of America has recently been plagued by several crisis situations. The Oklahoma City bombing being the most recent. Others being the devastating floods in the midwest, hurricane Andrew in southern Florida, the relatively recent riots in Los Angeles, California. American citizens whose lives were affected by these and other crisis situations reached out for help. The United States government responded the best any government could respond to these situations. However, the massive interest payments on our national debt along with other budgetary constraints forced the helping hand to close. How can we turn our heads as our fellow Americans live through such traumatic times?

In 1994 the Federal Government's deficit spending was close to $203 billion. The interest payment on the national debt was the same amount. So with a smaller principle the interest payment would fall. If the interest payment fell, the deficit spending would in turn fall. We could accomplish this without taking away the only hot meal some school children eat in a day and without making it harder for students to attend college.

No one regardless of racial, ethnic, or generational ties wants to pay higher taxes. House Resolution, HR 1442, The Check Off For Our Children Act, which is sponsored by Congressman David Minge (D-MN) and was originally co-sponsored by Representatives Jan Meyers (R-KS), Peter DeFazio (D-OR) and Tillie Fowler (R-FL) focuses national attention on PL 87-58 as a simple mechanism to rally people to retire our national debt. No citizen wants to be taxed without knowing exactly how he/she will benefit from the added tax burden. However, people all over this great land are willing to donate their hard earned money. What could be a better contribution than our posterity?

Longer than I've been alive, America has dug itself further and further into debt. We must all pull together to stop this insanity. If I ran my personal finances like the United States Government I would have gone bankrupt with in one year of reaching majority. I do understand the fundamental concept of government. It is there to provide the goods and services that the private

sector either can not or will not provide in a free market system. Thus, in times of crisis deficit spending is needed to spur economic growth. However, I can not fathom the thought that America has been in a continual crisis situation my entire life.

HR 1442, The Check Off For Our Children Act, is a bipartisan effort for several reasons. One being the fact that this will be the first time in thirty years that Congress will address the principle of the problem. This is a time for everyone to pull together and attack the cause of the problem, because now the debt through its interest is driving the deficit.

My father does not understand many of the things I do nor do I understand things he does. People refer to this as a generation gap. I suppose that is part of the reason we have our national debt. Every generation blames the one before. It is now time for all Americans to be afforded the opportunity to cross generational and cultural lines and together address the concern our government has failed to address for thirty years.

Since I learned about PL 87-58 I have been filled with new hope. When one person can get a piece of legislation so important passed not only through both Houses of Congress but also signed into law by the President of United States. This is true democracy.
The sad commentary to this happy story is that no one in America knows about this law. The passage of The Check Off For Our Children Act, HR 1442, will force all American tax payers to take notice of this opportunity.

HR 1442 gives any tax payer the ability to donate from one penny all the way to their entire tax refund to pay off the principle of the national debt. This piece of legislation, in conjunction with PL 87-58, also accomplishes two very important tasks. First, any debt instruments retired under PL 87-58 shall not be reissued. This prevents Congress from re-issuing the debt in a new form of debt instrument. Secondly, HR 1442 requires the government to actually reduce the debt by the amount of money citizens contribute.

I would also further urge your support of HR 1442 based on the fact that it is one of the shortest and simplest pieces of legislation I have had the opportunity to read. Having recently interned on Capitol Hill in the office of the Honorable Senator Dan Coats (R-IN), I have had the opportunity to read several pieces of legislation, including the recent GATT/WTO agreement. I often pondered over the technical jargon one commonly runs into when doing federal legal research. I found HR 1442 to be both concise and written in simplistic english that ordinary citizens can understand.

I sometimes sit awake at night wondering when our government will be unable to meet the interest payments much less make any effort toward reducing the principle of the national debt. I fear the future only if we continue on our present path. I realize my generation, "Generation X," will be forced to deal with the problems inflicted on us by this over burdened government. If we do not take action today the results could be so severe that America as we know it today will be nothing more then a college history course in how we failed.

Together we can keep America strong. Democracies begin with people. The debt belongs to the people and we are willing to help pay this debt if you just afford us this opportunity. I thank you, Mr. Chairman, for the opportunity to submit this written statement.

In closing, I would like to thank all the members serving on this committee, as well as, Congressman Minge and the current co-sponsors of HR 1442. I would also like to urge all members to take twenty minutes and read the complete text of this important bill.

On a final note, we must never forget the dedicated congressional staff that made these hearings possible.

Sincerely,

Charles Isley
Student Body President
Indiana University Northwest

CI/HH

STATEMENT OF
CONGRESSMAN DAVID MINGE

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
DURING A HEARING ON MISCELLANEOUS TAX REFORMS

JULY 11-13, 1995

Mr. Chairman and members of the committee, I would like to thank you for the opportunity to submit a statement on three tax reform proposals I have introduced.

1. Tax Refund Check-off to Retire the Debt (H.R. 1422)

This first tax reform proposal relates to the ability of taxpayers to conveniently make tax refund contributions to help eliminate our national debt. Representatives Jan Meyers, Tillie Fowler, Peter DeFazio and I introduced a bipartisan bill on April 6th to provide the American taxpayer with a way to contribute directly to eliminating the national debt. H.R. 1422 allows citizens to check a box on their Federal tax return and indicate the amount of their tax refund each would like to direct to retire the national debt. The Check-Off for Our Children Act will form a partnership for America's future between citizens and the Congress to reduce our national debt and to reclaim the economic future of the next generation of Americans.

I think that everyone would agree that America is at a crossroads in history. The next twenty years will determine whether we will let our staggering debt turn the American dream into a nightmare. The growth of our economy, creation of meaningful jobs, a reduction of federal spending, revitalization of our infrastructure and the preservation of our environment for future generations all depend upon our ability to reduce our national debt. We have all benefitted from these deficits over the years, but now it is time to own up. Unless the Congress and our citizens act in unison now, the federal government's sole function will soon be to transfer tax dollars to meet interest payments on the debt and the rapidly expanding entitlement programs.

There is now a growing willingness of the American people to play an active role in retiring the national debt, thanks in part to the efforts of Lucile McConnell and The Fund to End the Deficit. Lucile has worked tirelessly to educate Americans about the threat the deficit poses to future generations and opportunities they have to help solve this problem. This desire can be met by a little known federal statute, P.L. 87-58, which was signed into law in 1961 by President Kennedy. This law currently enables every citizen to contribute directly to retiring the national debt by making gifts to the Bureau of Public Debt. Since 1961, American citizens have donated $50 million to the Bureau of Public Debt to further the cause of debt reduction. Last year alone, Americans contributed $20.7 million to debt reduction. H.R. 1422 would amend P.L. 87-58 so that taxpayers can simply mark a check-off box on their tax returns to designate a portion of their tax refunds on the condition that it be used only to retire the national debt. This would greatly simplify the process and make it more likely that taxpayers would make contributions.

The Joint Committee on Taxation has estimated that H.R. 1422 would increase federal revenues by $2 million dollars over five years. While we believe that this figure is conservative, we are pleased that it will raise money. It should be noted that the IRS returned $74 billion in tax refunds in 1993. If even a small percentage of these refunds were voluntarily contributed, debt reduction would surely be larger than $2 million. H.R. 1422 has 23 cosponsors and should be non-controversial.

I recognize that this effort is largely symbolic. However,

symbols do matter and we should make every effort to attack our $4.8 trillion debt. Will everyone donate their tax refunds to help eliminate the debt? The answer is no. But a growing number of people are committed to contributing their money to reduce our debt. We should support their efforts by making it easier to do so. Each of us must take responsibility for our country and our future. Clearly, we in Congress have a responsibility to make the difficult choices required to cut federal spending and balance our budget. The Check-Off will ensure that every American has the opportunity to make a direct contribution to retire the national debt.

2. Disaster Income Carry back (H.R. 1408)

I also urge favorable Committee action on H.R. 1408. The need for this legislation arose as a result of the floods of 1993, which devastated tens of thousands of farmers throughout the Midwest. Farmers whose crops were damaged or destroyed applied to receive crop insurance or federal disaster payments. While some farmers received payments in 1993, the majority received them in 1994. At the end of 1993, the Department of Agriculture had only paid approximately one-third of the projected claims. This delay occurred because of the huge volume of farmers who suffered damage from the flooding in 1993.

During the flooding, the Administration told farmers they would receive the aid within two weeks. Unfortunately, this did not happen. As a result, many farmers who received payments in 1994 are suffering severe and unintended tax consequences. They had normal expenses in 1993 and 1994, but two years income in 1994. This income "bunching" has caused farmers to lose standard exemptions for 1993 and moved them into higher tax brackets for 1994. One accounting firm in Minnesota estimated that affected farmers will pay as much as $6,000 more in taxes this year. If farmers could carry the 1994 disaster income back to 1993, these problems would be averted. This would solve the symmetry problem we now have in Code, which allows farmers to carry income forward but not back.

This situation is completely unfair and unacceptable. Farmers wanted and expected to obtain payments in 1993, but through no fault of their own, they did not receive them until 1994. Farmers should not be punished by having to pay higher taxes because of the unforseen yet understandable difficulty in processing so many claims on a timely basis.

To remedy this problem, Senator Tom Daschle and I introduced legislation in 1994 and again this session to allow farmers to carry disaster and crop insurance payments received in 1994 back to 1993 to solve the symmetry problem. Both the Departments of Treasury and Agriculture have supported these bills as have members of both parties. The House version had 43 cosponsors last session. In addition, the American Farm Bureau Federation has strongly endorsed this legislation. The bill is non-controversial. The bill is estimated to cost $10 million over the next five years. I am pleased to report that the Committee on Joint Taxation was able to find a revenue offset. If Congress could expedite passage of this legislation as part of the budget reconciliation process, some farmers would still file amended returns for 1993 and 1994 and avoid the adverse and unfair tax penalties they currently face. However, even though many farmers hit by the 1993 floods would not go back and file amended returns and thus utilize the carry back provision, it is critical that we amend the Code so that we can prevent future natural disasters from turning into tax disasters. The carry back provision gives farmers the necessary flexibility to cope with natural disasters.

The problem is easy to fix. No one I have spoken with thinks the legislation is bad in concept. Everyone agrees that this is an unfair tax burden for disaster victims. The bottom line, then, is whether Congress is able to act swiftly to solve a

simple problem; whether we can make the federal government work.

3. Ethanol credit for cooperative members.

Third, I would also like to mention legislation that I am introducing which is not a formal part of this hearing. This legislation is a relatively minor correction to the Code relating to the application of the small ethanol producers credit. I, along with other members of Congress, am introducing bipartisan legislation that will allow small ethanol cooperatives the same opportunity to utilize the Small Ethanol Producers Credit that other business entities such as trusts, S-Corporations, and partnerships currently utilize. Passed into law in 1990, the Small Ethanol Producers Credit (Internal Revenue Code Section 40(b)(4)) was created and implemented because Congress determined that tax incentives were an appropriate means to promote and encourage development of renewable fuel alternatives. Specific limitations were included to ensure that large producers were ineligible for the credit, thus effecting the goal targeting smaller producers to become active in this development. At present, this credit is only extended to those entities which produce less than 30 million gallons of ethanol annually. They are eligible for a 10 cent per gallon tax credit for the first 15 million gallons produced. Tragically and inadvertently, cooperatives are in effect not eligible because the Internal Revenue Service has ruled that the Code does not permit the credit pass-through to patrons of a cooperative. Without specific inclusion in the Internal Revenue Code, thousands of farmers will be unable to benefit from this credit.

In the state of Minnesota and increasingly throughout the Midwest, cooperatives are the primary business organization involved in ethanol production. This form of operation usually passes the income generated by the cooperative on to its participating patrons. Inability to use this credit for ethanol often denies the tax benefit to those being taxed for cooperative income. Allowing the credit to be passed through to the cooperative patrons fulfills the intent and purpose of the law by benefitting those actively involved in the creation of the ethanol, the family farmer.

In the Second District of Minnesota alone, four small cooperatives are either currently in production or under construction. At least 18 other small ethanol cooperatives are in the planning stages in Minnesota, Iowa, Missouri, North Dakota, South Dakota and Illinois. On average, each of these cooperatives is comprised of approximately 300 farmers. For many, the availability of the Small Ethanol Producers Credit will determine their start-up viability and whether or not they can compete in the marketplace. This legislation is supported by the American Farm Bureau Federation, the National Council for Farm Cooperatives, the National Corn Growers Association, and the National Farmers Union.

For years, farmers have been encouraged to diversify their business operations. Ethanol cooperatives provide an excellent opportunity to create local jobs and local profits. Ethanol cooperative investment can help to maintain rural economies. I hope that Congress can make this correction to the tax code so that small farmers will be able to benefit from the same ethanol credits that other types of businesses presently utilize.

Thank you Mr. Chairman.

NELSON FRANKLIN SMITH
1001 JEFFERSON DAVIS DRIVE, CHATMOSS, MARTINSVILLE, VIRGINIA 24112

July 14, 1995

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Committee Members:

I am writing this letter in support of House Bill H.R. 960, "Persons With Disabilities Trusts Tax Rate Restoration Act". I am convinced, gentlemen, that the members of Congress who several years ago passed the Clinton tax package were not aware of the implications of that tax bill on the physically and mentally disabled. Due to the fact that most of these people are mentally disabled, they cannot be responsible for their financial decisions and are easily taken advantage of by unscrupulous people.

For this reason, my wife and I set up an **irrevocable** trust for our child, in hopes that this trust would accumulate money so that he could receive an income for the rest of his life and not rely on the state to support him. This irrevocable trust cannot be changed by ourselves or our child, yet the government has changed the tax policies of this trust. This trust has an income at the present time of approximately $12,000 to $13,000 per year - all of this income is reinvested to accumulate funds until we (the parents) die: at that time the trust will begin disbursing an income to our son. At the current tax rate, this means that almost 50% of these funds have to be paid back in taxes instead of reinvested. This trust is about nine (9) years old now and has been doing fairly well in accumulating income for him until the passage of the Clinton tax package. At that time the tax rate went up to 39.6% from a level of 12% to 15%. I don't need to describe to you the effects of this burdensome tax on my son's trust. I think that level-headed people would agree that this is most unfair since the purpose of this trust is to allow my child the ability to live free of government interference and not be a ward of the state. The state then turns around and punishes this independent thinking by slapping a burdensome tax on this trust. I have written several people concerning this, and most agree that my request is quite reasonable. We are not asking that the trust not be taxed, we are just asking that it be taxed at the same rate individuals are. We would love to attend the hearings, but were not made aware of them until a week ago. We could not find someone to stay with our son on such short notice or we would attend these hearings to personally plead our case.

I have heard from L. F. Payne's office that the tax committee has said that the tax laws from this change would amount to millions & millions of dollars in tax loss. We take issue with this statement because it is our contention that the change in the tax law would save the federal government money in that these disabled individuals who have trusts set up on their behalf would not become a ward of the state, thereby saving the federal government millions of dollars in S.S.I. payments. Our child is 19 years old, and would qualify for S.S.I. payments of approximately $500.00 per month. We have not availed ourselves of this as we feel it is our responsibility to raise our child and not the federal government's. But, if this tax stays in place we will have no other choice but to apply for S.S.I. and allow our child to start receiving payments every month for the rest of his life.

I appreciate your consideration of this letter and hope if you have any questions that you will contact us. We would be more than happy to come to Washington, given at least a two to three week notice and appear before the committee. I am sure that good judgment will prevail in this situation.

Sincerely,

N. Frank Smith
Kathryn A. Smith

Written in behalf of
Robert Harrison Smith
1001 Jefferson Davis Drive
Martinsville, Virginia

cc: Ways & Means Committee Members
Mr. Thad Woodard, NC Alliance Community Financial Institutions
Senator Pete Domenici
The Honorable Jesse A. Helms
Pamela G. Bailey, President, Healthcare Leadership Council

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TESTIMONY BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
HEARING ON MISCELLANEOUS TAX REFORMS
1100 LONGWORTH HOUSE OFFICE BUILDING
JULY 11-13, 1995

Mr. Chairman and Members of the Committee:

My name is J. Michael McGehee and I represent the U.S. Savings Bond Foundation. I come before you today to ask that you support the technical changes in this amendment that will clarify existing regulation regarding the promotion and marketing of U.S. Savings Bonds.

This legislation does not change the way in which savings bonds are sold. Indeed, various organizations can, and do, provide a service -- much in the same way a courier company operates -- for individuals who wish to purchase a savings bond. The organization may collect an individual's money and a properly filled out data form and take it to a bank or issuing agent for processing according to normal Federal Reserve procedures. In long standing discussions with the Treasury department, they have indicated that this process is appropriate and acceptable under existing law. The Treasury department has objected, however, when a small fee is attached to this service. This language clarifies this ambiguity and indicates that a non-profit organization may not only collect monies for this purpose from individuals, but may also charge a service fee and if it so chooses, charge the entire transaction to a credit or debit card.

During the first session of the 99th Congress, legislation was proposed by the Reagan Administration and approved by Congress (PL 99-571) that exempted organizations that promoted the purchase of savings bonds from the strict regulatory requirements of financial institutions and government securities brokers and dealers that engage in financial activities beyond the promotion of savings bonds. The intent was to actively encourage Americans to invest in America through the purchase of savings bonds and create significant new opportunities for organizations to promote and market the sale of U.S. Savings Bonds.

Unfortunately, the Treasury Department has been slow in turning this exemption into a reality for organization such as ours. Indeed, although the Treasury Department spends a significant amount of money to encourage private sector involvement in an annual savings campaign, they have nevertheless created a confusing fog regarding the proper legal involvement of non-profit organizations in this process. This language clarifies this role and clearly states that non-profit organizations should be significant participants in promoting the purchase of savings bonds by all Americans. The language also clarifies the point that a non-profit, educational foundation such as ours may assess a membership fee, or handling fee, or transaction fee as part of a savings bond promotional activity without violating federal law.

This point has been a matter of disagreement with the Treasury Department since the day the exemption was created. Treasury has consistently taken the position that they are happy for organizations to spend money promoting bonds, but they do not want any organization to recoup their costs in doing so by attaching a handling fee or a membership fee or a transaction fee to the process. For non-profit organizations this irrational approach simply means that we will never be able to actively participate in promoting increased savings by Americans who want to invest in America. Treasury's interpretations have, in fact, caused the entirely predictable result; i.e., most non-profit organizations only support the savings bond program by the purchase of a few bonds on an irregular basis and tie the distribution of these bonds to a specific promotion.

As a non-profit, educational foundation we are anxious to help expand the ability of all Americans to augment their savings activities by purchasing savings bonds. In this era of increased awareness of the need for greater savings, it is a national shame that home-bound elderly and disabled Americans who want to purchase these historically patriotic bonds as gifts for their grandchildren and children, must count on their family, neighbors or friends to take them to a local bank or collect the money on their behalf, fill out the form and take the materials to the local bank.

In addition, because of the hectic schedule of most Americans today, the inconvenience of a requirement to physically go to a bank to purchase a savings bond results in the lessening of people purchasing bonds. We believe that Americans who do not have access or the desire to go to their local bank to purchases a bond should be able to call a toll-free number, provide the required information, and charge the cost of the bond and a handling fee to their credit card.

We also believe that it is important that no individual should ever be confused about the rate of return on the interest of their bonds. Therefore, we strongly support the language in the proposed amendment that requires that any processing fee that is added to the cost of the bond must be separately identified to the bond purchaser.

There are several things that this language does <u>not</u> do. It does not cost the U.S. Government any revenue. In fact, by removing the artificial barrier to greater involvement by non-profit organizations in the marketing of savings bonds, it is reasonable to assume that a significant increase in the purchase of savings bonds by Americans will occur. This should result in a net increase in funds to the Treasury.

The clarification language does <u>not</u> affect the type of information required by Treasury. The language does <u>not</u> cause any change in the process by which the Federal Reserve conducts the transaction after receiving the information and monies from the duly authorized bank or issuing agent.

The language does <u>not</u> authorize any organization to sell savings bonds, but rather, only allows an organization to market the service of collecting monies and bringing them to an appropriate issuing agent of the Federal Reserve.

Finally, the language does <u>not</u> affect the current ability of any bank or issuing agent to sell savings bonds.

This amendment only clarifies the intent of Congress and removes the artificial barriers that have been erected by the Treasury to the active promotion of savings bonds by non-profit organizations.

I thank you for your time and respectfully request your support for this amendment.

Thank you.

STATEMENT OF THE

AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

FOR THE RECORD OF THE HEARING

OF THE COMMITTEE ON WAYS AND MEANS,

U.S. HOUSE OF REPRESENTATIVES

ON MISCELLANEOUS TAX PROPOSALS

JULY 11-13, 1995

The Air Line Pilots Association, International ("ALPA") is the collective bargaining representative of 43,000 pilots who fly for 35 commercial airlines. ALPA appreciates this opportunity to submit comments to the House Ways and Means Committee on miscellaneous tax proposals, for the record of the hearing held July 11-13, 1995.

ALPA's comments on the miscellaneous tax proposals are set forth in the order in which such proposals appear in the discussion of such proposals published by the Joint Committee on Taxation.[1]

1. Increase Deductibility of Business Meal Expenses for Individuals Subject to Federal Hours of Service Limitations[2]

ALPA supports the proposal to increase the deduction for business meals from 50% to 80%, with respect to employees, such as pilots, whose employment is subject to Department of Transportation hours-of-service limitations. However, ALPA urges that this proposal be modified to provide for 100% deductibility with respect to airline flight crews' expenses. Full deductibility of airline employee per diem payments was one of the measures recommended by The National Commission to Ensure a Strong Competitive Airline Industry, in its Report to the President and Congress of August 1993. The Commission determined that partial deductibility of these expenses represented one of the tax burdens impeding the ability of the airline industry to return to financial health.

Limiting deductibility of these expenses to 50% is inappropriate given that pilots (and certain other employees in the transportation industry) are required by the nature of their occupation to be away from home on business travel for all, or substantially all, of their working hours. It is unfair from a tax policy standpoint to limit a transportation employer's deductions for its traveling employees' admittedly reasonable and necessary meal expenses given that such a large percentage of the workforce of an employer in the transportation industry is required to be on business travel. Although a transportation employer's meal expenses are reasonable, they are disproportionately large as compared to other employers. Therefore, limiting the deduction for this significant business expense has a disproportionately negative impact on a transportation employer's profitability.

ALPA believes this is an unintended consequence of the 50% limit, and therefore, supports reinstating the 100% deductibility limit with respect to airline flight crew employees, or as a second choice, reinstating the 80% deductibility limit with respect to all traveling transportation employees

[1] Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995.
[2] *Id.*, Section I.C.3, p. 21.

2. Repeal Special Nondiscrimination Tests for Qualified Cash or Deferred Arrangements[3]

ALPA supports the proposal to repeal the special nondiscrimination tests under Section 401(k) of the Internal Revenue Code. The objective of these rules is to limit the amount of tax-deferred contributions made on behalf of highly compensated employees, as compared to non-highly compensated employees. These rules are some of the most complex, difficult and costly to administer, with the result that the end is not justified by the means. Moreover, the objective of these rules is more than adequately met by the combination of at least four other provisions of the Code designed to prevent discrimination in 401(k) plans: First, Code Section 402(g) places an absolute dollar limit on an employee's annual elective deferrals (indexed to $9,240 in 1995); second, Section 410 requires that employees covered under the plan meet standards of nondiscrimination; third, Section 415 limits the total amount of contributions that may be made to any employee to 25% of his or her compensation during the year; and fourth, Section 401(a)(4) generally prohibits a plan from discriminating in favor of highly compensated employees. Together, these provisions and others are more than adequate to meet tax policy goals in allowing 401(k) plans. The special nondiscrimination rules under Section 401(k) do little more than generate significant consulting fees for employee benefits consultants hired to assist plan administrators with compliance.

3. Repeal OBRA 1993 Provision Limiting Compensation Taken into Account to $150,000[4]

ALPA supports the proposal to repeal the $150,000 limit on the amount of compensation which may be taken into account under a qualified plan. Given that qualified plans must meet nondiscrimination standards under Sections 401(a)(4) and 410, and further given that overall contributions and benefits for each employee are limited by Section 415, there is no *retirement* policy justifying the $150,000 compensation limitation. In addition, the $150,000 limit has an unintended negative effect on individuals earning less than $150,000 in that it operates to further limit the elective deferrals which may be made by the lowest paid of the highly compensated employees.

Should the $150,000 limit be repealed, ALPA suggests making the effective date of the repeal retroactive to the date the limit became effective with respect to a plan, so as to avoid unnecessary confusion in application of the law. Should total repeal of the $150,000 limit not occur, ALPA advocates a limited repeal, applicable to collectively bargained pilot plans, as discussed in paragraph 4 below.

4. Repeal for Pilots OBRA 1993 Provision Limiting Compensation Taken into Account to $150,000 [in Collectively Bargained Plans][5]

ALPA strongly supports the proposal to repeal the $150,000 limit on compensation with respect to collectively bargained plans maintained on behalf of airline pilots. ALPA believes Congress' objective in establishing the $150,000 limit is not achieved with respect to qualified plans maintained on behalf of airline pilots pursuant to collective bargaining.

Beginning in the 1940's, ALPA recognized the importance of providing for pilots in their retirement years. Our interest in this area is especially keen since a pilot's period of retirement is expected to last longer than that of a typical employee, due to the federal government's requirement that pilots retire at age 60. Consequently, ALPA has made security in retirement -- through both defined benefit and defined contribution plans -- a primary objective in collective bargaining.

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[3] *Id.*, Section I.BB.A.1.a. pp. 244-245.
[4] *Id.*, Section I.BB.A.1.f, p. 251.
[5] [illegible]

The reduction of the compensation limit to $150,000, however, has upset in one fell swoop the balance of retirement security that has been achieved for pilots, in most cases over half a century of collective bargaining. Benefits initially bargained and maintained as pre-funded qualified plan benefits have suddenly become unfunded general obligations of the employer. Benefits bargained in lieu of hard cash compensation have suddenly become less secure. Benefits pilots counted on as eligible for rollover to an IRA, thereby increasing their retirement security, have suddenly become ineligible for rollover.

In the case of a typical non-airline employer, only a small number of employees, if any, earn $150,000 or more. They are usually among the employer's top management employees. Therefore, in this typical case, the $150,000 limitation impacts only a handful of participants in the employer's qualified retirement plan. An unfunded nonqualified plan may be established by the employer to provide these few employees with the benefits they lost due to the $150,000 limitation, but because the number of affected employees is so small, the employer's total unfunded liability for such lost benefits is not significant, overall.

The result is dramatically opposite in the case of plans maintained pursuant to collective bargaining on behalf of pilots at most of the major airlines. In these plans, the $150,000 limit impacts virtually all pilots participating in the plan. The impact is severe and immediate for retiring pilots who earn over $150,000, causing a reduction in their expected retirement income from the qualified plan.

For example, a pilot at a major airline retiring at age 60 in the year 2000, with 30 years of service, is expected to lose *more than $30,000* in annual retirement income from the qualified plan due to the $150,000 limitation. (This analysis even assumes that the $150,000 limit is increased in $10,000 increments over the next few years to reflect annual increases of 3.5% in the cost of living.) Although these lost benefits can be provided through nonqualified plans, such plans are, by definition, less secure than qualified plans since, *in no case are such plans funded.* Because a major airline employs *thousands* of pilots, the ultimate unfunded liability for these lost benefits can be quite high, and is disproportionately high when compared to the typical non-airline employer. The higher this unfunded liability, the less secure is the employer's general, unsecured promise to pay the lost benefits.

If the basis for the $150,000 limit is to further prevent discrimination in favor of highly compensated employees in qualified plans, these concerns are eliminated in the context of qualified plans maintained pursuant to collectively bargaining. In the case of airline pilots, fair representation of all pilots within a collective bargaining unit is safeguarded by the Railway Labor Act. Thus, in negotiating with an airline over the terms and conditions of the pilots' employment, including any qualified plan, ALPA must fairly address the needs and preferences of all pilots within the collective bargaining unit. Limiting compensation taken into account under a qualified plan to $150,000 unduly hampers the union's ability to treat all represented pilots fairly.

The net result of the $150,000 limitation has been a significant devaluation of the collective bargaining agreements maintained between ALPA and several major airlines -- agreements which have been developed over decades of bargaining under the Railway Labor Act. We believe this result was not intended by Congress, and we urge repeal of the limitation with respect to collectively bargained plans maintained on behalf of pilots.

5. Repeal 15% Excise Tax on Excess Distributions[6]

ALPA supports the proposal to repeal the 15% excise tax on "excess" distributions. The objective of the excise tax, to prevent "excessive" accumulations in tax-exempt retirement trusts, is adequately addressed by other provisions of the Internal Revenue Code. IRA contributions are limited to $2,000 annually, while Section 415 likewise provides specific maximums on annual contributions and distributions from qualified plans. The Code also requires minimum distributions from IRAs and qualified plans, commencing at age 70-1/2, making such amounts immediately taxable. Taken together, these provisions prevent "excessive" buildup, obviating the need for the excise tax.

Moreover, the excise tax often works as a penalty with respect to individuals who have invested well in their IRAs and defined contribution plans. That is, "excess" distributions may result from larger than usual returns on investment. Imposition of the excise tax may lead to unduly conservative investment of such assets, to prevent "excessive" accumulations.

6. Modification of Interest and Mortality Rate Provisions of the Retirement Protection Act[7]

ALPA supports the proposal to defer for existing plans the effective date of the interest rate and mortality assumptions which must be used to calculate Section 415's limits on benefits under the Retirement Protection Act.

7. Eliminate Combined Plan Limit for Participants in Both a Defined Contribution and a Defined Benefit Plan[8]

ALPA strongly endorses the proposal to eliminate the combined plan limit under Section 415(e) applicable to participants in both a defined contribution and a defined benefit plan. Elimination of this requirement alone will go a long way towards true simplification of pension law.

ALPA represents several airline groups whose pilots participate in both defined benefit and defined contribution plans. In our experience, Section 415(e) represents the single most complicated and misunderstood provision applicable to qualified plans. Involving as it does complex mathematical formulae to determine the "defined contribution fraction" and the "defined benefit fraction," Section 415(e) is the disastrous result of mixing retirement plan "apples" and "oranges." We have found that no employer is able to do the necessary calculations on its own and must hire outside consultants, at steep expense, in order to comply. Moreover, at airlines where pilots presently participate in only a defined contribution plan, the specter of having to comply with Section 415(e) operates as a distinct disincentive to the establishment of a defined benefit plan.

ALPA strongly urges repeal of the combined plan limit since the objective of limiting contributions and benefits can be more simply achieved by application of the separate limits on defined contribution and defined benefit plans.

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[6] *Id.*, Section I.BB.A.2.a, pp. 253-254.
[7] *Id.*, Section I.BB.A.3.a, p. 259.
[8] *Id.*, Section I.BB.A.3.b, p. 259.

8. Special Rules for Plans Covering Pilots (sec. 242 of the bill [H.R. 3419])[9]

Under present law, a qualified plan maintained on behalf of airline pilots pursuant to collective bargaining is permitted to exclude all employees not covered by the collective bargaining agreement in determining whether the coverage requirements are met. Under section 242 of H.R. 3419, this protection would be extended to any plan maintained on behalf of airline pilots, whether or not the plan was maintained pursuant to collective bargaining. ALPA supports the proposal to delete that provision from H.R. 3419.

The special coverage rule for collectively bargained pilot plans is set forth in Section 410(b)(3)(B) of the Internal Revenue Code. This Section was enacted in 1974 as part of ERISA. Prior to ERISA, the Internal Revenue Service had been reviewing several qualified plans maintained pursuant to collective bargaining on behalf of pilots at various airlines. The IRS had been questioning whether such plans met the then-applicable coverage requirements. Their concern was that, since pilots were highly paid compared to the other employees of an airline, the establishment and maintenance of a plan on behalf of the pilots alone could be deemed a discriminatory classification -- especially in those cases where the benefits bargained on behalf of the pilots were better than the benefits provided to other employees. Under the IRS' view before ERISA, therefore, it was possible that the pilots' collectively bargained plans could be considered discriminatory and thus not eligible to be considered qualified plans under the Internal Revenue Code.

This view threatened the freedom of the collective bargaining process under the Railway Labor Act. This is because the parties in collective bargaining would not be permitted to negotiate for the establishment of a separate plan on behalf of pilots, or for a level of retirement benefits for pilots which was higher than that made available to the airline's other employees. Thus, the retirement benefits of unionized pilots would be restricted to the level of benefits made available unilaterally by the airline to its other, nonunionized employees.

Other union groups did not have this problem before (or after) ERISA. Because employees in other union groups were not considered highly paid, they could have their own qualified plans which provided for higher benefits than those provided to other employees. Such coverage and benefits would discriminate in favor of the *lower paid*, which is permissible, and not in favor of the *highly paid*, which is not permissible.

The pre-ERISA situation unduly restricted the retirement plan options available to pilots and airlines engaged in collective bargaining. It also prohibited unionized pilots from striking a bargain regarding retirement benefits which other unionized groups, because they were not highly paid, could do.

To address these concerns, Congress enacted the special rule under Section 410(b)(3)(B). Under the special rule, a qualified plan may be maintained on behalf of airline pilots pursuant to collective bargaining under the Railway Labor Act, without being considered to discriminate in favor of highly paid employees. The rule allows pilots and their employers, through collective bargaining, to determine the appropriate level of the pilots' retirement benefits, without conditioning their bargaining *in any way* on the level of benefits provided to the employer's other employees. The special rule gives to pilots and their employers the same latitude in collectively bargaining for retirement benefits as the general rules give to other unionized employees and their employers.

Keeping in mind the intent of the special rule, it is clear that expanding the scope of the rule to situations which do not involve collective bargaining would be inappropriate. Such expansion would defeat the very purpose of the special rule. The rule's purpose is not simply to provide pilots with favored tax treatment, but to protect the collective bargaining process and to grant unionized pilots equal treatment as compared to other unionized groups.

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[9] *Id.*, Section II.2.e, p. 303.

Where pilots are not represented by a union, the terms and conditions of their employment are determined unilaterally by their employer. In such cases, there is no need to protect the collective bargaining process. Nor is there a need to place the pilots on the same footing as other employees. They are already on the same footing as other nonunionized, highly paid employees. Therefore, the circumstances requiring application of the special coverage rule simply do not exist in the case of nonunionized pilots.

Furthermore, at the time sec. 242 of H.R. 3419 was originally proposed, some pilot groups were not represented by a collective bargaining agent. Since that time, however, the pilots at Federal Express, Continental, America West, and several regional carriers have voted to be represented by a union and can bargain for a pension plan without fear of violating anti-discrimination rules. Thus, virtually all airline pilots now participate in the collective bargaining process and the perceived need for sec. 242 no longer exists.

In summary, ALPA strongly urges deletion from H.R. 3419 of the provision which would extend application of the special coverage rule for pilots to retirement plans maintained on behalf of nonunionized pilot groups.

Statement of Carol B. Hallett
President and Chief Executive Officer
Air Transport Association of America

Hearing Before the Committee on Ways and Means
U.S. House of Representatives
Concerning Miscellaneous Revenue Issues
July 11 and 12, 1995

I am Carol Hallett, President and Chief Executive Officer of the Air Transport Association of America. ATA represents the major carriers of the U.S. airline industry; our members transport more than 95 percent of all passenger and cargo traffic moved on U.S. flag carriers. On behalf of our member airlines,* I appreciate the opportunity to discuss three revenue measures that will have a substantial impact upon the financial health of our carriers.

Let me review our industry's recent financial condition. The airline industry has not made a profit in this decade. Collectively, the industry has lost more than $13 billion since 1990. The last year of black ink was 1989, when the industry reported a $128 million net profit, slightly better than breakeven. In the intervening period, our industry lost $3.9 billion in 1990, $1.9 billion in 1991, $4.0 billion in 1992, $2.1 billion in 1993, and $285 million in 1994.

During the course of the next few weeks, the airlines will be releasing their 2nd quarter financial reports. Wall Street analysts anticipate that the airline industry will have a collective profit this quarter, perhaps as much as $700 million. However, let me caution your reading of this result -- it is only a drop in the bucket. While welcome news after five consecutive years of losses, this quarterly profit and even an anticipated full year profit does not make up for the string of losses, $13 billion over the last five years, or the need for capital expenditures of more than $75 billion in the remaining years of the decade. We need a string of profits to make a dent in the industry's balance sheets.

It has been nearly two years now since the Administration and Congress established the National Commission to Ensure a Strong Competitive Airline Industry. In the spring of 1993, the industry had just finished reporting what many termed "staggering losses," which at that time totaled almost $10 billion. When the Commission issued its final report to Congress and the Administration in August 1993, one of its major conclusions was that the amount of taxes imposed on our industry has impeded our ability to return to financial health. The Commission stated:

> **"We believe those (tax) provisions violate responsible principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden."**

Thus it is with some chagrin, that the industry finds itself once again in the position of needing to address proposed changes to the tax code which would adversely affect the environment in which we operate. In addition, the airline industry is battling to repeal the new 4.3 cent-per-gallon tax on commercial aviation jet fuel scheduled to come into effect October 1, 1995. As I testified before this committee's Oversight Subcommittee on May 9 of this year, this new tax could have a devastating impact on the financial well-being of our industry.

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*ATA member carriers include: Alaska Airlines, Aloha Airlines, American Airlines, American Trans Air, America West Airlines, Continental Airlines, Delta Air Lines, DHL Airways, Evergreen International Airlines, Federal Express, Hawaiian Airlines, KIWI International Air Lines, Midwest Express Airlines, Northwest Airlines, Reeve Aleutian Airways, Southwest Airlines, Trans World Airlines, United Airlines, United Parcel Service, and USAir. ATA associate members include: Air Canada, Canadian Airlines International, and KLM-Royal Dutch Airlines.

Once again, we are discussing a series of proposals which would exacerbate the financial strains on the industry and add to the tally of jobs lost in the airlines, aircraft and engine manufacturers, and the travel and tourism industries.

Deduction for regularly scheduled air transportation limited to normal tourist class fare

The first proposal we wish to address amends the Internal Revenue Code to deny a business deduction for that portion of the cost of an airline ticket in excess of coach fare. While the proposal will be directed at the business traveler, the true burden will fall upon the airline industry itself. To the extent flyers switch to coach, as a result of the enactment of this proposal, the government does not gain any revenue and the airline industry loses much needed revenue. Assuming all business travelers who would otherwise travel in business or first class switch to full fare coach class, the U.S. airline industry would lose $220 million per year and would in all likelihood lay off several thousand flight attendants. In actual practice, we do not know, however, whether those business travelers who would currently travel in business or first class will switch to a coach seat. Some may, in fact, choose to charter aircraft at greater cost to the Treasury and injury to the airlines.

This proposal is particularly objectionable to ATA member airlines because it arbitrarily singles out 1) travel from all other business expenses and 2) air travel from all other travel. The proposal clearly and unfairly targets the airline industry. Deductions for business expenses for other sectors of the travel industry such as hotels, cruise lines, trains and rental cars are not impacted by this proposal even though different classes of service can be purchased in each and every one of those travel industry services. Why should the airline industry, which has been hemorrhaging since the beginning of this decade, be the only travel industry component that must bear the cost of this proposed change in deduction policy?

Mr. Chairman, travel in business or first class is not undertaken on a lark by business travelers. Many businesses allow their employees to travel in first class or business class of an airplane because the seating and table space are more conducive to work. Oftentimes corporate policies limit the use of first or business class only to flights of greater duration or distance. Such travel is particularly preferred by business travelers on international flights. In general they can rest more comfortably and be better equipped to handle their responsibilities at their international destination. In each of these situations the business traveler has made a legitimate business decision to purchase extra space in which to work or sleep while traveling.

The proposed change limiting the deductibility of fares in excess of "tourist class" will have a devastating effect upon the revenue generated by the class of service. A far higher proportion of passengers in a first class cabin have paid the full fare for their seats than passengers in coach. Moreover, the average yield for a first class passenger is 17% higher than that for a coach class passenger. Consequently, driving passengers out of the first class cabin will appreciably harm airline revenues and will place additional pressure on airlines to cut flights, reduce their work forces, and diminish capital expenditures, especially aircraft orders. There does not appear to be any rationale to disallow an otherwise lawful business expense deduction and penalize an otherwise commonly accepted business practice.

In addition, Mr. Chairman, from a tax policy standpoint, the proposal should not be adopted because of its clear propensity to distort competition in the marketplace. Deductions for travel on charters, corporate aircraft, or airlines which offer only one class of service are not limited by the legislation. Thus airlines which offer multiple classes of service and thereby respond to different consumer needs, would be penalized, and, first class only-carriers, rewarded.

From an administrative perspective, the proposal would be an accounting nightmare. It would create a layer of complexity both for taxpayers and the Internal Revenue Service. Business travelers, corporate travel departments and the IRS will be forced to monitor not only the first-class fare paid but also the coach price of a ticket for the flight taken and the availability of a coach seat. Identification of the cost of a coach ticket is not easy in the competitive air travel market. The price of a coach ticket may change numerous times between the time the traveler makes his reservation and the time he takes his flight. By the time a company is audited, a reliable data source identifying the difference between the coach fare and the first class fare is unlikely to exist.

Further compounding the problem would be the situation faced by a last minute traveler whose only means of access to a specific flight is the purchase of a first class ticket. Under the terms of the legislation, a business deduction would not be available for the difference between the first class and coach class ticket.

For these reasons, the Air Transport Association strongly opposes this legislation and recommends that the proposal not be adopted because of its negative impact upon the airline industry, the traveling public, and the federal government.

Increase deductibility of business meal expenses for individuals subject to Federal hours of service limitations

The second proposal we wish to address increases the deductibility of business meal expenses for individuals subject to hours of service limitations. This is a step in the right direction. An increase in the amount allowable as a tax deduction for payments of per diem expenses to airline pilots and flight attendants is warranted.

The current deduction limitations unfairly penalize the airline industry which must provide per diem expenses to its 148,000 pilots and flight attendants. The per diem expenses are designed to offset the high cost of meals incurred by flight crew members who are required by reason of the safety related aspect of their jobs to remain away from home. The limitations on tax deductions for meal expenses has resulted in a loss to the commercial airlines of over $234 million in deductions in 1994 for per diem expenses paid to pilots and flight attendants for overnight travel.

The per diem expense reimbursements are required in connection with the operation of the airline business. Our pilot and flight attendant flight schedules are arranged to meet an airline's operational needs subject to the hours of service limitations established by the Department of Transportation. The hours of service limitations mandate the provision of a rest period for safety reasons after the performance of a specified number of hours of flight time. As a result, our flight personnel must stay overnight, away from home, in connection with the performance of their jobs. The airlines provide per diem expense reimbursements to cover the cost of meals consumed during these mandatory non-flight periods.

Airline per diems are not lavish. The amounts paid are moderate and subject to negotiation with the pilot and flight attendant unions.

Congress has recognized the need to provide an exception to the deduction limitation rules for meals provided to crews of commercial vessels operating on the Great Lakes, the Saint Lawrence Seaway and inland waterways as well as crews of certain drilling rigs even though these employees are not subject to Federally imposed safety-related hours of service limitations. However, no similar exceptions are provided with respect to the payment of per diems to airline crews.

Airline per diems should be distinguished from the meal expenses targeted by Congress when the deductions were enacted in 1986. We urge the Committee to approve this revenue change and to amend its provisions to provide for full deductibility of per diem expenses provided to pilots and flight attendants by the commercial airlines. In addition, the law should be drafted to insure increased deductibility for 1995 per diem expense payments to flight attendants who were only recently covered under federal hours of service limitation rules. We have attached a re-draft of the law to cover these points.

Treat kerosene as a diesel fuel for excise tax purposes

The final proposal we wish to address is the treatment of kerosene as a diesel fuel for excise tax purposes. The airline industry is concerned that this proposal will increase the risk of an accidental mixing of dyed kerosene with commercial jet fuel. Dyed fuel cannot be safely used in commercial jet engines. While we are sympathic to the government's needs to address the tax evasion that exists with respect to kerosene fuel, we urge the Committee to consider other alternatives prior to enacting this provision.

Mr. Chairman, thank you for allowing me to submit the airline industry's views on the above proposals. The airline industry faces many hurdles as it tries to return to profitability. It does not need to face additional costs resulting from new tax rules which impact its business operations and expenses.

ATTACHMENT

AIR TRANSPORT ASSOCIATION OF AMERICA
RECOMMENDED VERSION OF H.R. 1003

(3) SPECIAL RULE FOR INDIVIDUALS SUBJECT TO FEDERAL HOURS OF SERVICE AND COMMERCIAL AIRLINES—The amount allowable as a deduction under paragraph (1) shall not exceed 100 percent (instead of 50 percent) of the amount of any expense for food or beverages (or, if lesser, the portion of the applicable Federal meals and incidental meals and incidental expenses per diem rate) consumed by (i) a flight or cabin crew member employed by a commercial air carrier and receiving a per diem amount; or (ii) an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation.

STATEMENT OF WILLIAM P. McCLURE

Submitted in Connection With the July 11 and 12, 1995 Hearings in Connection With Miscellaneous Tax Reforms

Before the U.S. House of Representatives Committee on Ways and Means

On behalf of Allied Capital Corporation, 1666 K Street, N.W., Suite 901, Washington, D.C. 20006 (202) 331-1112, I urge that the Internal Revenue Code be amended to repeal the so-called "short-short" test in section 851(b)(3) for regulated investment companies ("RICs"). Repeal of the short-short test of section 851(b)(3) was included in H.R. 11, which was vetoed by President Bush in 1992, and was included in H.R. 3419, the Tax Simplification and Technical Corrections Act of 1993, which was not enacted.

Under the short-short test, a corporation that derives more than 30 percent of its gross income from short-term trading in stocks, securities, options, or similar securities loses its status as a RIC. This rule has been defended on the grounds that it protects mutual fund investors from risky short-term trading activities by RICs. Our securities laws, however, are better suited to protect mutual fund investors against abuses arising from the trading activities of RICs by requiring the disclosure of the RICs' investment objectives and practices and by prohibiting the "churning" of investments to generate fees or commissions. Moreover, the rule against short-term trading may actually increase mutual fund investors' risks because it sometimes makes it difficult for RICs to dispose of investments that are losing value and restricts their use of options to hedge against such losses.

I also strongly urge that the short-short test of section 856(c)(4), applicable to real estate investment trusts ("REITs"), be repealed. Under section 856(c)(4), a corporation will not qualify as a REIT for any taxable year in which 30 percent or more of its gross income is derived from the sale or disposition of (1) stock or securities held for less than one year, (2) real estate held for sale to customers or held as inventory, and (3) real estate (including mortgages on real property) held for less than four years.

I am especially concerned about two situations in which a REIT may realize short-term gains that are not attributable to any short-term trading activity of the REIT. The first situation is where a REIT purchases a mortgage at a discount from its face amount and the obligor prepays the mortgage. In that event, the REIT realizes gain, but the gain was triggered by the borrower, not by the REIT. No purpose is served by penalizing a REIT just because a borrower prepays a mortgage.

The second situation that concerns me is the gain that a REIT may realize when it restructures the terms of a mortgage that it has purchased at a discount. Restructuring the debt so that the borrower can repay the mortgage can result in a deemed taxable exchange of the old mortgage for the restructured mortgage and the REIT could recognize gain. No good purpose is served by penalizing a REIT because it has restructured the terms of a mortgage to assist the borrower.

Therefore, I strongly urge that the short-short test of section 856(c)(4) also be repealed.

TESTIMONY OF AMERICAN BANKERS ASSOCIATION

Miscellaneous Tax Proposals
Committee on Ways and Means
U.S. House of Representatives

Capital Gains

The ABA supports legislative efforts to reduce the tax rate on capital gains. Capital gains relief is necessary in order to increase capital formation, stimulate saving and investment, raise real wages for U.S. workers and boost economic growth in the U.S. The banking industry would be encouraged to invest in venture capital businesses due to the lowered cost of U.S. capital.

4.Restore exception to market discount rules for tax-exempt bonds

The ABA supports repeal of the 1993 OBRA provision that changed the tax treatment of market discount on municipal securities from capital to ordinary. This provision has caused a dramatic decrease in liquidity and created inefficiencies in the market for municipal bonds traded at a discount.

Corporate

2. Lengthen corporate capital loss carryover from 5 to 15 years

The ABA supports the proposal to allow an extension of the capital loss carryforward from 5 to 15 years. Permitting corporations to carryforward capital losses to 15 years is an equitable means of linking capital gains and losses in certain transactions.

4. Provide exception to large corporate interest underpayment rules

The ABA supports the miscellaneous proposal that would exempt the large corporate underpayment rate to adjustments for loss or credit carried to a year subject to the underpayment rate. We believe that clarification and corrective action as it relates to adjustments to a loss or credit that is carried to a year in which the underpayment rate applies is necessary.

Education

2. Adopt education savings accounts

The ABA has long supported legislative efforts that promote savings and investment in America's future, including educational savings. We have previously testified and expressed ABA's support to the Committee on Ways and Means for the American Dream Savings Account in H.R. 1215 as an important first step toward recognizing that we must provide incentives for individuals to save more. ABA continues to express support for tax-advantaged savings vehicles, such as the educational savings account and IRAs that increase long-term savings and provide for certain financial needs.

Empowerment Zones

2.Tax incentives for economic recovery in designated areas with employment loss in financial and real estate businesses.

Current law rules restrict tax incentives for investments in economically depressed areas (such as empowerment zones) to an approved list of business activities. This amounts to "credit allocation" of a form that the ABA has long opposed. Investors and not

Congress or government officials should be permitted to choose which firms or activities in which they want to invest so long as an appropriate economic benefit is provided. This proposal would expand the list of approved investments to include financial and real estate businesses, bedrocks of any healthy local economy.

Foreign

12. Treatment of foreign base company sales and services income of controlled foreign corporations in the European Community.

H.R. 1690, introduced by Congressmen Houghton and Levin, contains a provision which would treat the European Union as a single country for certain types of foreign base company income. This provision, which recognizes the current status of the EU as a borderless economic unit, should be expanded to include foreign personal holding company income. US banks with European operations are reorganizing to take advantage of the single market just as US manufacturers are doing. Treating the EU as a single country for banking income would be a tremendous aid to US banks wanting to expand their European subsidiaries to permit them to provide financial services to their US business customers and others. This provision of H.R. 1690 is laudable, but would be made even better by this expansion.

19. Exception from foreign personal holding company income and foreign base company income for active financing income.

A very important provision of H.R. 1690, introduced by Congressmen Houghton and Levin, would restore an active banking and financing income exception to Subpart F.

Under the Tax Reform Act of 1986, interest, dividends and gains from the sale of stock and securities and other income from investments received by a controlled foreign corporation are subject to current tax as subpart F income even if received in the conduct of an active banking business. In essence, income from active banking activities, unlike income from active manufacturing activities, is treated like passive income. This provision imposes substantial costs and administrative burdens on banks because the activities and income of their many foreign subsidiaries must run through the U.S. tax return.

Inclusion of such income as subpart F income under the Tax Reform Act of 1986 was premised upon Congressional concern that interest, dividends and gains on the sale of stock and securities are "inherently manipulable," and therefore U.S. taxpayers had "excessive opportunities" to route such income through foreign tax havens to maximize U.S. tax benefits. See, e.g., H.R. Report No. 99-426, 99th Cong., 1st Sess. 393 (1985). Essentially, Congress concluded that because banking income largely consists of interest, dividends and stock and securities gains, that banking income, whether or not earned in an active business by a bona fide bank, must be regarded as passive, and therefore subpart F income.

The Tax Reform Act of 1986 itself recognizes the fallacy of such a conclusion in the Passive Foreign Investment Company provisions (sections 1291, et. seq). The provision requires a determination of whether a corporation is a PFIC based on the amount of "passive income" earned. However, for this purpose, Congress explicitly excepted income from "bona fide banks." In other words, another provision in the very same legislation that subjected all banking income to subpart F taxation carved out income earned by foreign "bona fide banks" as not constituting "passive income." Section 1296(b)(2)(A) of the Internal Revenue Code.

Section 5(a) of H.R. 1690, however, takes a different approach to the problem of separating bona fide banks and financing companies from sham entities. The bill would apply the exception only to income earned in the country in which the subsidiary corporation is organized. This "same country" limitation is arguably designed to address the "excessive opportunity" problem noted above, but unfortunately fails in this task.

If the goal of the provision is to isolate active from passive income, a same country exception misses the mark by focusing only on geography and not the type of activity that generated the income. Limiting the definition of "good" banking income in this way is also contrary to global business trends, especially in regions like the European Union, where financial transactions regularly occur across national boundaries. Furthermore, if a bank were required to have a separate subsidiary (or even a branch) in every country in which it wished to do business, it would have to set aside capital for each such unit, an expensive and inefficient exercise. Most importantly, this limitation would be a burden on U.S. banks alone; none of our trading partners imposes a similar rule on its banks. Thus, a same country limitation would end up benefiting few if any US-based banks in their drive to compete globally. The result would be that US manufacturers and other corporate consumers of business credit would find it harder to arrange financing abroad because of the continuing dearth of US-based banks.

The solution to the problem of separating income derived from the active conduct of a banking business from income derived from a passive activity is one that the ABA is very interested in pursuing with the sponsors of H.R. 1690 and others. One alternative would be to simply borrow the "bona fide bank" test of the PFIC rules. Another might be to test a bank's active status by the percentage of its income derived from unrelated customers. Each of these alternatives and more should be reviewed so that this legislation serves its goals of reducing US tax compliance burdens for US firms operating overseas while ensuring that each pays its fair share of US tax.

ABA supports restoring the active banking exception to foreign personal holding company income and foreign base company income with appropriate limitations.

26. Repeal portfolio interest exemption.

U.S. capital markets receive significant foreign investments in government and corporate debt of all kinds, as well as in a variety of asset-backed securities including mortgage, auto, home equity, and small business loans. The proposal would reinstate the U.S. 30 percent withholding tax (or a lower treaty rate if applicable) on such investments. Such a tax hike on foreign investors would have very detrimental impact as investors took their cash elsewhere. The real victims of this would be American consumers who would face roiled financial markets, a lack of liquidity, and higher borrowing costs as interest rates skyrocketed. Reimposing the US withholding tax on these investments would be wrongheaded and hurt US citizens, not foreign investors. ABA strongly opposes repeal of the portfolio interest exemption.

<u>Pass-through entities</u>

1. Subchapter S reform proposals to expand availability of Subchapter S and improve its operation

The ABA supports Subchapter S reform and expansion proposals, particularly expanding of the types of eligible shareholders. We strongly support the proposal to allow financial institutions to be an eligible small business corporation that may elect to be treated as an S corporation. However, we oppose restrictions on the availability of bad debt deductions for both small and larger banks that are required under the proposal in order to elect S corporation treatment. Smaller community banks would be discouraged from electing S corporation treatment and the proposal's conditional requirements creates a competitive disadvantage for smaller banks.

3. Establish financial asset securitization investment trusts (FASITS)

The FASIT is a pass-through securitization vehicle for all types of debt, especially revolving debt like home equity loans, small business lines-of-credit, and various consumer debt. The proposal raises nearly $100 million over 7 years by requiring the banks and other lenders that will use it to recognize the present-value of the income from

the assets contributed to the FASIT at the time that the FASIT issues debt instruments to investors. The proposal will help promote securitization, which in turn will improve the safety and soundness of the banking system by transferring assets from bank balance sheets to those of investors around the country. It will also improve liquidity in the banking system by permitting banks to turn assets into cash following the sale of FASIT interests to investors. A bill to create the FASIT, H.R. 1967, currently has 28 House Ways and Means cosponsors, including a majority of members of both parties.

5. Package of proposals to simplify and improve REIT provisions

ABA supports reform of the REIT provisions. Increasing the number and types of investors in REITs greatly assists in the recapitalization of commercial real estate. Simplification and improvement traps removes traps from the unwary that ABA supports.

6. Allow Bank Common Trust funds to be transferred to more than one mutual fund without taxing trust beneficiaries

Banks for many years have operated pooled investment vehicles called common trust funds to achieve economy, efficiency and investment diversification for their trust accounts where the bank serves as executor, trustee, administrator or guardian. Common trust funds are statutorily exempted from the registration requirements of the Securities and Exchange Commission if only the bank's trust customers are invested in the common trust fund. The common fund itself is tax-exempt, passing taxable income through to the participating trust accounts, provided the fund meets the requirements of Section 584 of the Internal Revenue Code. The common trust fund is extensively regulated by banking regulators.

In recent years there have been a growing number of banks who wish to convert their common trust funds into mutual funds. In a conversion, the assets of the common trust fund are transferred into or invested in shares of a mutual fund. The mutual fund may be a fund that the same bank serves as investment adviser. This type of mutual fund is commonly known as a private label or proprietary mutual fund.

There is an issue which has, in many cases, blocked the conversions of common trust funds into mutual funds. It has not been determined by the IRS whether an exchange of common trust fund assets for proprietary mutual fund shares would be considered to be a "sale". If it is considered a sale, the trust accounts which are investors in these funds, would have to pay taxes on any capital gains that have been built up within the common trust fund. This is true even though the conversion is similar to the merger of two existing registered funds which allow securities to move intact from one fund to another without being considered a "sale".

The Bush Administration introduced language in its proposal on banking reform several years ago, which stated that such a conversion from a common trust fund to a mutual fund will not result in a recognition of a gain or loss to the participants in the common trust fund. That language was added to H.R. 11, the Revenue Act of 1992. Unfortunately, that bill was vetoed in November 1990 by President Bush. The provision re-appeared as a simplification measure which was contained in H.R. 13, introduced by Dan Rostenkowski, on January 5, 1993. It was re-introduced by Rostenkowski, on November 1, 1993 in H.R. 3419, the "Tax Simplification and Technical Corrections Act of 1993". This bill was passed by the House of Representatives in May of 1994. A slight modification to the bill was introduced on November 11, 1993 by Congressmen Coyne, Jacobs, Neal, Hoagland and Brewster. This bill, H.R. 3631 would allow a bank to convert its common trust fund assets into one or more mutual funds without incurring any capital gains tax on the transfer. Recently, Senators Roth and Baucus on July 13, 1995 introduced S. 1032. This legislation would permit a bank to convert into one or more than one mutual fund without tax consequences to participants.

The passage of this provision would allow each bank customer, retail as well as trust, to have additional investment choices. It also will allow banks to stay competitive by giving their customers the mutual funds that bank customers are requesting. By allowing the conversions under this legislation, bank's trust customers will see a reduction of investment risk and, in some cases, increased total investment returns because the investment vehicles will be larger, more diversified and efficient investment pools.

The ABA strongly supports passage of legislation that would allow a bank common trust fund to convert into mutual funds without tax consequences to the participants of the common trust fund.

Pensions and employee benefits

10. H.R. 682 ("Savings and Investment Incentive Act of 1995")

The ABA has consistently supported efforts to revitalize individual retirement accounts (IRA's) to encourage long-term personal savings and investment. Studies have shown that the level of personal savings in America has declined significantly over the past few decades. As a result of this trend, individuals are less prepared to meet a variety of financial needs such as the purchase of a home, tuition, medical expenses and an adequate retirement income. In order for a product to be successful and appealing, the ABA believes that it must satisfy three criteria: it is simple to understand; its eligibility requirements provide for a much greater number of participants than current law allows; and it is generally flexible. H.R. 682 satisfies this criteria.

Tax-exempt bonds

12. Modification of Exception to Bank Interest Deduction Disallowance for Qualified 501(c)(3) Bonds

Specifically, the proposal would modify the small issuer exception to allow 501(c)(3) organizations that did NOT borrow[1] more than $5 million in any calendar year to qualify its bonds under the small issuer exception regardless of the amount issued by the governmental unit under whose authority the bonds of the 501(c)(3) organization are sought to be issued. By excluding debt obligations of certain qualifying 501(c)(3) organizations from the overall $10 million cap, both qualifying 501(c)(3) organizations and certain larger governmental issuers will now qualify, under this proposal, as small issuers.

While the ABA is most appreciative of these and other efforts undertaken by this Committee to increase liquidity and depth in the tax exempt securities market, these efforts do not, unfortunately, go far enough. Commercial bank investment in municipal securities has declined dramatically as the interest expense banks could claim has been reduced. In 1980, banks held 41% of all tax exempt securities, but by the end of 1994 that figure had dropped to 9.6%. This decline has continued into 1995.

Communities that qualify as small issuers enjoy a yield advantage over larger issuers. That yield advantage is generally in the range of 20 to 30 basis points, but can be much higher. Increased yield equals increased demand. Increased demand results in lower borrowing costs for the issuing municipality.

Over the intervening years, the borrowing needs of small communities have grown, the $10 million limit has, however, remained frozen at previously established levels and fewer and fewer communities can take advantage of the small issuer exception. The Anthony Commission Report recommended that the cap itself be raised and, at least 19 different

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[1] The term "borrow" should be clarified, the ABA would submit. Borrow can be used to mean raising capital on a more permanent basis such as issuing debt obligations. It can also mean, borrowing for short-term funding purposes by using reverse repurchase agreements.

trade associations representing state and local government officials support raising the $10 million limit. We join them and urge this Committee to raise the limit and consider indexing the amount in the future.

While the ABA supports the proposal to modify the small issuer exception to exclude from the $10 million cap those bonds issued by or on behalf of governmental units by

certain qualifying 501(c)(3) organizations, the ABA would strongly urge the Committee to raise the cap for all small issuing communities.

POSSIBLE MODIFICATIONS OF SIMPLIFICATION PROVISIONS CONTAINED IN H.R. 3419 (103RD CONGRESS)

Provisions Relating to Individuals

1. Permit payment of taxes by credit card (section 112 of the bill)

"Consideration is being given to clarifying that the fees that may be imposed for using a credit card to pay Federal taxes could not be borne by the Federal government."

ABA opposes any attempt by the Federal government to legislate the benefits of the credit card payment system for free. This system, developed by the banking industry over a period of many years and billions of dollars in investments, would provide the Federal government with certain benefits it does not now enjoy in the collection of taxes, including same day payment, transfer of credit risk, and the ability to accept payments electronically. Any private sector firm wishing to make use of this system must pay a fair price; the Federal government should be treated no differently. Market forces and business considerations should determine the price paid for credit card services, not Federal legislation.

TESTIMONY OF AMERICAN BANKERS ASSOCIATION TRUST FUND

The American Bankers Association's Trust Division ("ABA") is pleased to submit this written testimony on the issues which have been gathered together by Chairman Archer under the heading of Miscellaneous Tax Reforms. The ABA supports a number of these issues which we feel will simplify and improve the current tax laws.

The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about 94 percent of ABA members are community banks with assets less than $500 million.

The ABA's Trust Division represents approximately 3000 banks that actively engage in trust activities. These trust or fiduciary activities are in the areas of personal, employee benefit and corporate trust. These approximately 3000 banks administered $10.6 trillion of assets as of December 31, 1993 or more than three times the banking industry's on-balance sheet assets.

High Priority Items for the American Bankers Association's Trust Division

I. Z. Pass-through Entities

6. Allow Bank Common Trust funds to be transferred to more than one mutual fund without taxing trust beneficiaries

Banks for many years have operated pooled investment vehicles called common trust funds to achieve economy, efficiency and investment diversification for their trust accounts where the bank serves as executor, trustee, administrator or guardian. Common trust funds are statutorily exempted from the registration requirements of the Securities and Exchange Commission if only the bank's trust customers are invested in the common trust fund. The common fund itself is tax-exempt, passing taxable income through to the participating trust accounts, provided the fund meets the requirements of Section 584 of the Internal Revenue Code. The common trust fund is extensively regulated by banking regulators.

In recent years there have been a growing number of banks who wish to convert their common trust funds into mutual funds. In a conversion, the assets of the common trust fund are transferred into or invested in shares of a mutual fund. The mutual fund may be a fund that the same bank serves as investment adviser. This type of mutual fund is commonly known as a private label or proprietary mutual fund.

There is an issue which has, in many cases, blocked the conversions of common trust funds into mutual funds. It has not been determined by the IRS whether an exchange of common trust fund assets for proprietary mutual fund shares would be considered to be a "sale". If it is considered a sale, the trust accounts which are investors in these funds, would have to pay taxes on any capital gains that have been built up within the common trust fund. This is true even though the conversion is similar to the merger of two existing registered funds which allow securities to move intact from one fund to another without being considered a "sale".

The Bush Administration introduced language in its proposal on banking reform several years ago, which stated that such a conversion from a common trust fund to a mutual fund will not result in a recognition of a gain or loss to the participants in the common trust fund. That language was added to H.R. 11, the Revenue Act of 1992. Unfortunately, that bill was vetoed in November 1990 by President Bush. The provision re-appeared as a simplification measure which was contained in H.R. 13, introduced by Dan Rostenkowski, on January 5, 1993. It was re-introduced by Rostenkowski, on November 1, 1993 in H.R. 3419, the "Tax Simplification and Technical Corrections Act of 1993". This bill was passed by the House of Representatives in May of 1994. A slight modification to the bill was introduced on November 11, 1993 by Congressmen Coyne, Jacobs, Neal, Hoagland and Brewster. This bill, H.R. 3631 would allow a bank to convert its common trust fund assets into one or more mutual funds without incurring any capital gains tax on the transfer. Recently, Senators Roth and Baucus on July 13, 1995 introduced S. 1032. This legislation would permit a bank to convert into one or more than one mutual fund without tax consequences to participants.

The passage of this provision would allow each bank customer, retail as well as trust, to have additional investment choices. It also will allow banks to stay competitive by giving their customers the mutual funds that bank customers are requesting. By allowing the conversions under this legislation, bank's trust customers will see a reduction of investment risk and, in some cases, increased total investment returns because the investment vehicles will be larger, more diversified and efficient investment pools.

ABA Position: The ABA strongly supports passage of legislation that would allow a bank common trust fund to convert into mutual funds without tax consequences to the participants of the common trust fund.

II. EE. Trusts and Estates

1. Income Tax Rates applicable to trusts and estates

The Revenue Reconciliation Act of 1993 perpetuated and increased a discriminatory effect against two types of entities that impact families of all income levels in the United States. It not only increased the income tax rates for estates and trusts but again sharply compressed the tax brackets resulting in higher rates of tax for these entities.

What has occurred since the passage of the Tax Reform Act of 1986 and continued with OBRA '91 and OBRA '93, is that funds which are income for an estate or trust are subject to tax at the maximum rate than if those same funds were passed through the trust or estate and were in the hands of individuals who would also have to pay income tax on those same funds. It is only the fact that these monies are income for an estate or trust rather than an individual which subjects them to a much higher rate of tax.

One of the reasons bankers are concerned about this issue is that they have to make the distribution decisions regarding funds contained in trusts or estates. There are many good reasons for holding money within the trust or estate rather than distributing to beneficiaries. Unfortunately, under the current tax law, those good reasons must be weighed against the negative tax consequences. Whatever decision the bank trust department makes may subject them to potential second-guessing by beneficiaries.

ABA Position: The ABA strongly supports H.R. 329 which was introduced by Jim McCrery (R-LA) on January 4, 1995.

III. P. Estate and Gift Tax

8. Proposals to Simplify and Improve estate and gift taxation
   a. Equal treatment for individuals who utilize revocable trusts
      (1) Set-aside deduction (Code sec. 642(c)

Section 642(c) provides for a deduction for estates or trusts for amounts paid for a charitable purpose, it also allows a deduction for an estate for amounts permanently set aside for a charitable purpose. It is clear that estates are permitted a deduction in situations where a trust may not. The reasoning behind this incongruity is the assumption that all trusts will hold funds earmarked for a charitable purpose for a long period of time while estates will make the funds available to the ultimate charitable beneficiaries much sooner.

The Tax Reform Act of 1969 changed the preexisting rule that both trusts and estates were allowed a deduction for amounts permanently set aside for charitable purposes. After passage of the Act only certain trusts which where in existence before 1969 were permitted to enjoy the benefit of the old rule. The new limitation on the use of the deduction for trusts appears to be related to the changes in the 1969 Act concerning private foundations. Congress felt that private foundations were taking an immediate deduction for charitable contributions but were not distributing significant amounts of their income to the charitable beneficiaries. In order to avoid circumvention of the new rules relating to private foundations, Congress decided that changes were needed to force trusts to distribute their income to the charitable beneficiaries if a deduction for a charitable contribution was sought. In this manner, the rules regarding private foundations could not be circumvented by shifting to a trust format.

ABA Position: ABA strongly supports extending the set-aside deduction to revocable trusts. The reasoning behind the different treatment for estates and trusts is not justified under present circumstances.

c. Repeal of income-shifting provisions (i.e. throwback rules (Code secs. 665-668, capital gains (Code sec. 644))

To forestall any possibilities of tax avoidance, Congress in 1954 adopted a concept known as the "throwback" contained in IRC 667. The throwback rules generally treat a trust beneficiary who receives a distribution of funds that had been held in the trust over a period of years as if the beneficiary had received the distributed amounts in the year or years in which they were deemed

income to the trust.

The purpose of the throwback rules is to prevent avoidance of income taxes through the accumulation of income in one or more trusts at income tax rates which may be lower than the rates at which the beneficiary of the trust would pay if the money had been distributed to the individual from the trust.

Although the throwback rules have been successful in their mission in the past, the need for them has been eliminated. The reason is quite simple, since the passage of the Tax Reform Act of 1986, funds which are income for an estate or trust are subject to more tax than if those same funds were passed through the trust or estate and were in the hands of individuals who would also have to pay income tax on these same funds.

Bank trust departments would like to see the throwback rules eliminated because it would simplify the tax code and it would simplify the operations area of the trust department. The throwback rules are costly for trust administrators in terms of the time it takes to accumulate and input the necessary information and for the implementation of computer systems capable of making the necessary calculations and for the maintenance of all the data which must be gathered and maintained over a period of many years in order to calculate the income tax.

The same reasoning for repeal of the throwback rules can be applied to the repeal of IRC Section 644. This section gives a special tax rule when property is transferred to a trust and later sold by the trust at a profit when the sale occurred less than two years after the date the property was transferred to the trust. The special tax imposed on the trust on the profit from the property sale is at the same tax rate as that of the individual who transferred the property to the trust.

The Section 644 rule presents difficulties to bank trust departments as information must be gathered from grantors with whom the bank may no longer have contact with in order to comply with the rules under Section 644. Computer systems must also be established to make the required calculations to determine what tax payment is required for the trust.

ABA Position: ABA strongly supports the repeal of the throwback rules (Sections 665-668) and the Section 644 Rule. The rules are no longer needed due to the increase in the income tax rates for trusts and the compressions of the brackets.

9. Require Notification to Charitable Beneficiaries of Charitable Remainder Trusts

This legislation would require notice in a particular format and a copy of the will or the document setting up the trust, to be sent by executors to the charitable remainder beneficiaries to inform them of their interest in the charitable remainder trust. It would also require copies of the tax returns of those trusts be sent by the trust fiduciary to the charitable beneficiaries on a continuing basis that could extend for many years in the future.

The information that the charity would receive under the legislation is more than what most family members are provided unless they are directly involved in the administration of the trust or the estate. If the executor of the estate or the fiduciary of the charitable remainder trust fails to provide the information within the time periods allowed, penalties will be assessed. The penalties and notice requirements apply if the executor or fiduciary is an individual or a corporate entity.

This legislation or H.R. 32 introduced by Congressman Gibbons (D-FL) on January 4, 1995 will cause some individuals to discontinue utilizing these vehicles for charitable giving because of the disclosure requirements. The bill will require information to be given to charities which is private and confidential. This is information about the donor and his or her family which they may not want to give to outside parties. Finally, such notification to the charities may subject donors and their family members to unwanted charitable solicitation.

ABA Position: ABA strongly opposes this legislation and H.R. 32 introduced by Congressman Gibbons on January 4, 1995.

IV. BB. Pensions and Employee Benefits

8. Deny Federal Tax Information to states imposing a pension source tax.

Our mobile society has given rise to a state income tax issue that many people believe should be

resolved by federal legislation. There are several bills which have been introduced that would prohibit states from imposing income taxes on retirees who earned their pension income in that state but have since moved to another state.

Such source-taxing requires the collection, maintenance, and reporting of "state-earned" information, a task that is magnified when a retiree, during the course of his career, has held several jobs in several different states.

Aside from the concerns about tax fairness and the burden on retirees, source-taxing pension income presents a recordkeeping nightmare for pension plan sponsors and banks who act as recordkeepers and trustees for these plans.

There are three levels of concern associated with states taxing non-resident pension income: 1) Are plan sponsors or their consultants able to maintain sufficient records to determine what portion of a pension income belongs to a given state?; 2) Even if the plan sponsor has the ability to split the benefit by "state earned" this may be further aggravated by municipalities implementing their income tax on the same convoluted bases; 3) For those plan sponsors who can furnish the "state earned" information, does the bank have the ability to maintain the breakdown for two or more states within each payment so that the proper tax amounts can be withheld and reported at year end by the payor to each state? Most banks do not.

ABA Position: The ABA strongly supports this proposal as well as H.R. 394 introduced by Barbara Vucanovich (R-Nev) on January 4, 1995.

V. II. Possible Modifications to Simplification Provisions Contained in H.R. 3419 (103rd Congress)

2. Pension Simplification
   a. Tax-exempt Organizations eligible under Section 401(k)

Congress has always believed that qualified cash or deferred vehicles should not be the primary employer-maintained retirement plan. One way Congress achieved this result was to limit the number of employers that can maintain cash or deferred arrangements. Thus, Congress believed it was necessary to preclude the availability of qualified cash or deferred arrangements to State and local governments and tax-exempt employers.

Enactment of this proposal would assist these employers in attracting and retaining highly qualified individuals. Competitiveness in hiring practices was part of the reasoning for the establishment in 1986 of the Thrift Savings Plan, a tax deferred savings plan for federal employees. In its discussion of the Thrift Savings Plan, the Committee on Government Affairs concluded that a Federal retirement plan should continue to offer incentives to build a career workforce. Any employer must have a cadre of employees to provide stability, continuity and the institutional memory to run an organization effectively.

It would be inequitable to allow corporate America and the federal government to offer these attractive employee benefits and continue to disallow state, local and other tax exempt employers to do so.

ABA Position: The ABA strongly supports permitting nongovernmental tax exempt organizations to offer 401(k) plans.

5. Provisions Relating to Regulated Investment companies
   a. Require brokers and mutual funds to report basis to customers (section 522 of the bill)

H.R. 3419 had a provision that would have required mandatory basis reporting to all shareholders.

ABA Position: The ABA strongly supports the deletion of this issue as industry practice has changed in the last several years.

9. Other Provisions
   a. Treatment of pre-need funeral trusts

The pre-need funeral trust industry was thrown into a tailspin when the IRS issued a series of

technical advice memoranda that stated that each pre-need funeral contract established a grantor trust and that each purchaser of a contract is the grantor of that trust and all trust income is taxed to the purchaser in the year in which it is earned by the trust.

The Service tried to remedy the situation when it is issued proposed regulations on July 21, 1994. Unfortunately it only complicated the situation for bank trustees.

ABA Position: The ABA strongly supports H.R. 1729 introduced on May 25, 1995 by Congresswoman Mink of Hawaii. This legislation would establish the provider of funeral services as the owner of the funds deposited in the funeral trust. All income therefore, would be taxed to the provider of the funeral services rather than the individual who purchases the pre-need funeral contract. This would eliminate the need for the proposed regulations issued by the IRS on July 21, 1994.

Priority Items for the American Bankers Association's Trust Division

I. E. Capital Gains

4. Exempt Tax-Exempt Bonds from treatment as market discount bonds

The Revenue Reconciliation Act of 1993 which expanded the market discount rules to tax-exempt bonds has made life difficult for investment managers of bank common trust funds as well as bank proprietary mutual funds. The unexpected realization of taxable income can provide unpleasant surprises to fund shareholders and participants of common trust funds.

ABA Position: The ABA supports H.R. 843 which would exempt tax-exempt bonds from treatment as market discount bonds. It is our understanding that the gain attributable to accrued market discount generally would be taxable as capital gain.

II. F Charitable Deduction

4. Repeal of Charitable Substantiation Rule for Contributions of $250 or More

ABA Position: The ABA supports this proposal which would repeal the section 170(f)(8) substantiation requirement for charitable contributions of $250 or more. This proposal has created problems for both bank trust departments as well as our member's trust clients. The IRS has apparently recognized some of the difficulties involved as they have issued Notice 95-15 which provides transitional relief for contributions of $250 or more made during 1994.

III. P Estate and Gift Tax

5. Extend the "Predeceased Parent Exception" to collateral heirs and to taxable terminations and distributions

ABA Position: The ABA supports H.R. 1099 which was introduced by Mr. Houghton on March 1, 1995. The bill would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. The bill also would extend the predeceased parent exclusion to taxable terminations and taxable distributions.

8. Proposals to Simplify and Improve Estate and Gift Taxation
   a. Equal Treatment for Individuals who Utilize Revocable Trusts
      (2) 65-day Rule (Code sec. 663(b)

ABA Position: ABA supports the extension of the 65 day rule to estates if the executor has the ability to treat distributions made within 65 days after the close of the tax year as distributions from the previous year. The extra time is needed to determine the actual income of the estate that needs to be distributed, particularly when partnership income is involved. The subject of distributions becomes critical with the current rates on estates and trusts as the beneficiary may be in a lower tax bracket than the estate or trust.

(3) Separate Share Rule (Code sec. 663(c))

ABA Position: ABA supports extending the application of the separate share rule to estates. This will allow equity to executors since there may be situations where a separate and independent share exists within an estate.

(4) Passive Loss Rules (Code Sec. 469 (i)(4)

ABA Position: The ABA supports extending the same 2 year waiver period to post death revocable trusts as many clients choose revocable trusts as an alternative to a probate estate. Clients do this because of privacy. A will is a public document and a revocable trust agreement is not. Another reason is that a revocable trust allows a client to have a trust arrangement in place during his life that will provide continuity in case of illness or disability as well as continue "as arranged" after death.

(5) Sales to Related Persons (Code secs. 267 and 1239)

ABA Position: For the reasons explained above, the ABA supports making the same exemptions applicable to revocable trusts as are available to estates.

(6) Treatment as Qualified Shareholder for Subchapter S Purposes (Code secs. 1361(c)(2) and (d)(3)

ABA Position: For the reasons explained above, the ABA supports the allowance of revocable trusts to be shareholders of S corporations for a two year period after the grantor's death. We understand that the proposal would clarify that distributions to a post death revocable trust by a Qualified Subchapter S Trust (QSST) would meet the requirements of a QSST (Code sec. 1361(d)(3)(B)) that the trust distribute its taxable income annually to the sole income beneficiary of the QSST.

(7) Taxable years (Code sec. 645)

ABA Position: For the reasons explained above, the ABA supports permitting a revocable trust to elect a fiscal year during the period of administration. We understand that the use of a fiscal year for an intervivos trust that will continue after its administration functions will require the filing of an additional tax return for the short year and annualization of the short period income.

(8) Treatment of Gifts from Revocable Intervivos Trusts (Code secs. 2035(e) and 2038)

ABA Position: The ABA supports treating transfers by the predeath revocable trust as if they had been made directly by the trust's grantor. It is inherently unfair that these arrangements be treated for income tax purposes as the property of the grantor and taxed directly to the grantor, yet gifts made from these trusts are not being treated as direct gifts by the grantor.

d. Restore Unified Credit in Case of Split Gifts

ABA Position: The ABA supports this proposal which would restore any unified credit applied to any split gift that is subsequently included in the estate of the donor spouse.

e. Provide for Portability of Unified Credit and GST exemption

ABA Position: The ABA supports this proposal which would allow a surviving spouse to inherit and use any unused unified credit and GST exemption amount of a decedent spouse.

g. Modification of rule relating to Marital Deduction
(1) Allow for Reformation of Defective Marital Trusts

ABA Position: The ABA supports this proposal which would allow the marital deduction with respect to a defective trust if there is a "qualified reformation" of the trust that corrects the defect. We understand that in order to qualify, there must be sufficient evidence that the trust was intended to qualify for the marital deduction, the reformation of the trust should commerce soon after death, and, as part of the reformation, a QTIP election would be mandatory.

j. Modify Rules for Qualified Domestic Trusts (QDOTs)
(2) Modify Non-Estate Tax Consequences of Transfers by Surviving Spouse to QDOT

ABA Position: The ABA supports this proposal which would provide that the transfer of property by a surviving spouse to a QDOT is to be treated as passing directly from the deceased spouse to the QDOT for income and transfer tax purposes.

k. Modification of Generation-Skipping Transfer Tax Rules

ABA Position: The ABA supports all eight listed modifications to the GST rules.

IV. T. Foreign

25. Exempt Certain Short-Term OID obligations held by a non-resident alien from U.S. estate tax

ABA Position: The ABA supports this proposal which would treat any debt obligation the income from which would be eligible for the exemption for short-term OID exclusion under section 871(g)(2) as property located outside of the United States for determining the U.S. estate tax liability of a non-resident who is not a U.S. citizen. This change would clear up the problem caused in 1986 when Congress inadvertently excluded short-term OID obligations from the estate tax relief provided by §2105(b)(3). Currently, there is a trap under which short-term OID obligations owned by foreign investors generate interest which is tax-exempt for income tax purposes but the obligations themselves technically are subject to estate tax. No other debt instruments which are exempt from income tax are subject to estate tax in the hands of a foreign investor.

V. Z. Pass-Through Entities

1. Subchapter S reform proposals.
   d. Certain trusts eligible to hold stock in S corporations

ABA Position: The ABA has a problem with one portion of this proposal. In the "treatment of items relating to S corporation stock" the second paragraph states: "In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit would be allowed for any item other than the items described above." This creates a problem for a trust in a year when distributions are made, particularly in the year of termination of the trust. We would suggest that there should be some provision for income to be taxed to the beneficiaries if distributions are made.

VI. II. Possible Modifications to Simplification Provisions Contained in H.R. 3419 (103rd Congress)

8. Estate and Gift Tax Provisions
   a. Statute of Limitations Applicable to Valuation of Gifts

ABA Position: The ABA supports the idea of enacting a proposal which would provide that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. We also support extending the special rule governing gifts valued under Chapter 14 to all gifts.

TESTIMONY OF AMERICAN BAR ASSOCIATION COMMITTEE ON ESTATE AND GIFT TAXES

COMMENTS ON ESTATE AND GIFT TAX PROPOSALS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

The individual members of the Estate and Gift Taxes Committee of the Section of Taxation who have reviewed the miscellaneous tax proposals currently before the House Ways and Means Committee strongly endorse many of the estate and gift tax proposals. As discussed below, many of the proposals are similar to the simplification proposals which were prepared by individual members of the Section of Taxation and the Real Property, Probate and Trust Law Section in 1991 and then updated in November 1994. A copy of the November 1994 simplification proposals (hereinafter the "Tax Simplification Proposals.") is attached hereto. The proposals currently before the Ways and Means Committee which the individual members regard as most significant are discussed briefly below.

Ways & Means Proposal I.P.5.: Extend the "predeceased parent exception" to collateral heirs and to taxable terminations and distributions[1].

As discussed in Proposal No. 23 in the Tax Simplification Proposals, the "predeceased child exception" under section 2612(c)(2) of the Code should extend to collateral heirs and to taxable terminations and distributions, as well as to direct skips. It is significant to note that the proposed changes do not present opportunities for tax avoidance, since the distributions will be made to a skip person only because his or her parent has died. Thus, no tax avoidance can be planned.

Ways and Means Proposal I.P.8.a.: Equal treatment for individuals who utilize revocable trusts.

We support these proposals to equalize the tax results when an individual chooses to uses a revocable trust for his or her testamentary bequests rather than a will. A "post-death" revocable trust (i.e., a revocable trust after the settlor's death) is generally taxed for income tax purposes in the same quasi-conduit manner as an estate. Unfortunately, the Code contains various provisions that produce different tax results depending on whether one has used a revocable trust or a will as a testamentary device. We believe that in all of these cases, there are no policy reasons for these differences. We strongly support the proposal to eliminate the income tax differences (items (1) to (7) below) as well as the transfer tax differences (items (8) and (9).

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[1]All references to proposals before the Ways and Means Committee refer to the "Description of Miscellaneous Tax Proposals Scheduled for Hearings Before the House Committee on Way and Means on July 11-13, 1995" prepared by the Staff of the Joint Committee on Taxation, issued July 10, 1995 (JCS 19-95) (the "Joint Committee Description").

Each of the post-death revocable trust proposals, briefly discussed below, is discussed in our Tax Simplification Proposal No. 1. We note that our Proposal No. 1, part 5, contains an additional proposal which is not included among the Ways & Means proposals, dealing with marital deduction qualification for gifts and bequests to a spouse's revocable trust. We strongly support that proposal as well. In addition, we note that section 1396a(k)(2) of the Social Security Act (42 U.S. Code) denies Medicaid benefits to any person who is the beneficiary of a trust created by his or her deceased spouse "other than by will." It seems unlikely that Congress intended to discriminate in this way against spouses who use revocable trusts. Since this presents a serious trap for the unwary, we hope that this additional distinction between wills and revocable trusts will be corrected by legislation.

(1) Set-aside deduction (Code sec. 642(c)).

We support treating a post-death revocable trust like an estate and allowing a trust a charitable deduction for amounts permanently set-aside for charitable purposes. This would eliminate a trap for the unwary trustee who is unable to make a payment to the charity until the trust administration has been completed. Exhibit A to our Tax Simplification Proposals contains a 1989 ABA House of Delegates Resolution that fully explains the need for this change.

(2) 65-day rule (Code sec. 663(b)).

We fully support this proposal which permits estates, like post-death revocable trusts, to deduct distributions made in the first 65 days of the taxable year.

(3) Separate share rule (Code sec. 663(c)).

Similarly, we agree with applying the "separate share" rule to estates. This rule presently applies to post-death revocable trusts. Extending this rule to estates would permit fairer tax treatment for estate beneficiaries.

(4) Passive loss rules (Code sec. 469(i)(4)).

We agree with the proposal to extend the two-year waiver of the active participation requirement enjoyed by estates to post-death revocable trusts for the same two-year period. Post-death revocable trusts often face the same difficulties as estates do in satisfying this rule during the administration period.

(5) Sales to related persons (Code secs. 267 and 1239).

Post-death revocable trusts should be granted the same exemption from these "related person" rules that has been granted to estates. We support this proposal which would eliminate significant income tax differences in the funding of bequests depending on whether the bequest was made by a revocable trust or an estate.

(6) <u>**Treatment as qualified shareholder for Subchapter S purposes (Code secs. 1361(c)(2) and (d)(3))**</u>.

The description of Proposal I.P.8.a.6.on page 92 of the Joint Committee Description begins by stating that: "The proposal would allow post death revocable trusts to be shareholders of S corporations for a two year period after the grantor's death." In fact, since a revocable trust is generally a grantor trust includible in the gross estate of the decedent, a two-year period is already allowed under section 1361(c)(2)(A)(ii) of the Code. An estate, on the other hand, is permitted to hold S corporation stock during a reasonable period of administration, which may extend beyond two years. We recommend that a comparable period be allowed for revocable trusts. Our Tax Simplification Proposals suggested that, if a federal estate tax return is required to be filed, the period allowed a revocable trust should be extended to include taxable years commencing no later than six months after the final determination of the federal estate tax.

In addition, the next sentence of the proposal refers to distributions to a "post death" revocable trust by a Qualified Subchapter S Trust. This sentence should refer instead to a "pre death" revocable trust. As set forth in our Tax Simplification Proposals, we recommend that the following sentence be added at the end of section 1361(d)(3):

> "Distributions to a revocable trust described in (c)(2)(A)(i) [a grantor trust] shall be treated as distributions to the grantor individually."

(7) <u>**Taxable years (Code sec. 645)**</u>.

We agree that, during their period of administration, post-death revocable trusts should be permitted to adopt fiscal years other than the calendar year as estates presently can do.

(8) <u>**Treatment of gifts from revocable inter-vivos trusts (Code secs. 2035(e) and 2038)**</u>.

We strongly support the proposal that would rewrite section 2035 to clarify that the transfer tax consequences of a settlor making a gift from a revocable trust are no different from those of a settlor making the gift directly. A settlor should not be forced to withdraw the asset from the trust and then make the gift directly to avoid a tax trap.

(9) <u>**Equal generation skipping tax treatment of estates and revocable trusts following death of settlor (Code sec. 2652(b)(1))**</u>.

We agree with the proposal to treat post-death revocable trusts in the same manner as estates for purposes of the generation-skipping transfer tax ("GST tax") rules. Such a change would greatly simplify an extremely complex area of the transfer tax law.

(10) Equal treatment of individuals and revocable trust with regard to amortization of reforestation expenditures (Code sec. 194).

We support this equalization proposal. Although only a small number of people are affected by this proposal, we see no reason why Section 194 should be expressly applicable to estates and expressly not applicable to trusts. We would hope that this proposal would make clear that section 194 can be utilized by both pre-death revocable trusts (so that the deductions can be taken by the settlor under the grantor trust rules) and by post-death revocable trusts, which should be treated like estates.

Ways & Means Proposal I.P.8.b.: Eligibility for ordinary loss deduction on loss on small business stock (Code sec. 1244).

As we understand this proposal, section 1244 losses would be deductible notwithstanding the fact that the stock was held by a pre-death revocable trust. Thus, the loss would be deductible by the settlor under the grantor trust rules. We support such a proposal.

Ways & Means Proposal I.P.8.c.: Repeal of income-shifting provisions (i.e., throwback rules (Code secs. 665-668), capital gains (Code sec. 644)).

As explained in more detail in our Tax Simplification Proposal No. 2, these provisions are now anachronisms that made sense only when individual tax rates exceeded the trust tax rates. The complexity of these rules and the equalization of trust rates with individual rates (in fact, trust rates reach the maximum income tax rate at a much lower threshold than individual rates) make these rules obsolete. We strongly support the repeal of these provisions.

Ways & Means Proposal I.P.8.d.: Restore unified credit in case of split gifts.

We support this proposal to correct what can only be described as a "glitch" in the law. As set forth in detail in our Tax Simplification Proposal No. 3, a non-transferor spouse who "gift-splits" can use up part or all of his or her unified credit in the deemed gift, but not have that unified credit restored if the gifted property is then included in the other spouse's taxable estate. This results in double taxation. Therefore, we support the proposed restoration of that "lost" unified credit.

Ways & Means Proposal I.P.8.e.: Provide for portability of unified credit and GST exemption.

Maximum use of the unified credit and GST exemption requires sophisticated tax planning that some taxpayers do not receive. The surviving spouse (and ultimately the

descendants) of a decedent who did not obtain timely expert advice should not suffer from the loss of exemptions that Congress intended the spouses to use. As explained in our Tax Simplification Proposal No. 4., we endorse this proposal which will simplify many estate plans and put residents of common law states on a more equal footing with those of community property states.

Ways & Means Proposal I.P.8.g.: Modification of rules relating to marital deduction.

(1) Allow for reformation of defective marital trusts

We support this rule which simply allows a surviving spouse to benefit from the marital deduction and avoid estate tax where the marital deduction was intended but the trust document contains a technical defect. As explained in our Tax Simplification Proposal No. 6, this kind of provision has ample precedent in the tax law and would result in tax deferral rather than tax loss.

(2) Treat QTIP like power-of-appointment trusts.

Our Tax Simplification Proposal No. 5 explains in some detail the convincing rationale for this proposal which promotes simplification and avoids tax traps without the loss of any revenue.

Ways & Means Proposal I.P.8.h.: Provide for Federal disclaimer rules.

As explained in our Tax Simplification Proposal No. 8, the disclaimer rules need certain clarifications. We support these proposals which will greatly increase the certainty of the tax consequences of these important decisions, which must be made in a short period of time by heirs making irrevocable decisions as to whether to forego benefits under a will or trust.

Proposal I.P.8.i.: Modify rules for qualified domestic trusts (QDOTs).

(1) Modification of rules relating to trustee of a QDOT.

It is widely recognized that the different QDOT trustee requirements set forth in TAMRA, OBRA and the Revenue Reconciliation Act of 1990 created a serious trap for the unwary. We endorse any modification that will ensure that instruments which were properly drafted to comply with the then-existing QDOT trustee requirements will qualify as QDOT's. We are concerned, however, that any proposal protect instruments drafted in conformity with the OBRA requirements, as well as those drafted to satisfy the requirements of TAMRA or the 1990 Act.

(2) Modify non-estate tax consequences of transfers by surviving spouse to QDOT.

We endorse the proposal to treat property transferred by a surviving spouse to a QDOT as passing directly from the decedent for income and transfer tax purposes. The proposed change eliminates another trap for the unwary, clarifies existing ambiguities and promotes reasonable and fair tax policy.

(3) Transfers in civil law countries to QDOT.

and

(4) Delete requirement that U.S. trustee have power to approve distributions from a QDOT.

Proposals (3) and (4) both address practical difficulties which can arise where the law of the decedent's country does not recognize trusts or does not permit the use of a U.S. trustee. Both proposals should be adopted.

(5) Clarification of who is the transferor for GST purposes in case of QDOT.

Under existing law, it is not clear who the transferor of a QDOT is for GST tax purposes. It appears that the decedent is the transferor, since the estate tax is treated as a tax paid with respect to the estate of the decedent. However, because the QDOT must also meet other marital deduction requirements, it may also be includable in the estate of the surviving spouse. The surviving spouse therefore also meets the section 2652(a)(1)(A) definition of a "transferor." The proposed change should **both** clarify who the transferor is and provide an election to treat the other spouse as transferor.

Ways & Means Proposal I.P.8.k.: Modification of generation-skipping transfer tax rules.

The GST tax is an extremely complex tax which, for individuals subject to the tax, often results in very involved and sometimes otherwise undesirable drafting in wills and trusts. In addition, a number of issues have arisen in interpreting the statutory provisions which require clarification.

In the Tax Simplification Proposals, individual members of the Section of Taxation and of the Section of Real Property, Probate and Trust Law recommended a number of changes involving the GST tax (see Proposals 15 through 22). These proposals are basically the same as those described under paragraph I.P.8.k. in the Joint Committee Description. These proposals should be included in any tax legislation since they (1) simplify an extremely complex area of the tax law, (2) affect most taxpayers who are subject to the GST tax, and (3) should be revenue neutral.

Ways & Means Proposal II.8.a.: Statute of limitations applicable to valuation of gifts.

We recommend that a proposal be added to the simplification provisions included in H.R. 3419 to provide that a gift for which the limitations period has passed cannot be revalued for purposes of the estate tax calculation under section 2001. In addition, we strongly favor a provision to the effect that the statute of limitations will run on a gift notwithstanding the taxpayer's use of the unified credit with respect to the gift. (This may obviate the need to address the proposal set forth at I.P.8.f. of the Joint Committee Description to make use of the unified credit during life optional.) Further extension of the Chapter 14 requirement that a gift be adequately disclosed on the return is reasonable. As discussed in Proposal No. 7 in the attached Tax Simplification Proposals, these proposals are consistent with the well-established concept of a unified transfer tax system and would eliminate controversy and litigation regarding the value of gifted property years after the transfer when reliable evidence may be difficult to obtain.

American Council of Life Insurance

Jeanne E. Hoenicke
Chief Counsel. Federal Taxes

July 27, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Phil:

We request that this written statement of the American Council of Life Insurance be included in the record of the hearings on Miscellaneous Tax Proposals. Our statement is directed to the tax issues under the Foreign heading and the proposals to expand IRAs.

With respect to the "foreign" issues, we address the foreign tax provisions included in the hearing which were also proposed in H.R. 1690. This bill was recently introduced by Representatives Sander Levin and Amo Houghton.

The life insurance industry is concerned about the existing tax provisions that make it difficult for United States insurers to compete abroad. H.R. 1690 contains much needed simplification and technical changes to these provisions. Of particular interest, H.R. 1690 would change the current definition of subpart F income, which is misdirected and inappropriate and creates severe competitive impediments for life insurers.

We support in general the provisions in H.R. 1690, but suggest in our comments some technical changes. We contemplate discussing these provisions further with the appropriate members and Congressional staff representatives.

We have also enclosed a copy of our August 4, 1992, written statement filed for the record of the hearings on H.R. 5270. The Council continues to support these comments and the need for corrective legislation on the foreign tax issues that are addressed.

Regarding the issues raised by proposals to expand IRAs, we are concerned that this effort could also include provisions to combine contribution limits for IRAs with the contribution limits for qualified pension plans. Such combined contribution limits would not encourage new savings, would decrease funds set aside by individuals in qualified retirement plans, and would be difficult to enforce.

Thank you for your consideration of our views. We look forward to working with you on these tax matters.

Sincerely,

Jeanne E. Hoenicke

JEH/slp

Encs.

[SEE WAYS AND MEANS HEARING 102-126, "FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT OF 1992," FOR A COPY OF THE AUGUST 4, 1992, SUBMISSION.]

July 27, 1995

SUBPART F SHOULD BE CHANGED TO ALLOW U.S. LIFE COMPANIES TO COMPETE GLOBALLY; H.R. 1690, WITH TECHNICAL MODIFICATIONS, WOULD LARGELY SOLVE THE PROBLEM

Background

U.S. shareholders generally are not taxed on the undistributed income of foreign corporations. However, U.S. shareholders are taxed currently on the undistributed subpart F income of controlled foreign corporations ("CFCs").

The subpart F income of a life insurance CFC includes investment income earned under policies insuring residents of its home country, and all income earned under policies insuring residents of other countries. In contrast, a CFC engaged in manufacturing, sales or nonfinancial services does not have subpart F income from its dealings with unrelated parties, wherever they are located.

Problems

- Subpart F tilts the playing field against U.S. life companies competing abroad. Life insurance CFCs are taxed more heavily than their foreign competitors are taxed, and also more heavily than manufacturing and nonfinancial services CFCs are taxed.

- The subpart F treatment of life insurance CFCs is based on the misapprehension that they are tax haven operations designed to avoid tax on investment income. In fact, however, life insurance CFCs operate where their policyholders live, and their investment income is needed to fund their obligations to these policyholders. There is no tax avoidance.

- Life insurance CFCs create skilled jobs and other economic benefits in the United States, and do not export jobs overseas. Meanwhile, foreign competitors are increasingly penetrating the U.S. market. If subpart F continues to impede U.S. life companies' ability to compete, other countries will reap these economic benefits instead of the United States.

- The subpart F rules for life insurance CFCs are highly complex. The allocation of income and expenses between same-country and other insurance and between investment and premium income imposes severe compliance burdens.

Solution

Changes are needed in subpart F to allow U.S. life companies to compete abroad, and to equalize the treatment of life insurance CFCs with CFCs in other industries. In particular, all or most income of life insurance CFCs should be excluded from subpart F.

H.R. 1690 largely solves the problem (and similar problems of bank and casualty insurance CFCs) by excluding investment income earned on reasonable reserves and surplus held for home-country insurance. H.R. 1690 (which also contains other salutary international tax provisions) should therefore be enacted. However, a few technical modifications are needed for it to operate as intended. (Language making these technical modifications is attached.)

Specifically, H.R. 1690 excludes only interest, dividends and gains on stock and securities. Moreover, the source of these amounts must be in the CFC's country of incorporation to qualify for the exclusion. Life insurance CFCs with well-balanced portfolios, however, also may earn other types of investment income (such as rents), and may invest in other countries. To prevent the application of subpart F in these cases, the exclusion should be expanded to cover all investment income, regardless of its type or source.

In addition, H.R. 1690 uses "earned premiums" to compute the exclusion for income derived from the investment of surplus. While this concept may be an appropriate measure of reasonable surplus for property and casualty insurance contracts (as well as health insurance contracts), it is not for life insurance and annuity contracts. It will result in an arbitrarily high or low life insurance and annuity exclusion depending on circumstances having nothing to do with the company's need for surplus. To more accurately reflect the need for surplus, the exclusion for life and annuity contracts should be based on the greater of 10 percent of reserves (a reasonable surplus level for the risks involved) or ten million dollars (to provide for start-up companies that need greater surplus).

Attachment

July 27, 1995

SEC. 5. EXEMPTION FOR ACTIVE FINANCING INCOME.[1]

(a) EXEMPTION FROM FOREIGN PERSONAL HOLDING COMPANY INCOME. Subsection (c) of section 954 is amended by adding at the end of the following new paragraph:

"(4) CERTAIN INCOME DERIVED IN ACTIVE CONDUCT OF TRADE OR BUSINESS. -- For purposes of paragraph (1), foreign personal holding company income does not include income which is ~~{derived from sources within the country under the laws of which the controlled foreign corporation is created or reorganized and which is}--~~

"(A) income derived in the active conduct of a banking, financing or similar business, but only if such corporation is predominantly engaged in such active conduct;

"(B) ~~{dividends, interest, and gains from the sale or exchange of stock or securities}~~ [income or gains described in paragraph (1) (before application of this paragraph)] derived from the investments made by a qualifying insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and which are received from a person other than a related person (within the meaning of subsection (d)(3)); or

"(C) ~~{dividends, interest, and gains from the sale or exchange of stock or securities}~~ [income or gains described in paragraph (1) (before application of this paragraph)] received from a person other than a related person (within the meaning of subsection (d)(3)) derived from investments made by a qualifying insurance company of an amount of its assets equal to [--

"(i) in the case of contracts regulated in the country in which sold as property, casualty or health insurance contracts,] ⅓ of the premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4))[, and

[1] This material is H.R. 1690 marked up to reflect the changes suggested in the accompanying written statement.

"(ii) in the case of contracts regulated in the country in which sold as life insurance or annuity contracts, the greater of 10 percent of the reserves described in subparagraph (B) or ten million dollars.]

which are not directly or indirectly attributable to the insurance or reinsurance of risk of persons who are related persons (within the meaning of subsection (d)(3)).

Dividends, interest, income equivalent to interest, rent and royalties received or accrued from a related person (within the meaning of subsection (d)(3)), shall be subject to look-thru treatment for purposes of ~~{subparagraph (A)}~~ [this section] under regulations prescribed by the Secretary which are consistent with the principles of section 904(d)(2). The Secretary shall prescribe regulations which interpret subparagraph (A) in accordance with the applicable principles of section 904(d)(2)(C). For purposes of [subparagraph (B) and] subparagraph (C), the term 'qualifying insurance company' means ~~{an insurance company}~~ [any entity] which is subject to regulation as an insurance company under the laws of its country of incorporation and which realizes at least 50 percent of its gross income (other than gross income derived from investments) from premiums written on risks situated within its country of incorporation."

(b) EXEMPTION FROM FOREIGN BASE COMPANY SERVICES INCOME. -- Paragraph (2) of section 954(e) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by adding at the end of the following:

"(C) the active conduct of a banking, financing[, insurance] or similar business, but only if --

"(i) the controlled foreign corporation is predominantly engaged in such active conduct, and

"(ii) the income so derived is from sources within the country under the laws of which the controlled foreign corporation is created or organized.

The Secretary shall prescribe regulations which interpret subparagraph (C) in accordance with the applicable principles of section 904(d)(2)(C)."

July 27, 1995

SEC. 5. EXEMPTION FOR ACTIVE FINANCING INCOME.[1]

(a) EXEMPTION FROM FOREIGN PERSONAL HOLDING COMPANY INCOME. Subsection (c) of section 954 is amended by adding at the end of the following new paragraph:

"(4) CERTAIN INCOME DERIVED IN ACTIVE CONDUCT OF TRADE OR BUSINESS. – For purposes of paragraph (1), foreign personal holding company income does not include income which is –

"(A) income derived in the active conduct of a banking, financing or similar business, but only if such corporation is predominantly engaged in such active conduct;

"(B) income or gains described in paragraph (1) (before application of this paragraph) derived from the investments made by a qualifying insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and which are received from a person other than a related person (within the meaning of subsection (d)(3)); or

"(C) income or gains described in paragraph (1) (before application of this paragraph) received from a person other than a related person (within the meaning of subsection (d)(3)) derived from investments made by a qualifying insurance company of an amount of its assets equal to –

"(i) in the case of contracts regulated in the country in which sold as property, casualty or health insurance contracts, ⅓ of the premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4)), and

"(ii) in the case of contracts regulated in the country in which sold as life insurance or annuity contracts, the greater of 10 percent of the reserves described in subparagraph (B) or ten million dollars,

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[1] This material is a revised version of H.R. 1690 that reflects the changes suggested in the accompanying written statement.

which are not directly or indirectly attributable to the insurance or reinsurance of risk of persons who are related persons (within the meaning of subsection (d)(3)).

Dividends, interest, income equivalent to interest, rent and royalties received or accrued from a related person (within the meaning of subsection (d)(3)), shall be subject to look-thru treatment for purposes of this section under regulations prescribed by the Secretary which are consistent with the principles of section 904(d)(2). The Secretary shall prescribe regulations which interpret subparagraph (A) in accordance with the applicable principles of section 904(d)(2)(C). For purposes of subparagraph (B) and subparagraph (C), the term 'qualifying insurance company' means any entity which is subject to regulation as an insurance company under the laws of its country of incorporation and which realizes at least 50 percent of its gross income (other than gross income derived from investments) from premiums written on risks situated within its country of incorporation."

(b) EXEMPTION FROM FOREIGN BASE COMPANY SERVICES INCOME. -- Paragraph (2) of section 954(e) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by adding at the end of the following:

"(C) the active conduct of a banking, financing, insurance or similar business, but only if --

"(i) the controlled foreign corporation is predominantly engaged in such active conduct, and

"(ii) the income so derived is from sources within the country under the laws of which the controlled foreign corporation is created or organized.

The Secretary shall prescribe regulations which interpret subparagraph (C) in accordance with the applicable principles of section 904(d)(2)(C)."

**STATEMENT OF
THE AMERICAN FARM BUREAU FEDERATION
TO THE
HOUSE WAYS AND MEANS COMMITTEE
ON
MISCELLANEOUS TAX REFORMS**

July 13, 1995

Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. We appreciate the opportunity to comment on tax issues important to our member families.

Farm Bureau applauds the efforts of this committee to hold hearings and move forward with the tax debate in the 104th Congress. The current debate contains many good tax reform proposals which are important to farmers and supported by Farm Bureau including: a lower capital gains tax, a higher estate tax exemption, deductibility of health insurance premiums by the self-employed and expanded use of individual retirement accounts (IRAs). We urge the committee to view these proposals as the start of a series of tax changes that will help improve the economic well-being of our nation.

Tax policy and the resulting rules and regulations are critical to our members. Farm Bureau policy states that tax policy should be designed to encourage private initiative, economic growth, equity and simplicity. Tax policy that is fair and equitable promotes both the economic well-being of farmers and our nation's food supply. Our tax system must provide incentives for citizens to pay their fair share of respective tax liabilities and encourage all citizens to create personal financial safety nets. We urge the debate to continue as America moves toward such a system.

Miscellaneous Revenue Issues:

In an effort to further encourage private initiative, economic growth, equity and simplicity, Farm Bureau would also support the following changes (as described by the staff of the Joint Committee on Taxation) in the current tax code.

Changes in accounting procedures to allow the expensing of costs associated with natural disasters. Present law indicates that no deduction is allowed for costs incurred for permanent improvements or betterments made to increase the value of any property. Rather, such costs must be capitalized into the basis of the underlying property (Sec. 263). A bill introduced by Rep. Matsui (HR 1569) would provide that if plants bearing an edible crop for human

consumption were lost or damaged by reason of freezing temperatures, disease, drought, pests, or casualty, section 263 would not apply to removal costs or 80 percent of the special replanting costs. Since natural disasters cannot be foreseen by farmers and ranchers, we recommend that this change be made in an attempt to give the farm sector greater flexibility during the trying and uncertain times these situations create. Weather isn't a factor that can be controlled or even accurately predicted. In years of natural disasters, farm income from the sale of crops may be severely reduced or even eliminated. In addition to problems caused by reduced income, irregular and unexpected cash flows make farm financial planning very difficult. This change would make such planning easier and less of a burden.

New treatment of livestock sold on account of weather-related conditions A bill introduced this year by Rep Tim Johnson (H R 1588) would amend Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought but also to floods, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. Once again, special and uncertain conditions have created this situation. In some instances, livestock producers who face multiplied feed costs due to drought may be forced to sell animals prematurely. By giving farmers and ranchers greater flexibility, their economic future can be planned with more certainty in the face of drought, flood or other natural disasters. Farm Bureau supports legislation to allow farmers and ranchers who are forced by disaster to sell livestock early to include sale proceeds in the following year if that is when the sale would have normally occurred.

New treatment of crop insurance proceeds and disaster assistance payments. A bill introduced by Rep. Minge (H.R.1408) would amend the special rule of section 451(d) to allow a cash-method taxpayer to elect to accelerate or defer the recognition of certain disaster related payments if the taxpayer establishes that income from the crops lost in the disaster would have been accelerated or deferred. This change would also deal with a special disaster circumstance and give the farmer or rancher more flexibility to deal with the situation in a manner best fit for their needs. Fortunately, the federal government provides disaster assistance to farmers and ranchers in times of need. Unfortunately, disaster assistance payments are often not received in the same tax year as the normal sale of commodities would have occurred. Receiving extra income in a single year increases taxes paid by farmers and ranchers who are already financially handicapped by natural disaster and negates some of the benefits of disaster assistance.

Modify the application of passive loss rules to timber activities. Current passive loss rules limit deductions and credits from passive trade or business activities. Private non-industrial timber owners need the opportunity to use annual expensing of interim timber management expenses rather than capitalizing them over time. These are practices that should be done to maintain a healthy timber stand, but are often neglected because owners see them only as a short-term cost and not as a long-term investment. Generally these activities do not occur every year, nor do they all occur in the same year. Therefore, it would have a very small effect on the Treasury's receipts from income taxes. Well-managed timber stands also promote wildlife and green space which the public desires. Allowing expensing would be a much less expensive way

for the government to achieve these goals than for the government to control and mange the land itself.

Adjustments in the capital gains tax to allow a 10 percent alternative tax on gains from assets held 5 years or more. H.R. 1215 would adjust the capital gains tax by providing individuals a deduction equal to 50 percent of net capital gain and an inflation adjustment of certain assets. This parallels Farm Bureau policy that calls for the cutting of the tax rate on capital gains to a maximum of 15 percent and indexing capital gains to inflation. This change would allow farmers and ranchers to increase investment in their farms and ranches and ensure the continued production of the ample quantities of food needed to feed Americans and the world. In most instances, the capital gains tax is not a tax on income, but rather a tax on transferring capital from one asset to another. The tax creates a disincentive for farmers to upgrade farm operations because capital gains taxes must be paid on land and other farm assets sold to finance improvements. Unimproved farm businesses are less efficient which reduces agriculture's competitiveness in world markets. These farms are less profitable, creating a disincentive for young farmers to pursue a career in agriculture.

Incentives for education including the adoption of education savings accounts. Present law does not contain any special tax provisions relating to this issue. H.R. 1215 would create an American Dream Savings account to which nondeductible contributions can be made. Distributions from the account after 5 years would not be included in income. Even better, H.R. 3449 introduced last year, would permit individuals to deduct up to $1,500 per year for contributions to an education savings account. This change would allow farmers and ranchers as well as all other Americans to be able to provide funds earmarked for sending their children to institutes of higher education. Such education is imperative to keep our country competitive in the world economy.

Changes in estate and gift taxes to allow exemption of certain land subject to permanent land conservation easement from estate tax. A federal estate tax is imposed on the value of property passing at death. A bill introduced by Rep. Houghton (H.R. 864) would provide that an executor may elect to exclude from the estate and gift tax the value of any land subject to a qualified conservation easement. Since the value of this land is reduced because of the easement, farmers should not be held liable for an estate tax based on this special situation. Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise-based industry. Without estate tax law changes, the next generation will find it more difficult to begin farming. Perhaps like no other family business, today's farmers and ranchers owe a great deal to the generation who farmed before them. According to USDA figures, roughly 45 percent of young farmers in 1989 either purchased their land from a relative or had received it as an inheritance. Multi-generational farming is a fact of life and any positive changes in the estate tax laws will help preserve this fact.

Increase the special use valuation limit to $1.5 million. Under section 2032A, an executor may elect to value certain qualified real property used in farming at its current use value, rather than its highest and best use value. Under present law, the maximum reduction in

the value of such real property is $750,000. A bill by Rep. Thomas (H.R. 520) would increase the maximum reduction in the value of qualified real property resulting from an election under section 2032A to $1,500,000. This change would especially impact farmers close to urban areas. These farmers are still very much interested in continuing operation of the farm. However, under some situations a farmer may be forced to sell his farm for a different use due to the impact of high estate taxes because of increased land prices caused by demand pressures in urban areas. This could have a negative long-term impact on the amount of land available in the U.S. for farming and may also negatively impact the long-term production of farm commodities.

Each of these changes would greatly enhance the ability of the current tax system to encourage private initiative, support enhanced economic growth, as well as provide greater equity and simplicity.

As this committee continues to debate the merits of a new tax system, we would encourage the above changes be made in the interim--until the current system can be reformed.

Thank you.

**STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
MISCELLANEOUS REVENUE PROPOSALS**

July 11-13, 1995

The American Gas Association (A.G.A.) supports the following proposals which would: 1) clarify that consolidated tax adjustments violate the normalization requirements of the Tax Code; 2) provide a tax credit and tax-exempt financing for environmental remediation expenses; 3) allow certain integrated natural gas companies to elect and qualify for the tax benefits of an independent producer; 4) allow gas and oil producers to currently expense geological and geophysical expenses in the year incurred; 5) allow the Section 29 credit for fuels derived from nonconventional sources to be claimed against the alternative minimum tax (AMT); 6) repeal the 1986 provision requiring contributions in aid of construction to be included in gross income of natural gas utilities, provided there are no limitations placed on the utility's depreciation method or lengthening of the utility's asset recovery periods; 7) modify rules on large corporate underpayments; 8) allow taxpayers to estimate shrinkage for inventory accounting; 9) allow the election to use earnings and profits basis for allocation of interest expense for foreign tax credit limitation purposes; 10) repeal the foreign tax credit basket for "10/50" noncontrolled corporations; 11) repeal the "charitable substantiation rule" for contributions of $250 or more; and, 12) simplify the taxation of employee benefits.

The Committee is also considering three alternative proposals to adjust the federal excise tax rate for certain alternative fuels, including compressed natural gas (CNG) and liquified natural gas (LNG). While none of these proposals would address fully the problems inherent in applying the federal excise tax to CNG and LNG, A.G.A. supports the repeal of the tax. Repeal would encourage the use of natural gas, which is environmentally clean-burning fuel, enhance the national policy of creating a market for alternative fuel vehicles to reduce our reliance on imported oil, and remove the inequities and burden of administering and collecting the tax.

I. Introduction and Executive Summary

The American Gas Association (A.G.A.) is a national trade association comprising some 275 natural gas distribution and transmission companies throughout the United States, Canada and Mexico. These companies deliver gas energy from the wellhead and various unconventional sources to the burnertip serving over 56 million consumers. These firms also account for approximately 90 percent of the nation's total annual gas utility sales. In addition, a number of A.G.A. member companies are involved in gas and oil exploration and production (E&P). Many members own, operate, or lease vehicles fueled by compressed natural gas or liquified natural gas, or sell these fuels for transportation use to owners or operators of motor vehicles or motor boats. Virtually all A.G.A. members provide a comprehensive benefit package to their employees.

Because of their varied activities, A.G.A.'s member companies are subject to numerous provisions of the Internal Revenue Code (Tax Code) covered by these hearings. In addition, our members incur costs in complying with a variety of environmental statutes and regulations. Thus, A.G.A. and its member companies have a direct and substantial interest in these hearings addressing a number of miscellaneous revenue issues. A.G.A. supports several of the proposals before this Committee which we believe would be revenue neutral, simplify the Tax Code, provide fairness for taxpayers, ease the burden of tax compliance and stimulate natural gas E&P. In addition to promoting tax simplification, fairness and investment, the proposals A.G.A. supports would enable natural gas to play a more critical role in the long-term economic health and security of the United States. Natural gas is an abundant resource that can be utilized to help the nation attain cleaner air, energy efficiency, domestic energy security, more jobs and technological development.

II. Consolidated Tax Adjustments (CTAs)

A.G.A. fully supports the proposal that consolidated tax adjustments are violations of the normalization provisions of section 168 of the Tax Code. A.G.A. has submitted statements and testified before the Subcommittee on Select Revenue Measures that adjustments to a utility's ratebase or cost of service to account for tax benefits the utility receives when it files a consolidated return with non-utility affiliate(s) is in contravention of normalization principles.[1]

State PUCs consider various costs of regulated utilities in determining appropriate utility rates. The federal income tax expense is one of the costs considered by state PUCs in setting utility rates. A "consolidated tax benefit" is a reduction in federal income tax liability to a public utility resulting from the inclusion of losses and/or tax benefits of affiliated non-utility companies in a consolidated federal income tax return. Some state public utility commissions (PUCs) have adjusted the utilities' rates through cost of service adjustment (total operating costs) or rate base adjustment (amount of invested capital on which a utility may earn a rate of return) to account for consolidated tax benefits.

A. Normalization Principles

Under present law, in order for a public utility to avail itself of certain accelerated depreciation allowances for federal income tax purposes, the benefits of accelerated depreciation must be normalized Mandatory normalization provisions, first inserted in the Tax Code as part of the Tax Reform Act of 1969, assure utilities of the availability of tax benefits of accelerated depreciation by using accounting procedures to reconcile tax treatment with regulatory treatment. When a utility files its federal income tax return, it may take a deduction for accelerated depreciation on its plant and equipment. When the state PUC determines the utility's cost of service in setting rates, it computes the tax expense component of cost of service as if the utility had used a slower method of depreciation, such as straight line, on its tax return. In the early years of the life of the plant, the taxes paid on the tax return are less than the amounts shown as tax expense in rates. In the latter years, the reverse is true.

The difference between the use of accelerated depreciation for tax purposes and the slower straight line method used to determine the tax expense in setting rates creates a "deferred tax reserve." This reserve represents the cumulative amount of income taxes that the utility has not yet paid to the Treasury, but will pay when the accelerated tax deductions that give rise to the reserve reverse.

Under normalization, the utility benefits through the use of the money and the ratepayer benefits through lower capital costs charged through rates. Since the utility does not incur costs for this benefit, the utility does not earn any return on it from ratepayers. In theory, however, the imposition of a CTA would permit a utility commission to reduce the utility's rates by the tax benefits from stockholder-funded

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[1] *The Treatment of Consolidated Tax Savings Under the Normalization Requirements of the Internal Revenue Code: Hearing Before the Subcomm. on Select Revenue Measures of House Ways and Means Committee, 101st Congress, 2d. Sess (1991)* (statement of American Gas Association) (testimony of Steve Wagner, Assistant Treasurer, National Fuel Gas Distribution Corporation, on behalf of the American Gas Association).

investments of an affiliate. Passing these tax benefits on to customers of the utility frustrates Congress' attempt to encourage investment in capital. In effect, non-utility affiliates would be providing capital to subsidize ratepayers, instead of generating capital for these affiliated corporations as intended by Congress.

Congress enacted the normalization provisions to ensure that the capital formation incentives of accelerated depreciation would achieve their intended purpose with respect to utilities, rather than be used to subsidize ratepayers.[2] The normalization provisions ensured that the capital costs of regulated utilities would not be higher than the capital costs of non-utility companies by prohibiting rate subsidization to utility customers.[3]

Over a period of two decades, the Internal Revenue Service (IRS or Service), Treasury Department, state PUCs and the Federal Energy Regulatory Commission (FERC), have supported the concept of normalization to ensure the effectiveness of Congressional policy for stimulating capital formation through the use of accelerated depreciation available to regulated utilities and non-utilities alike. The rationale for the normalization principles of the Code is still relevant today.

B. Effect of CTAs and Current Law

In recent years, utility shareholders have diversified into non-utility businesses. Such investments have included, for example, exploration and production of gas and oil, the development of an infrastructure to market natural gas vehicles and energy-service companies. The costs and risks associated with these businesses have been borne by shareholders. Typically, the utility joins in the filing of a consolidated federal income tax return with the non-utility subsidiaries. Consolidated tax adjustments could: 1) create disincentives to develop domestic energy reserves since any benefits of gas affiliates would have to be flowed through to ratepayers; 2) reduce funding for R&D, capital formation and low-income housing since the tax benefits would flow through to ratepayers; 3) preclude shareholders of non-utility companies from earning a full rate of return on their investment because they would be forced to subsidize utility ratepayers; and, 4) cause ratepayers in one jurisdiction to subsidize ratepayers in another jurisdiction where a consolidated group contains more than one utility or where one utility is regulated by more than one jurisdiction.

During a September 11, 1991 hearing before the Subcommittee on Select Revenue Measures, Treasury indicated that "absent regulations, CTAs can be made without violating the normalization requirements of the Code."[4] At present, there is a fair amount of uncertainty in an area of the tax law that was previously well established. Since Congress adopted the normalization principles in 1969, the Treasury, Service, state PUCs, FERC, courts and utilities have generally operated under the premise that CTAs violated the normalization principles of the Code. However, more recently, a few state PUCs and courts have deviated from this longstanding policy of normalization and found cost of service adjustments to be consistent with normalization provided the adjustments did not exceed the utility's current tax expense.[5] The State of Texas has recently addressed the CTA issue through legislation as well as through its court system. A.G.A. believes that Texas law provides some guidance to Congress that CTAs should not be permissible.

C. Fairness

Fairness is a fundamental goal of proper tax administration. One aspect of fairness is that similarly-situated taxpayers are treated equally. The CTA undermines these concepts. For example, assume that utilities A and B each have the same taxable income. Assume further that utility A is a member of a group of corporations filing consolidated federal income tax returns while utility B files a separate return. Some of

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[2] S. Rep. No. 552, 91st Cong., 1st Sess. 171-172 (1969) Sections 38, 46 168(f)(2) and 168(i)(9)(A) prohibit the use of flow through accounting, where the tax benefits of using investment tax credits and accelerated depreciation are flowed through to utility ratepayers.

[3] S. Rep. No. 552, 91st Cong., 1st Sess. 171-172 (1969).

[4] Note, *supra* note 3 (statement of Michael Graetz, former Deputy Assistant Secretary of the Treasury Department). Accompanying Graetz's written testimony was a memorandum from Internal Revenue Service (IRS) Chief Counsel Abraham Shashy supporting Graetz's position on the current IRS position on treatment of consolidated tax adjustments under normalization. The Shashy memorandum did not suggest that the Treasury Department is without regulatory authority to prevent consolidated tax adjustments as being inconsistent with the policies behind normalization, but in the absence of such regulations, normalization requirements do not prohibit them as a general rule.

[5] *See Continental Telephone Co. of Pennsylvania v. Pennsylvania Public Utility Commission*. 548 2d. 344 (Pa. Commw. 1988).

the other members of utility A's group reported tax losses. Utility A could be required to take the CTA into account and reduce its rates, while utility B would not be required to reduce its rates. FERC has recognized the potential for discrimination and rejected this approach in *Columbia Gulf Transmission Company*, 23 F.E.R.C. ¶61,936 (1983) (Opinion No. 173).

III. Tax Credit and Tax-Exempt Financing for Environmental Remediation Expenses

A.G.A. supports tax incentives that encourage environmental cleanup and remediation. A.G.A. supports H.R. 2340, *The Environmental Remediation Tax Credit Act of 1993*, which would allow a 25 percent tax credit for environmental remediation costs incurred by taxpayers pursuant to a plan approved by the Environmental Protection Agency at any qualified contaminated site owned by the taxpayer. The tax credit would have an overall limit of $75 million per year for all taxpayers, and would be available to taxpayers in five states and 24 cities chosen to participate in the environmental remediation credit program. The proposal would also create a new class of tax-exempt private activity bonds, "qualified contaminated site remediation bonds." These bonds would be used to finance the acquisition of a contaminated site or the costs of environmental remediation.

A tax credit and tax-exempt financing for environmental remediation would further the national policy goal of improving and preserving the environment. There are nearly 40 federal statutes enacted to preserve and clean the environment For example, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA),[6] is perhaps the most important statute enacted for the purpose of environmental remediation That law establishes a program for appropriate environmental response action to protect public health and the environment from the dangers posed by inactive hazardous waste sites. In addition to federal statutes, virtually every state has enacted environmental legislation.

Tax incentives for environmental remediation would enable some taxpayers to cleanup certain sites voluntarily that it may be uneconomic to do otherwise. Environmental cleanup costs oftentimes far exceed any possible value that is produced as a result of the cleanup. Taxpayers will have a strong financial incentive to delay making expenditures as long as possible if they are forced to incur environmental cleanup costs that do not produce significant value. Clearly, this would frustrate efforts for achieving national environmental objectives of encouraging remediation. Tax incentives for environmental remediation could also strengthen the international competitiveness of American businesses. The competitiveness of U.S. companies are severely strained as a result of the costs imposed on businesses to comply with environmental standards. Tax incentives could reduce the high costs that U.S. companies incur to remain competitive globally.

Last year, the IRS recognized the significance of federal tax policy not thwarting the goals of national environmental policy. In *Revenue Ruling 94-38*[7], the Service held that companies may deduct as a business expense the cost of cleaning up land and treating water they have contaminated with hazardous waste in their operations. Companies may write off these costs in the year in which they are incurred, rather than capitalizing them and writing them off over a period of years. The ruling reversed the position taken by the IRS in technical advice issued in 1993 requiring the costs associated with the cleanup of soil contaminated with PCBs to be capitalized.

IV. Independent Producer Status

Congress should give natural gas companies the option to elect independent producer status under the retailer and refiner exceptions of Tax Code Section 613A(d)(2). That section currently limits the scope of the independent producer exception. A taxpayer meets the retailer exception and is considered an integrated producer if 1) the taxpayer sells natural gas or oil (domestically) through a retail outlet operated by the taxpayer or related person, and 2) the combined gross receipts from the sale of such gas or oil exceeds $5 million Most gas companies with local utility affiliates are denied independent producer status, primarily because of their utility sales.

The Committee is considering a bill that would permit the gross receipts from retail sales of natural gas by a utility that is a related party to be disregarded in determining whether a taxpayer is a retailer. This bill would enable the producer to gain independent producer status, regardless of the amount of retail sales

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[6] Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. Secs. 601-9675.

[7] Internal Revenue Bulletin 1994-25 (June 20, 1994). In addition, the Internal Revenue Service issued *Revenue Ruling 95-32*, which held that "expenditures incurred by a public utility for the implementation and operation of energy conservation and load management programs are currently deductible under Internal Revenue Code Section 162. These rulings are both examples of the government's efforts to have consistent tax and energy policies.

by the related utility. A.G.A. urge that the legislation give taxpayers flexibility to elect independent producer status.

While there is limited legislative history, it appears that Congress determined to treat integrated producers differently from independents during enactment of the Tax Reform Act of 1975. Section 613A of the Code was added by that Act as a reaction to increases in energy prices brought on by the foreign oil embargo. The House Ways and Means Committee Report states that the Committee believed the percentage depletion tax benefit was no longer necessary for the "25 large oil companies" that had reaped windfall profits from foreign oil price increases.[8] The Committee decided to exempt the "smaller producers, or virtually all independents" from general repeal of the percentage depletion provisions because it was believed these companies needed the incentive to continue their exploration of domestic oil.[9] The Report also sought to treat federally regulated natural gas companies as independent producers with respect to percentage depletion. This was based on the theory that the price established by the then Federal Power Commission (today it is FERC) had historically been significantly below the market price, and that percentage depletion was necessary to encourage exploration.[10] The Committee further provided that the percentage depletion deduction would be phased out if the deregulated price of natural gas were raised to equal or exceed comparable deregulated oil prices.[11]

Unlike integrated oil companies, regulated gas utilities have profit levels determined by regulatory authorities and are not in a position to raise substantial capital through their retail marketing operations. Section 613A of the Code treats gas companies like the major integrated oil companies that can raise substantial capital through their gasoline marketing operations. Producers who have gas distribution affiliates cannot rely on retail sales which are regulated by state PUCs as a source of substantial capital for their domestic exploration and production operations.

State PUCs generally protect utility customers against any cross-subsidizing that might occur between the utility and its affiliates. Natural gas systems because of their regulated status, are even more in need of tax incentives than many large independent producers, who are unrestricted in their ability to fund exploration and production from the profits of affiliated entities.

Denying natural gas companies independent producer status results in inequitable treatment among similarly situated taxpayers within the same industry. When a production company sells gas and oil within its consolidated group to a sister company to produce electricity for resale at retail, there are no problems with the group being designated an independent producer. It is only when a production company supplies its sister gas utility for resale at retail that the group can be considered an integrated company. There is nothing in the legislative history to suggest that Congress intended to favor electric utilities over gas utilities. This oversight should be corrected.

It is inconsistent with emerging U.S. energy and environmental policy to continue to discriminate against producers with retail natural gas sales. The Clean Air Act Amendments of 1990 and the Energy Policy Act of 1992 illustrate the expanded role of natural gas to cleaning the environment and reducing dependence on foreign oil.

V. Geological and Geophysical Costs (G&G)

A.G.A. supports enabling taxpayers to expense all G&G costs incurred in connection with gas and oil development in the year incurred. Treating such costs as deductible business expenses will enhance producers' capabilities and resources to explore and drill for natural gas. Geological and geophysical costs incurred in the United States in connection with the exploration for, and development of, gas and oil reserves shall be treated as currently deductible expenses under the proposal. These costs are expenditures incurred for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of properties by taxpayers for gas and oil. Such costs include those incurred for seismic, gravity and magnetic surveys, geologists and drilling of core holes.

While there is no specific provision in the Tax Code for the treatment of G&G costs, they have been the subject of a number of court decisions and administrative rulings. Courts and the IRS have held that such costs are capital in nature and are not currently deductible as ordinary and necessary business expense. If a property becomes productive, G&G costs are amortizable through the allowance for cost

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[8] H.R. REP. NO. 93-1502 93d Cong., Sess. (1974).

[9] *Id.* at 6.

[10] *Id.* at 51.

[11] *Id.* at 52.

depletion over the life of the property. However, under *Revenue Ruling 77-188*, 1977-1 C.B. 76, the Service has held that if gas or oil is not discovered on the property, the taxpayer can deduct G&G costs as a loss under section 165 of the Tax Code in the taxable year the project is abandoned as a potential drilling area.

VI. AMT Reform for Section 29 Credit

A. Need for AMT Reform

A.G.A. supports the proposal to allow the section 29 tax credit for fuels produced from nonconventional sources to be applied against the taxpayer's AMT. The Section 29 credit applies to "qualified fuels[12]" produced from domestic wells drilled before January 1, 1993 and sold before January 1, 2003. Congress created the credit for the production of fuel from a nonconventional source as part of the Windfall Profit Tax Act of 1980. The credit was part of the nation's response to the OPEC oil embargo and the gas shortage crises of the 1970s. Congress felt that development of our vast nonconventional gas resources should be stimulated through a production credit which would reduce dependence on imported oil. The credit was also designed to provide an incentive for domestic gas and oil producers to invest time and capital in the E&P of gas and oil from deposits that would be uneconomical to develop without the credit.

Under present law, AMT is payable, in addition to other tax liabilities, to the extent tentative minimum tax (TMT) exceeds the taxpayer's regular income tax liability. For example, if a taxpayer's TMT for a tax year is $100 while its regular tax is $75, the taxpayer must pay an AMT of $25 and an overall tax of $100. The TMT for a corporate taxpayer is 20 percent of the excess of the alternative minimum taxable income (AMTI) over the AMTI exemption amount[13], reduced by the AMT foreign tax credit. Under the AMT system, regular taxable income is modified by a series of adjustments and tax preference items, such as accelerated depreciation, excess percentage depletion and excess IDCS, to arrive at AMTI.

Many producers of gas from nonconventional sources are not able to take full advantage of the Section 29 credit because preferences and allowances, such as accelerated depreciation, IDCs and percentage depletions, are added back to regular income in determining AMT tax liability. The amount of Section 29 credit that may be used in any tax year is limited to the taxpayer's regular income tax liability in excess of its TMT. Any Section 29 credit not utilized in a tax year because of TMT limitations may be carried forward and used to the extent regular tax exceeds TMT in future years, which may never occur. In addition, to the extent the Section 29 credit exceeds the taxpayer's regular income tax liability, such excess may not be carried forward and is permanently lost [14] To the extent Section 29 credits have to be carried forward, the net present value of those credits for purposes of determining project economics is reduced. Further, the value of the credit would be reduced by inflation.

Without the full credit, many producers are not able to recover the costs expended to drill and produce a well and to make the project economically feasible. Thus, some producers have sought unsuccessfully to obtain partners who have high taxable incomes and are not in an AMT situation to share the costs of drilling and producing fuel from a nonconventional source. The end result is that the Section 29 credit has not achieved its intended legislative purpose because of the AMT.

A.G.A. urges Congress to provide relief to allow taxpayers to use the Section 29 credit against AMT. We also urge Congress to enable taxpayers to carryforward any portion of the credit generated but not used in a particular tax year.

B. Benefits of AMT Reform

There are several benefits in enacting legislation that will enable taxpayers to use the Section 29 credit against AMT and/or to preserve any portion of the credit that otherwise would be permanently lost under current law. First, producers would be able to use the credit as intended by Congress for domestic production. A.G.A. believes AMT relief and carryforward reform would have a revenue neutral effect since

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[12] Qualified fuels include natural gas produced from geopressurized brine, Devonian shale, coal seams, tight formations or biomass.

[13] The alternative minimum taxable income (AMTI) exemption amount is completely phased out when AMTI reaches $330,000.

[14] For example, if the taxpayer's regular tax liability for 1994 before credits is $300, tentative minimum tax (TMT) is $200 and the Section 29 credit generated equals $350, then $100 of the Section 29 credit may be utilized in 1994, since the regular income tax liability exceeds TMT by this amount. Of the remaining $250 of Section 29 credit not currently utilized, $200 may be carried forward indefinitely and $50 is lost permanently. If the taxpayer's regular tax liability was zero, the full $350 of Section 29 credit would be lost permanently.

reform would allow the credit to be used as originally intended. Second, the credit has stimulated the development of technology. The development of nonconventional resources includes "learn-as-you-go" technology which would cease to advance if production ceased because producers were unable to utilize the credit.

Third, since nonconventional gas development is often a less attractive investment due to the higher costs and lower well production rates involved, the credit makes the project economically feasible only for those taxpayers who are able to take full advantage of the credit. The wells typically require expensive fracturing techniques and other technology to stimulate production to commercial levels. Further, it can take 30 years or more to deplete the recoverable gas reserve.

VII. Adjustments in Federal Excise Tax Rates for Certain Fuels

Under current law, motor gasoline is taxed at a rate of 18.4¢ per gallon. This includes 11.5¢ per gallon paid to the Highway Trust Fund (14¢ per gallon after September 30, 1995), 0.1¢ paid to the Leaking Underground Storage Tank Trust (LUST) fund and 6.8¢ per gallon for deficit reduction. Special motor fuels, including LNG, are taxed at the same rate as motor gasoline. According to the Omnibus Budget Reconciliation Act of 1993 (OBRA), compressed natural gas is taxed at a rate of 48.54¢ per thousand cubic feet (Mcf) as a deficit reduction measure. Currently, the CNG tax is based on the level of tax (determined on a Btu basis) imposed on a propane gallon. Since approximately 1.35 gallons of propane equal a gallon of gasoline (on a Btu basis), the tax on a "gasoline gallon equivalent" or GGE of compressed natural gas is 5.89¢.[15] The GGE for LNG is approximately 28.2¢ per gallon.

A. Problems With the Alternative Proposals

The Committee is considering three alternative proposals relating to the taxation of special motor fuels. Alternative One would exempt LNG from the Highway Trust Fund component of the special motor fuels tax, and adjust the rate of the deficit reduction component of the tax to reflect LNG's Btu equivalence to CNG. Alternative Two would continue imposing the tax as under current law, but reduce the aggregate tax on CNG, LNG, propane and methanol to reflect their Btu equivalence to gasoline. Under Alternative Three, Congress would adjust only the propane tax rate to a rate based on propane's Btu equivalence to gasoline. These proposals would be effective beginning on January 1, 1996.

Each of these proposals only addresses partially the problems associated with administering the federal excise tax on CNG and LNG. Alternative One would reduce the LNG tax rate by 11.5¢ per gallon for the Highway Trust Fund plus an adjustment to the deficit reduction part of the tax. While the proposal would reduce the tax rate on LNG, it does not consider the GGE rate of 5.89¢ imposed on CNG by the OBRA of 1993. That Act imposed an effective tax rate which is 37 percent higher for CNG than the 4.3¢ per gallon tax increase imposed on gasoline.

Alternative Two would reduce the GGE rate of the federal excise tax increase created by OBRA on CNG to 4.3¢ per gallon, the same rate as applied to motor gasoline. While this is a step in the right direction, the proposal fails to tax LNG at the same rate as CNG. There is considerable confusion whether LNG, a liquid, should be taxed at the higher special motor fuels rate of 18.4¢ per gallon (a GGE rate of 28.2¢) or at the lower CNG rate. LNG and CNG are derived from the same product -- natural gas. The difference between CNG and LNG is in the manner in which they are stored. In a LNG vehicle, the natural gas is stored as a liquid; in a CNG vehicle, natural gas is stored in a compressed, gaseous state. Both fuels are used in the engine in a gaseous state. These fuels should both be taxed at the CNG rate when used for transportation purposes. Alternative Three only addresses adjustments in the propane rate. This proposal fails to consider the issue of taxing all forms of natural gas at the same rate or reducing the GGE of those rates to 4.3¢ per gallon.

B. Repeal of Federal Excise Tax on CNG and LNG

A.G.A. supports repeal of the federal excise tax on CNG and LNG, which was imposed as a deficit reduction measure. Repeal would have a nominal effect on revenues since the industry is in an infancy state (the amount of revenues would be relatively small in comparison to the sizable burden of compliance and collection). Taxing CNG and LNG now will harm the industry's growth into a viable industry that could generate revenues for the industry in the future. Each of the proposed alternatives have shortcomings.

First, natural gas is a clean-burning fuel which has benefits for our environment. The use of natural gas in lieu of gasoline can produce significant emission reductions. According to a report by the EPA, these

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[15] Compressed natural gas is taxed at 48.54¢ per thousand cubic feet (Mcf). With 1,031 Btu per cubic feet, this corresponds to 47.08¢ per million Btu or 5.89¢ per gallon of gasoline equivalent.

reductions include: a 50 percent reduction in tailpipe emissions of carbon monoxide; a 40 percent reduction in tailpipe emissions of reactive hydrocarbons; and a 100 percent reduction in emissions of reactive hydrocarbons from filing stations and evaporation.[16] Natural gas vehicles have the potential to make the greatest contribution to reducing volatile organic compounds (or reactive hydrocarbons), the principal cause of urban ozone pollution.

Second, the natural gas vehicle market is in an infancy stage. The excise tax has the effect of thwarting growth and stifling investment in a natural gas vehicle (NGV) and refueling stations infrastructure. Because of this country's entrenched reliance on liquid fuels, such as gasoline and diesel fuel, government incentives rather than disincentives are needed to overcome institutional impediments to increased use of AFVs, such as NGVs.

Recognizing the significance of the alternative fuels market to the nation, the federal government has provided a number of incentives and mandates for the purchase of alternative fuel vehicles. The Energy Policy Act of 1992, for example, provides tax incentives for clean fuel vehicles and refueling stations. That Act also requires the federal government to purchase AFVs and for federal and state fleets located in major metropolitan areas to acquire AFVs when they purchase new vehicles.[17] To retain a burdensome tax on such fuels as CNG and LNG conflicts with Congressional policy in favor of encouraging the growth in domestic, alterative transportation fuels.

Third, repeal would resolve the current problems inherent in administering the tax. It would eliminate the discrimination of taxing CNG and LNG (clean-burning fuels) at a higher effective tax rate than gasoline; it would remove the different tax rates for two forms of natural gas. Fourth, the burden imposed on natural gas companies and other gas suppliers in collecting the tax is unreasonable in relation to the amount of taxes to be collected. Gas suppliers must spend a considerable amount of time in collecting the tax and maintaining recordkeeping functions in a market that is minuscule in comparison to motor gasoline. And fifth, NGVs are economic, clean, reliable, safe and fuel efficient. Due to favorable properties of natural gas as an engine fuel, NGVs require less complex emission control systems than gasoline vehicles to achieve extremely low levels of pollutant emissions.

VIII. Tax Treatment of Contributions in Aid of Construction (CIAC)

Contributions in aid of construction are cash payments or transfers of other property from customers that enable utilities to extend or expand utility services to customers. These payments are made by such persons as new home buyers, commercial or office plants, plants, developers, farmers and some government units (i.e. schools, hospitals and prisons). Ultimately, taxing CIACs imposes an undue burden on these utility customers. The Tax Reform Act of 1986 provided in Section 118(b) of the Tax Code that CIACs or any other contributions by a customer or potential customer are gross income to the public utility taxpayer. H.R. 957 would restore the contributions in aid of construction provisions that were repealed by the Tax Reform Act of 1986 for utilities that provide water or sewage disposal services.

Congress should also amend the provisions of Section 118 to exclude CIACs from the gross income of natural gas utilities. A.G.A. seeks to restore the historic, pre-1987 federal tax law which properly treated CIACs as capital contributions to be excluded from the income of regulated gas utilities. A.G.A. would not, however, accept as a condition of restoring Section 118(b) the limitation on depreciation method or lengthening of the recovery period as provided in H.R. 957 for water utilities.

Dynamic changes in the public utility industry have resulted in unexpected gaps in current federal tax law addressing CIACs. The CIAC is an important method utilities use to raise the capital required to construct the basic infrastructure needed to provide utility services in response to residential and commercial growth and development. Public utilities are also constructing connection facilities between their existing service territories in order to expand the market for their products beyond the confines of their traditional service territories. Moreover, public utilities today are seeking multi-million dollar interties at the borders of their service territories to share power transmission networks or other energy sources. Some public utilities have encountered tax law policies that have penalized utility expansions.

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[16] United States Environmental Protection Agency (EPA), *Technical Report: Guidance on Estimating Motor Vehicle Emissions from the Use of Alternative Fuels and Fuel Blends* (Jan. 28, 1988).

[17] Beginning in 1993, the Energy Policy Act of 1992 requires the federal government to purchase 5,000 alternative fuel vehicles (AFVs), 7,500 in 1994 and 10,000 in 1995. Beginning in 1996, the government must ensure that 25 percent of its new purchases of light-duty trucks and light-duty vehicles are AFVs; in 1997, 33 percent must be AFVs; 1998, 50 percent must be AFVs; and for 1999 and later years, 75 percent of all new purchases must be AFVs.

Historically, state PUCs require utilities to collect the cost of the tax attributable to CIAC either from all customers generally, through across-the-board increases in utility rates, or from the customers making the CIAC. The current tax on CIACs is not really a tax on utilities, but on their customers. However, consistent with contemporary regulatory policy, many state regulators have now required utilities to recover the CIAC tax from customers who contribute the capital for services.

While the CIAC generates income tax expense to the utility, this expense like other costs of doing business, is passed on by the utility to its customer through a "gross-up" factor. Utilities generally charge customers a grossed up amount to account for both the CIAC and the CIAC tax. However, one cannot merely add on the tax rate, for the gross up is also taxable. These additional tax costs are ultimately borne by the consumer who makes the contributions for utility service. For most types of CIACs, the utility acts as a collection agent for the taxing authorities because of the pass through nature of the tax gross-up billed to the ratepayer.

The tax imposed on CIAC unfairly discriminates against customers who are served by taxpaying utilities as opposed to customers of municipal and other utilities that are exempt from federal income taxes. The CIAC tax can influence developers in seeking ways to avoid the tax by locating in areas served by tax-exempt utilities or by encouraging such utilities to annex areas intended for development.

IX. Modify Large Corporate Underpayments Rule

A.G.A. supports a proposal to provide that the large corporate underpayment rate would not apply to an adjustment for a loss or carryover merely because the taxable year to which the loss or credit is carried is subject to the large corporate underpayment rate. A large corporate underpayment is any tax payment by a corporation exceeding $100,000 for any tax period. Currently, interest on large underpayments of tax by corporations is imposed at the federal short-term rate plus five percentage points under Tax Code Section 6621(c)(1) if the corporation fails to pay a tax deficiency of $100,000 or more within 30 days of receiving the notice of deficiency.

According to the proposal, if, for example, the large corporate underpayment rate applies to taxable year 1994 and the corporation incurs a net operating loss in 1997 that is carried back to 1994, the large corporate underpayment rate would not apply to an adjustment to the loss by the IRS merely because 1994 had been subject to the large corporate underpayment rate. The proposed change would help to simplify compliance for corporate taxpayers and would be revenue neutral.

X. Allow Shrinkage Estimates for Inventory Accounting

A.G.A. supports a proposal to allow taxpayers to estimate shrinkage for purposes of inventory accounting. This proposal would allow a deduction for an actual estimated loss. The Tax Court has accepted this precise rule in *Dayton Hudson Corp. v. CIR* (101 TC 462-1993). Therefore, codifying this principle will elevate its visibility and simplify compliance for the IRS and taxpayer. As this provision is consistent with existing law, it would be revenue neutral to the federal government.

XI. Allocation of Interest Expense for Foreign Tax Credit

A.G.A. supports H.R. 1690 which would allow taxpayers to use an earnings and profits basis for the allocation of interest expense for foreign tax credit limitation purposes. This proposal would create equity in the interest allocation by valuing both foreign and U.S. assets in the same manner. Under the current tax book value approach, the allocation is unfairly skewed as the depreciable lives for U.S. and foreign assets are different by statute. The proposal would create a much needed balance in this computation.

XII. Repeal Foreign Tax Credit Basket

A.G.A. supports repeal of the current requirement that dividends received from each noncontrolled foreign corporation be placed in a separate foreign tax credit basket. We believe that current law is completely arbitrary. Further, it ignores the economics of today's international business where foreign investment is often limited to less than 50 percent. In its Regulation 1.701-2(f), Treasury has sanctioned planning that avoids the consequences of 10/50 noncontrolled corporations. Repeal would merely streamline current law and simplify compliance for the IRS and taxpayers.

XIII. Repeal Charitable Substantiation Rule

With respect to C Corporations, A.G.A. supports the repeal of the Charitable Substantiation Rule of $250 or more. By exempting C corporations, compliance would be simplified without loss of federal revenue. Tax Code Section 170(f)(8) was designed to address problems resulting from fundraising techniques "in which an organization that is eligible to receive tax deductible contributions provides goods or services in consideration for payments from donors." Congress intended to prevent individual taxpayers from claiming

deductions for charitable contributions when they had purchased goods or services for personal use from a qualifying organization. This abuse is not present in a corporation which claims a deduction (i.e. an ordinary and necessary business deduction or charitable contribution).

XIV. Pensions and Employee Benefits Simplification

A.G.A. supports a number of proposals designed to simplify the tax administration of employee benefits and pensions. We believe these measures will simplify compliance without reducing federal revenues. Pensions and health care benefits alone cost our industry nearly $2 billion annually.

First, A.G.A. supports measures that are designed to improve the taxpayer's compliance with the nondiscrimination rules for employee pensions. (A plan qualified for certain tax benefits may not discriminate in favor of highly compensated employees with respect to contributions or benefits under Section 401(a)(4) of the Tax Code). This would include measures to: 1) repeal special nondiscrimination tests[18] for qualified cash or deferred arrangements and employer matching contributions and employee contributions; 2) simplify the definition of highly compensated employees; 3) repeal the additional requirements imposed by Section 416 for "top heavy" plans -- plans which primarily benefit an employer's key employees in terms of their compensation or ownership interests; 4) repeal provisions of OBRA of 1993 limiting the amount of employer's deduction for contributions to a tax- qualified pension plan to $150,000 (for 1995 it would have been $245,000 if OBRA did not apply); and, 5) repeal the "minimum participation rules[19]" that must be met to satisfy the requirements of a tax-qualified plan.

Second, A.G.A. supports several of the proposals to simplify current tax rules on pension distributions. We support measures to: 1) repeal the 15 percent excise tax on distributions from qualified retirement plans, tax-sheltered annuities and individual retirement accounts in excess of $150,000 for the calendar year; 2) provide that employee pension distributions are taxed as capital gains versus ordinary income; 3) permit individuals to use 10-year forward income averaging for lump sum distributions from a qualified plan; and, 4) permit penalty-free withdrawals from qualified plans for unemployed individuals -- those that do not impose an additional 10 percent income tax on early withdrawals.

Third, A.G.A. supports elimination of the limits placed on contributions and benefits from a qualified plan Present law provides a limit on contributions and benefits under qualified plans based on the type of plan, and imposes an overall limit if an individual is a participant in both a defined benefit pension plan and a defined contribution plan. (A defined benefit plan under Tax Code Section 414(j) promises specified benefits, generally in the form of monthly retirement pension based on levels of compensation and years of service). We endorse the proposal to eliminate combined plan limits for participants in both a defined contribution plan and defined benefit plan.

Fourth, Congress should modify the sanctions for failure to comply with qualification requirements. Under present law, the employer is generally denied a deduction for failure to qualify a plan. Under the proposals, failure to qualify a plan would result in the 1) addition of *de minimis* error rules for which no separate sanction would apply, 2) repeal of penalties for noncompliance unless the errors are not corrected after the employer is notified, and 3) imposition of penalties only in egregious cases.

XV. Conclusion

A.G.A. supports proposals that will simplify tax compliance, provide fairness in the tax treatment of taxpayers as well as stimulate investment. We believe the proposals we support will have minimal effect on federal revenues. A.G.A. appreciates this opportunity to submit this statement to the Committee.

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[18] The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is met if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either 1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement or 2) the lesser of the 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus two percentage points.

[19] One of the requirements a plan must meet to qualify for certain tax benefits in addition to providing benefits for rank-and-file employees as well as highly compensated employees is that it must include a minimum number of employees. Under Internal Revenue Code Section 401(a)(26), a qualified plan must benefit no fewer than the lesser of a) 50 employees of the employer or b) 40 percent of all employers of the employer.

WRITTEN STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction

The AICPA is the national organization that represents over 320,000 CPAs, and our members work for all types of taxpayers, applying the tax laws that you develop. We want the system to work better, with laws that make taxes simpler, fairer, and easier to administer. We have practical, front-line experience--we know what works and what does not.

The testimony of Robert Israeloff before the Committee on July 11, 1995 called your attention to the problems for American business that result from requiring most non-corporate taxpayers to end their tax year on December 31. We re-emphasize the importance of this issue because workload compression for CPAs and businesses is harmful to the tax system and the economy.

In this statement which is submitted for the record, the AICPA is pleased to offer comments on several other proposals being considered by the Committee on Ways and Means.

Pass-Through Entities--Subchapter S Reform

The AICPA strongly supports H.R. 2039, the *S Corporation Reform Act of 1995*. Enactment of this legislation would modernize subchapter S. This legislation is a high priority for the AICPA, which has taken a leadership role in the reform effort from the beginning.

S corporations comprise more than 48 percent of all corporate tax return filers, and our members prepare tax returns for and provide planning advice to many of these 1.9 million businesses, almost all of which are small businesses. Our members know first-hand the restrictions imposed and the complexities encountered under the current S corporation tax laws.

Our awareness of the real-world situations that face small businesses today convinces us that it is time to amend the tax Code to better reflect the business realities of the 1990s, simplify tax compliance for S corporations, and enhance capital availability for America's small businesses. H.R. 2039 achieves these important and laudable goals, and the AICPA is proud to voice strong support for this bipartisan legislation.

We thank Representative E. Clay Shaw, for introducing this important legislation, and the 26 cosponsors at introduction, which included 21 additional members of this fine Committee. Further, we thank Chairman Archer for providing this forum to express our views on and support for H.R. 2039.

Many of the members of this Committee already are familiar with H.R. 2039, and we will focus on the policy concerns and general goals addressed by the legislation. The AICPA would be glad to provide additional information on the particulars of H.R. 2039 to the committee or any of its members.

Enactment of the *S Corporation Reform Act of 1995* would make S corporations more useful and flexible by expanding capital formation techniques, preserving family-owned businesses, reforming S corporation fringe benefit treatment, and removing undesirable tax traps. H.R. 2039 would amend the Code to allow small businesses to keep pace with the realities of modern business. The AICPA, the U.S. Chamber of Commerce and members of the American Bar Association's Section of Taxation helped develop the provisions of H.R. 2039, and we are confident that it represents good tax policy. We urge the full Committee to approve the measure.

Many of the prohibitive restraints currently in subchapter S date back to its original enactment in 1958. The financial environment in the 1990s is far more complex than that of four decades ago, and 1950s' legislative restraints are handicapping small businesses today. A small business simply does not operate—and in fact, if it seeks to survive, should not operate—the way a small business did forty years ago. Times (and financial transactions) were simpler then.

Subchapter S requires a fresh outlook for the 1990s and beyond! The current rules are antiquated in many respects and, as a result, S corporations face obstacles and limitations not imposed on other forms of entities. As would any business seeking to survive into the 21st century, S corporations want to update their operations and the rules that govern them.

The S corporation reform package, taken as a whole, would modernize the Code by accomplishing four broad goals:

- Expansion of the capital formation techniques available to S corporations;
- Preservation of family-owned businesses;
- Reform of S corporation fringe benefit rules; and
- Removal of undesirable tax traps.

Modernization is needed so that, as new businesses emerge and choose the form of entity for their operations, S corporations will be as attractive a choice as are regular corporations and limited liability companies. The time has come to level the playing field and bring S corporations on a par with these other forms of entities.

The *S Corporation Act of 1995* contains over 25 separate proposals, most of which were included in H.R. 4056, the *S Corporation Reform Act of 1994*, which was supported by 66 representatives in the 103rd Congress (including 20 members of the Ways and Means Committee). We would like to emphasize five ways in which the 1995 House bill differs from the 1994 House bill.

First, the bill (at section 221) would permit an S corporation to own more than 80 percent of a C corporation's stock and to own S corporation stock. The AICPA recommends (1) that a corporation be permitted to elect S status regardless of the percentage of stock it owns in a C corporation subsidiary and (2) that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. H.R. 2039, generally, would accomplish this goal and we support the legislative effort to achieve this objective. It appears, however, that the bill would mandate passthrough treatment for a wholly-owned corporate subsidiary. As a result, this approach would distinguish between a 100-percent-owned corporate subsidiary (that is, one which would be treated as a "qualified subchapter S subsidiary") and a 99-percent-owned corporate subsidiary (that is, one which would be treated as a C corporation). We plan to further examine the details of the provision and, as appropriate, to offer suggested language for inclusion in committee reports or other legislative explanations of the bill.

Second, the bill (at section 201) would permit S corporations to issue convertible preferred stock. The AICPA supports this provision, which was among our original recommendations back in 1992.

Third, the bill (at section 101) would increase the 35-shareholder limitation to 75 shareholders. The AICPA supports an increase because the present limitations cause preservation problems and also restrict capital formation opportunities of smaller businesses. As to whether the maximum number of permissible shareholders should be 75 rather than 50, as provided for in S. 758, the Senate counterpart to H.R. 2039, we have not yet formed an opinion.

Fourth, the bill (at section 227) would exclude health insurance costs from those fringe benefits with respect to which S corporation shareholders would be placed in the same position as owners of C corporations. While we support across-the-board application of the C corporation rules for S-corporation fringe benefits purposes, we are pleased that H.R. 2039 addresses at least part of our concerns. A technical adjustment to the bill's language may be required to achieve the intended treatment of health insurance costs for 2-percent shareholders of an S corporation.

Fifth, the bill (at section 401) would provide transitional relief, in the form of a waiver of the five-year waiting period imposed on S corporations who have terminated their S elections and then want to re-elect S status, for any termination in effect as of the date of enactment. We have not yet formed an opinion on this provision, which appears to be a reasonable attempt to provide equity.

The legislation would not alter the essence of S corporation taxation, but it would remove a significant number of obstacles that entrepreneurs who own S corporations long have identified as major hindrances to their growth. H.R. 2039 would amend the tax Code to allow small businesses to keep pace with the realities of modern business, without compromising the framework of our federal tax system. The reform bill would remove the straightjacket of restrictions, many of which are no longer supportable on tax policy grounds, currently binding S corporations and give those 1.9 million entities the flexibility that they need to compete effectively in today's marketplace.

For instance, with commercial banks restricting their small-business loans, these businesses have had to turn to non-traditional sources of financing such as venture capitalists and pension funds. Typically, these sources want either an equity stake in the business or, at a minimum, debt that may be converted into equity interests. A small business operating as a regular corporation or a limited liability company may offer these benefits to a financier. Restrictions in subchapter S limit or preclude tapping these sources of financing and, in turn, these limitations preclude S corporation status as a viable option for a newly-formed entity in need of third-party financing.

As we already have noted, a newly-formed entity now is able to chose a form of business, such as a limited liability company, that provides far more beneficial treatment than that currently afforded to an existing S corporation. The current tax laws, however, render it impractical for an existing S corporation to liquidate and then reform as a limited liability company. Under current tax laws, liquidation of an existing S corporation is a taxable event. Due to this toll charge, exiting corporate solution is not practical for many, if not most, existing S corporations. In modernizing subchapter S to address the real business concerns faced today by S corporations, H.R. 2039 would help level the playing field for existing S corporations.

Despite the current popularity of limited liability companies, we are not convinced that the hybrid entity will replace the S corporation as the entity of choice in all situations. Several elements of the S corporation form, especially if taken in combination, continue to make S corporations a very attractive alternative to limited liability companies. These factors include:

- the greater simplicity—due to the ease of both formation and operation from a tax perspective—of S corporations;
- the lack of current guidance on forming a single-owner limited liability company, which is of particular concern given that 1993 data indicates approximately 50 percent of all S corporations had only one shareholder during that period; and
- the uncertainty of many business issues related to the relatively new "limited liability company."

The AICPA fully supports the essence of the legislation and the general goal of modernizing subchapter S. Further, the reform effort has attracted broad interest and support from diverse sectors of the business community. A fact that is clearly demonstrated by the large number and diversity of organizations publicly voicing support for H.R. 2039. In fact, no opposition to the reform proposals has surfaced in the approximately three-year period that the current reform effort has been underway.

S corporation reform is needed now, and we are confident that H.R. 2039, which contributes substantially to this goal, represents good tax policy. The AICPA again thanks those members of the Committee who already support the *S Corporation Reform Act of 1995*, and we urge the remaining members of the Committee to join in approving the measure.

Trusts and Estates--Tax Rate Reduction

The Revenue Reconciliation Act of 1993 increased the income tax rates and sharply reduced the brackets applicable to estates and trusts. The AICPA generally does not comment on the political issue of tax rates and who should bear the burden of taxes, but we believe the higher tax rates on estates and trusts are unfair and complex.

Historically, estates and trusts have been taxed at the highest income tax rates applicable to individual taxpayers--those pertaining to married persons filing separate returns. However, the Tax Reform Act of 1986 (TRA '86) changed that. Under TRA '86, the first $5,000 of taxable income of trusts and estates was taxed at 15 percent and taxable income in excess of $5,000 was taxed at 28 percent. Married persons filing separate returns, however, were only subject to the 28 percent tax rate when their taxable income exceeded $14,875.

The Revenue Reconciliation Acts of 1990 and 1993 (1990 Act and 1993 Act) further compressed the rate brackets. For example, in 1991 the 31-percent marginal tax rate brackets for married persons filing separate returns began at $41,025, compared to $10,350 for estates and trusts. The 1993 Act changed the income tax rates and brackets applicable to estates and trusts so that the 15 percent income tax bracket for estates and trusts will end at only $1,500 as compared with $18,450 for married persons filing separate returns. Furthermore, the 39.6 percent surtax rate on "high-income

taxpayers" (so called in the 1993 Act) applies to all taxable income in excess of $7,500 in the case of estates and trusts, but is levied on married persons filing separately only on taxable income above $125,000.

To help explain our concern the issue can be graphically displayed in a simple table. Note how, starting with the 1986 Act, each change in the maximum tax rate has resulted in a further compression of the brackets for trusts and estates. We have used 1986 as representative of the historical pre-1987 pattern.

		Maximum Rate Applies To Taxable Income Over		
Year	Maximum Rate	Married, Separate Returns	Trusts and Estates	Approximate Fraction, Trust Income to Married Separate
1986	50%	$85,790	$85,790	Equal
1988	28	14,875	5,000	1/3
1991	31	41,075	10,350	1/4
1993	39.6	125,000	7,500	1/16

This post-1986 trend appears to have adopted a conclusion that there is no reason for establishing a trust or an estate except tax avoidance - a concept that is just not accurate. Most individual taxpayers would cheerfully forgo the act of creating their estates, and trusts have been a significant part of the common (and statutory) law of this country and England for hundreds of years, for totally non-tax reasons.

The highly compressed rates which were part of the 1993 Act have had a harsh effect on many trusts and estates. The greatest areas of difficulty arise in instances where there is a need to accumulate income for non-tax reasons. The grantors' intentions or the best interests of the beneficiaries are frustrated by the diversion of funds either to pay the tax or make unwise distribution to avoid the tax.

There are many non-tax reasons for accumulations in estates and trusts. For example, estates may accumulate income because of: liquidity needs to pay bequests and debts (including taxes); unavoidable recognition of income (IRA and other qualified plan distributions); state law requirements that distributions cannot be made until the claims period for debts expires (personal liability of executor); litigation; and will contests, etc. Trusts may need to build a fund for the future education of minor children, for the care of surviving spouses, orphans, elderly parents, the mentally or physically disabled, children with special needs, protection of spendthrifts, and other special non-tax reasons.

Although Congress gave no reason for further compression of income tax brackets for estates and trusts in the Conference Committee Report in the 1993 Act, the reason given in the Report of the Conference Committee for the 1990 Act changes is enlightening. That Committee report stated that the tax rates applicable to trusts and estates were modified, "in order to not increase the benefit of the lower brackets that might otherwise arise from the adoption of the 31-percent marginal tax rate bracket. The conferees believed that modification of these rates is necessary to prevent additional undesirable incentives to create multiple trusts."

Insufficient recognition was given in all three statutes (1986, 1990 and 1993) to the fact that the compression in the tax brackets enacted affected not only multiple trusts, but <u>all trusts</u> and <u>all estates</u>. There is nothing sinister or subversive about estates and trusts. For example, an estate is created when an individual dies. The executor merely steps into the shoes of the decedent and collects income and pays expenses until disposition of the assets and liabilities of the estate. Generally, estates are not planned, and the executor wants to wind them up as soon as possible but may not be able to do so for various reasons. There is no reason for a discriminatory tax in this situation.

Further, with respect to multiple trusts, Congress has already given the IRS the necessary weapons to combat the multiple trust "evil," in 1976 by the enactment of heavy penalties levied on distributions from more than two accumulation trusts to the same beneficiary for any taxable year (I.R.C. § 667(c)). Also, in 1984, Congress enacted a provision (under regulations still not issued) to treat as one trust, two or more trusts having substantially the same grantors and beneficiaries, when a principal purpose of such trusts was the avoidance of tax (I.R.C. § 643(f)).

The revenue lost from lowering the rates on trusts is overestimated because they ignore the fact that fiduciaries who are charged with the responsibility to act prudently and not to commit waste will distribute income downstream to lower bracket beneficiaries. Almost every taxpayer will be in a lower bracket than the trust or estate. Restoration of more appropriate rates could actually lead to revenue gain as trusts accumulate income they would otherwise be driven to distribute to those who are lower bracket individuals.

Even if there is a revenue loss, it would likely result from those circumstances where there is the greatest non-tax objective. For example, the trustee may choose to withhold current distributions of income from a drug addict beneficiary or to accumulate income for the future care and support of a child with special needs. The tax burden then falls where the non-tax reason for accumulation is the greatest. We would also expect that any revenue loss would lessen over the years as trustees and executors became more sensitive to the problems of compressed rates and provide appropriate drafting in instruments and adopt defensive practices and procedures.

We urge you to restore the estate and trust tax rate brackets to the highest individual income tax rate brackets which are those rates applicable to married persons filing separate income tax returns.

Estate and Gift Tax--Simplification and Improvement

Equal Treatment for Individuals who Utilize Revocable Trusts--Set-aside Deduction (Code sec. 642 (c))

Section 642 (c) of the Code currently provides that estates are allowed a deduction for amounts which are paid or permanently set aside during the taxable year for charitable purposes but that trusts are allowed a contribution deduction only for amounts which are currently paid for such purposes during the taxable year.

For some time, revocable trusts have been increasingly used as substitutes for wills, thus avoiding the expense, delay and publicity of probate. The trustees of such trusts are under the same constraints as the executors of estates in making immediate distributions until settlement of death tax liabilities and, in some cases, court approval of their accounts.

Recent amendments to the Internal Revenue Code have recognized the similarity between an estate and such a trust. Thus § 1361 (c) (2) (A) (ii) provides that such a trust can be a qualified holder of Subchapter S stock for 2 years after the death of the grantor. Similarly, § 6654 (1) (2) (B) extends to such a trust the 2 year exemption from the payment of estimated taxes that previously was allowed only to estates.

Because of the practical constraints on early distributions from such trusts mentioned above, it is felt that the deduction for amounts permanently set aside for charitable purposes should also be allowed to such trusts for taxable years beginning within 2 years after the grantor's death. If litigation over the trust or some other event continued to prevent such distributions, an extension of this period could be granted in the discretion of the Commissioner of Internal Revenue.

The result will be that charitable beneficiaries would not be penalized by having taxes reduce their ultimate distributions where, for practical reasons, a trustee is under a constraint in making early distribution.

We recommend that § 642 (c) be amended to allow a grantor trust used as a will substitute to deduct amounts of income permanently set aside for charity in taxable years beginning within 2 years of the grantor's death.

Repeal of Income-Shifting Provisions (i.e., Throwback Rules (Code Secs 665-668), Capital Gains (Code Sec 644))

The throwback rules of Subchapter J of the Internal Revenue Code (§§ 665-669) generally treat a trust beneficiary who receives distributions of accumulated income as if the beneficiary had received the distributed amounts (including the taxes paid by the trust on them) in the year or years in which they were earned by the trust. The purpose of the throwback rules is to prevent avoidance of income taxes through the accumulation of income in one or more trusts at tax rates which are lower than the rates at which the trust beneficiary would have paid taxes with respect to the same income if it had been distributed.

Section 644 seeks to prevent the use of trusts to avoid tax on capital gains at high marginal rates by providing that if appreciated property is given to a trust and the trust sells the property within 2 years, that appreciation will be taxed at the grantor's highest marginal tax rate.

The abuses sought to be corrected by these complex provisions arose as a result of the broad progressive rate schedule which made it profitable to use trusts as separate taxpayers rather than tax income and gains at an individual's top marginal rate. However, as stated above, the trust rate compression that began in 1986 have made these provisions virtually obsolete in that most trusts are now taxed at rates greater than most individuals, and this would continue to be true if trust rates were reduced to be equal to married filing separately as we have recommended.

The effect of the throwback rules is to impose complex tax calculations on the trust beneficiary and difficult recordkeeping burdens on the fiduciary. In case of the § 644 rules taxing gains in a trust at the grantor's marginal rate, the necessity of securing tax return information from the grantor to be able to complete the trust's return can create serious problems.

We recommend that the throwback rules be repealed as far as they apply to domestic trusts. They would remain in the Code and continue to apply to foreign situs trusts with U.S. beneficiaries. Because such foreign trusts would have paid no U.S. tax with respect to accumulations, the potential for abuse would still exist.

We recommend that § 644 should be repealed.

Require Notification to Charitable Beneficiaries of Charitable Remainder Trusts

Section 7301 of H.R. 11 and H.R. 32, introduced by Representative Sam Gibbons on January 4, 1995, requires that notice be given to charitable beneficiaries of their interest in a charitable remainder trust created by a will and annually thereafter.

The legislation provides that, before a decedent's estate tax return is filed with the Internal Revenue Service, a copy of "Pertinent parts ... and such other information as may be required by form or regulation" must be provided to each charitable organization which has an interest in the estate or trust. In addition, the bill provides that the charities receive a copy of the annual income tax return before it is filed with the IRS, a provision which is unduly burdensome to tax return preparers.

Most states' laws allow a testator's executor and trustee the right to hold financial matters private from remainder beneficiaries regardless of whether the beneficiary is an individual or an institution. The proposed legislation overrides that right by imposing a federal obligation on executors and trustees to provide a continuous flow of financial data to a trust remainderman.

Placing this type of responsibility on an executor or trustee makes no sense because most states have dedicated personnel within the Office of the Attorney General to review such financial data. Also, the disclosure of financial data about a future interest in a trust can lead to unwarranted questions from the potential remainderman which can impede the fiduciary in meeting its duty and responsibility to the unitrust beneficiary or the annuitant. Finally, the disclosure of an individual's financial affairs to organizations which are not directly related to the administration of an estate or trust leaves all individual beneficiaries open to solicitation by the charity, has a "chilling effect" on such potential contributors, and violates the privacy of the creator of the trust.

We urge you to refrain from passing this legislation until careful thought has been undertaken as to the effects of the enactment of this legislation.

Statute of Limitations Applicable to Valuation of Gifts

Under current law, courts have held that the lapsing of the gift tax statute of limitations does not prevent the IRS from increasing adjusted taxable gifts in the estate tax calculation. Evanson v. United States, 30 F.3d 960 (8th Cir. 1994), Levin v. Commissioner, 986 F.2d 91 (4th Cir. 1992), Smith v. Commissioner, 94 TC 872 (1990), acq. 1990-2 CB 1. However, a District Court reached a contrary result in Boatman's First National Bank of Kansas City, 705 F. Supp. 1407 (DC Mo. 1988). The regulations provide that the IRS may adjust prior gifts in determining the gift tax due and the unified credit available in a later gift tax return unless there is an actual payment of gift tax. Treas. Reg. § 25.2504-2 (1983).

The ability to make retroactive adjustments upon examination of a gift or estate tax return creates unnecessary uncertainty for taxpayers. This uncertainty discourages intrafamily transactions which are necessary for ownership succession.

The AICPA recommends that Congress enact legislation to modify the judicial interpretation that allows retroactive adjustment of the current taxable gift so that the gift tax statute of limitations will expire even though there is not a gift tax payment and the adjusted taxable gift cannot be revalued on the estate tax return.

Foreign Taxation

Foreign Tax Credit

Repeal Foreign Tax Credit Basket for "10/50" Noncontrolled Corporations

We strongly support this proposal to amend section 904(d) of the Code to apply the look-thru rules to dividends received by a corporation from noncontrolled section 902 corporations if the information necessary to make such determinations is readily available to the taxpayer. It provides much needed reform to the international provisions by recognizing that U.S. multinationals have become more involved in foreign joint ventures as part of their global business strategies. Present law divides the active business income of U.S. multinationals earned through noncontrolled foreign corporations into a potentially unlimited number of "baskets," but combines the active business income earned directly and through controlled foreign subsidiaries into one overall basket. By eliminating unnecessary complexity engendered by numerous "10-50" baskets, and eliminating the effort companies must undertake to properly avail themselves of the single overall basket, this proposal will be a major step in reducing the otherwise mind-boggling complexity of the tax rules U.S. multinationals must comply with as they attempt also to compete in the global marketplace.

Extension of Period to which Excess Foreign Tax Credit May Be Applied

This proposal to permit taxpayers to carry back excess foreign tax credits 3 years and to carry forward excess foreign tax credits 15 years would help mitigate the expiration of excess foreign tax credits faced by many taxpayers due to the section 904 foreign tax credit limitation and other factors. We believe this extended period is warranted given the extended period for other attributes, such as the net operating loss deduction and general business credits.

Use of Average Rate to Translate Foreign Taxes

We support the proposal in H.R. 1690 to simplify the rules for translating foreign taxes paid by accrual basis taxpayers into U.S. dollars. Current law provides that these taxes are to be translated using the exchange rate in effect on the date the foreign taxes are paid. Under the bill, accrual basis taxpayers would use the average exchange rate for the tax year to which the taxes relate. However, if those taxes are not paid within two years, the proposal provides that no credit will be allowed in the year of accrual. Such taxes would be taken into account in the tax year they were paid.

This proposal would reduce the time required to determine the U.S. dollar amount of each foreign tax payment and to calculate a taxpayer's foreign tax credits. Like the United States, foreign countries require taxpayers to make tax payments at various times during the year; some countries require monthly estimated payments. Thus, under current law, taxpayers must determine the amount of each payment, determine the exchange rate in effect on each payment date and separately translate each payment into U.S. dollars. The process is repeated for each country in which the taxpayer pays taxes. The use of a single rate will greatly simplify this process. Thus, while there is some sentiment for returning to the *Bon Ami* rule, the AICPA believes the H.R. 1690 bill is a significant improvement.

We note that proposed section 905(c)(2) in H.R. 1690 may have an unintended, adverse effect on U.S. taxpayers that operate abroad in branch form. The branch's income is subject to U.S. tax, which can be offset if foreign taxes are imposed on the branch. However, if there is a dispute between the taxpayer and the foreign tax authorities over the amount of foreign income tax due for a particular year, and the dispute is resolved by payment of additional foreign tax, but not until more than 2 years after the close of the disputed year, proposed section 905(c)(2) appears to prevent the U.S. taxpayer from crediting the additional foreign tax against the original U.S. tax for the disputed year. We believe that the proposal would be improved if it accomplished its goals without causing this adverse incidental effect.

<u>Extend Indirect Foreign Tax Credit from Third to Sixth Tier</u>

We support the proposal in H.R. 1690 to amend section 902 to allow taxpayers to claim a deemed paid credit for foreign income taxes paid by foreign subsidiaries down to the 6th tier. The provision limits the extension beyond the third tier to taxes paid by controlled foreign corporations (CFCs) and to domestic corporations that are U.S. shareholders in such corporations (as defined in Code section 951(b).

We support this provision because it would make it easier for taxpayers to restructure their foreign operations without worrying about the "fourth tier" subsidiary problem, which currently inhibits necessary restructurings or requires the use of structures solely for the purpose of avoiding that problem.

<u>Anti-Deferral Regimes</u>

<u>Expansion of *De Minimis* Exception to Subpart F Income Treatment</u>

This proposal amends the subpart F *de minimis* exception by increasing the minimum percentage from 5% to 10% and by repealing the $1,000,000 threshold. We support this proposal as it would make the *de minimis* rule more meaningful. The existing lesser of 5% or $1,000,000 test is unusable because it is virtually impossible for most major multinationals to satisfy. As most such corporations have at least one CFC that would satisfy the revised test, the proposal should reduce their compliance costs (time and money) with little (if any) revenue cost to the government.

<u>Treatment of Foreign Base Company Sales and Services Income of Controlled Foreign Corporations in the European Union</u>

This provision would treat all countries in the European Union as one country for purposes of defining foreign base company sales and services income under subpart F. The AICPA supports this proposal because it will adapt the Internal Revenue Code to the economic environment of today's global marketplace, preventing needless complexity in business organization. The proposal merely reforms an aspect of a 1962 statute that has become overrun by the political, business, and social realities of Europe after 1992.

<u>Restore the Active Business Exception for Financial Services Income</u>

H.R. 1690 would amend section 954 to revive exemptions from foreign personal holding company income and from foreign base company services income for income derived from the active conduct of banking, financing or similar business, provided the controlled foreign corporation (CFC) is predominantly engaged in such activities. We support this provision. Subpart F introduces tremendous complexity into the tax law, which can only be justified as a form of prevention of tax abuse. For this reason, we believe that subpart F should not apply to income derived from the active

conduct of a trade or business by a CFC in its country of incorporation in an inherently non-abusive situation

Exemption of U.S. Shareholders of Controlled Foreign Corporations from Passive Foreign Investment Company Provisions

The AICPA strongly supports this change to provide that the passive foreign investment company (PFIC) rules will not apply to a U.S. taxpayer that is a U.S. shareholder of a CFC. The change will remove an unintended consequence of the PFIC regime whereby U.S. shareholders of CFCs are subject to the PFIC rules. The overlap of the CFC and PFIC regimes imposes an unnecessary compliance burden on U.S. taxpayers and does not raise significant government revenues. It is primarily a trap for the unwary and a compliance problem for the wary. The proposal to exclude U.S. shareholders of CFCs from the PFIC regime would provide welcome simplification of the Code.

Other Simplification Proposals

Exempt Controlled Foreign Corporations from Uniform Capitalization Rules

Under current law, taxpayers are required to apply the uniform capitalization rules in determining the earnings and profits and subpart F income of their foreign subsidiaries. Elimination of this requirement will greatly relieve the compliance burden imposed on taxpayers in attempting to obtain the information necessary to apply those rules. The adjustments required by the application of the uniform capitalization rules have minimal effect on the underlying tax liability of U.S. multinationals because the pooling rules of section 902 tend to mitigate the effects of timing differences on the determination of a CFC's earnings and profits.

Reporting of Foreign Corporation Earnings and Profits on a U.S. GAAP Basis

The AICPA supports this proposal to use of GAAP in determining the earnings and profits of CFCs because it will provide much-needed simplification. However, to be truly effective, the proposal should also apply in determining a CFC's subpart F income.

Increase in Reporting Threshold for Stock Ownership of a Foreign Corporation

The proposal would increase the section 6046(a) threshold for filing Form 5471 from 5% to 10%. This is a good change, as it will reduce some of the unnecessary compliance burden faced by U.S. multinationals.

Other Reform Proposals

Recharacterization of Overall Domestic Loss for Foreign Tax Credit Limitation Purposes

This proposal resources domestic source income as foreign source income where a domestic source loss previously reduced foreign source income. This provision mirrors existing section 904(f), which resources foreign source income as U.S. source income where there has been an overall foreign loss that reduced U.S. source income in a prior year. The policy underlying that provision (segregation of U.S. and foreign source income for purposes of applying the foreign tax credit limitation) should also apply where domestic losses reduce foreign source income. Therefore, we believe the provision is both equitable and necessary.

Election to Use Earnings and Profits Basis for Allocation of Interest Expense for Foreign Tax Credit Limitation Purposes

The proposal would amend the rules for allocating and apportioning expenses, such as interest, under the asset method. Taxpayers would be permitted to use the adjusted basis of assets determined for earnings and profits purposes. The AICPA supports this change because it provides a fairer method for allocating and apportioning expenses. Present law contains a bias resulting in the understatement of foreign source taxable income, with a resulting understatement of the foreign tax credit limitation, under asset-based expense apportionment. Under present law, the relationship of foreign to domestic assets is often computed by measuring asset basis net of depreciation. The amount of depreciation is determined by taking into account the rates used for computing taxable income. Those rates are

typically different depending on whether the assets are used in the United States or abroad--with foreign assets being depreciated more slowly than U.S. assets.

The proposal would eliminate this bias because, for earnings and profits purposes, the rate of depreciation does not depend on the location of the asset.

Extension and Modification of Special Allocation of Research and Experimental Expenditures to U.S. Source Income for Foreign Tax Credit Limitation Purposes

H.R. 1690 would amend the Code to extend permanently the rule that provides for allocating 64% of the research and development expenditures for research activities performed in the U.S. to U.S.-source income. The IRS and Treasury recently issued proposed regulations that provide for a 50% allocation of such expenditures to U.S. source income and that otherwise follow the 1977 regulations. The AICPA favors this proposal because it provides a permanent solution to this issue and a more equitable solution to the problem of allocating U.S. research expenses to foreign income, the local tax on which often cannot, in practice, be reduced by the expense of conducting research activities in the United States.

Additional Recommendation

Repeal AMT - 90% Foreign Tax Credit Limitation

Existing law provides a 90% limitation on the amount of foreign taxes that can be claimed as a credit against the alternative minimum tax. That limitation can subject a U.S. taxpayer's foreign source income to double taxation (depending on when-if-ever the AMT will be creditable against regular tax), violating the basic premise of the foreign tax credit--indeed, violates the spirit of our tax treaties as well as, in many cases, the letter. Therefore, we recommend the repeal of that limitation as proposed in H.R. 1690.

Statement of

Raymond A. Lewis
President
American Methanol Institute

Before the

Committee on Ways and Means
United States House of Representatives

Regarding

Miscellaneous Revenue Issues
Under Consideration by the Committee

Washington, D.C.
July 27, 1995

On behalf of the American Methanol Institute, the national trade association for the U.S. methanol industry, I am very pleased to have the opportunity to present this statement for the record on three of the miscellaneous revenue issues that the Committee has announced are under consideration:

-- Modifying the excise tax rates on propane, CNG, LNG, and methanol to reflect their BTU equivalence to gasoline (Excise Tax Proposal No. 7, Committee Release No. FC-8, June 30, 1995, page 4);

-- Reducing current ethanol fuels tax subsidies if carbon dioxide produced as a by-product is marketed by the producer (Excise Tax Proposal No. 12, Committee Release No. FC-8, above, page 4); and

-- Extending the tax credit for electricity derived by wind and closed-loop biomass processes to electricity from certain gas-powered fuel cells (Energy Tax Proposal No. 6, Committee Release No. FC-8, above, page 4).

<u>The American Methanol Institute (AMI) supports placing all non-petroleum fuels on an equal tax footing</u>. We therefore are in favor of a proposal along the lines of the first proposal, above, that would treat <u>all</u> non-petroleum fuels -- including methanol, propane, CNG, LNG, and ethanol -- on an energy-equivalent basis for excise tax purposes.

AMI has long been in favor of leveling the competitive playing field with respect to the tax treatment of methanol and ethanol. We therefore are supportive of the direction taken by the second proposal described above, a proposal that recognizes this disparity and reduces ethanol tax subsidies. We note, however, that this particular proposal, which focuses on carbon dioxide as an ethanol by-product, is a very limited measure that does not solve the basic inequity in the existing ethanol tax subsidies.

The third proposal described above would extend tax credits for electric generation to electricity produced from certain gas-powered fuel cells. AMI does not take an overall position on this proposal at the present time but believes that any such proposal, if adopted, should be neutral with respect to the fuel -- e.g., gaseous fuel or liquid methanol -- used to produce the electricity from such a fuel cell.

These proposals and their relation to the methanol industry are discussed in greater detail in the remainder of this statement.

The U.S. Methanol Industry. Methanol is a major domestic product, and the members of AMI produce virtually all of the methanol used as a fuel and as a chemical feedstock in the United States. Methanol is produced almost entirely from abundant supplies of domestic natural gas. Methanol can be produced also from other sources and, for example, promising technology is being developed to produce methanol cleanly as an integral feature of domestic steelmaking.

In recent years, the quest for cleaner air and greater energy diversity has caused an increase in demand for methanol fuel products. Over one-third of the methanol currently marketed in the United States is used to manufacture MTBE (methyl tertiary butyl ether), the most widely-used clean-fuel gasoline additive today. Last year over 2 billion gallons of MTBE were blended into gasoline.

In recent years, the domestic methanol industry has expanded rapidly to meet the growing demand for clean fuels and fuel additives. The methanol industry is providing a key market for domestic natural gas. Currently, some 76 percent of the methanol consumed in the United States is produced domestically, with another 12 percent produced from secure natural gas supplies elsewhere in North America. An additional 9 percent comes from the Caribbean and Latin America, with only 3 percent produced in other parts of the world.

Methanol fuel products have a major role in reducing America's reliance on imported petroleum and strengthening the energy security of the Nation. Methanol fuel products also have a major role in improving the environment: methanol fuels add oxygen to gasoline and burn cleanly, reducing carbon monoxide, urban smog, and air toxics including benzene. MTBE, the principal methanol clean-fuel additive, is a key component of "reformulated" gasoline and other cleaner burning gasolines throughout the Nation.

The methanol industry has made remarkable progress in accomplishing these energy security and environmental results -- progress that has been achieved on the merits of methanol products, without tax subsidies, environmental waivers, or other government favoritism. If permitted to compete fairly, this pattern of strong domestic methanol production and growth can continue, to the benefit of the Nation's clean air and energy security.

The methanol industry is not asking that methanol be treated any differently from any other non-petroleum fuel. We ask only for the opportunity to compete fairly in the marketplace. Our fundamental position on taxes is that all non-petroleum fuels should be taxed alike, on an energy-content basis. We believe that this is an eminently fair and workable position.

With the goal of tax equality and fairness in mind for methanol and all other competing non-petroleum fuels, we offer the following comments on three of the miscellaneous tax reform items currently under consideration by the Ways and Means Committee.

AMI Supports Fuel-Neutral Tax Treatment for Non-Petroleum Fuels. The Committee describes Excise Tax Proposal No. 7 as a proposal to "reduce the excise tax rates on propane, CNG, LNG, and methanol to reflect their BTU equivalence to gasoline." Release No. FC-8, supra, page 4. AMI supports equalizing taxes on all non-petroleum fuels based upon the energy content of the fuels.

The existing excise tax rates on non-petroleum fuels do not follow a rational pattern and are badly in need of reform. Taxes on various non-petroleum fuels have been established from time to time over the years without a broader look at the relationship of these fuels to each other or to gasoline. The result is a pattern of taxation in which a number of non-petroleum fuels that serve national goals established in, e.g., the Energy Policy Act of 1992, such as methanol and propane, are not only taxed at widely different rates from each other but in many cases are actually taxed at rates higher than the energy-content equivalent rate for gasoline.

The disparities in existing tax rates for various competing fuels are summarized in the following table:

Fuel	Effective Rate of Tax Compared to Gasoline Based on Energy Content
Gasoline	18.4
Diesel	20.8
100% Methanol ("M-100")	23.18
85% Methanol ("M-85")	21.42
100% Ethanol ("E-100")	(54.10)
85% Ethanol ("E-85")	(44.05)
10% Ethanol ("E-10")	13.47
Propane	25.07
Compressed Natural Gas ("CNG")	5.89
MTBE (produced from methanol)	22.63
ETBE (produced from ethanol) -- per Treasury regulations	(5.72)
ETBE -- if Treasury regulations are invalidated	21.84

The calculations of these effective rates are shown on Exhibit I.

The disparity in these tax rates is shown particularly starkly in the difference in rates between methanol, an alcohol usually produced from natural gas, and ethanol, an alcohol usually produced from corn. Both are non-petroleum fuels, and methanol performs as well as or better than ethanol in producing clean-air benefits. Yet ethanol is highly subsidized, which places methanol at an enormous disadvantage. There is no sound justification for the disparity in tax rates between these fuels. Similarly, it is not appropriate to tax natural gas in its compressed form (CNG) at a rate far lower than the rate applied to methanol, which is simply natural gas reacted with water to produce a natural-gas-based fuel in liquid form.

For these reasons, AMI supports a proposal to equalize the tax rates for non-petroleum fuels on an energy-content basis. In undertaking such a reform, it is crucial that all non-petroleum fuels be included.

AMI Supports Equalizing Tax Rates for Ethanol and Methanol. The Committee describes the second proposal on which AMI is submitting comments, Excise Tax Proposal No. 12, as a proposal to "reduce current ethanol fuels tax subsidies if carbon dioxide produced as a by-product is marketed by the producer." Release No. FC-8, supra, page 4. This proposal highlights one of the ripple-effect market distortions created when a product such as ethanol is subsidized so heavily -- i.e., that its by-products are subsidized as well, and this can adversely affect fair competition in secondary markets as well as primary markets.

The ethanol tax subsidies, originally enacted in 1978 on the ground that temporary help was needed for what was then a start-up fuel, are now benefitting a well-entrenched industry that produces more than one billion gallons of subsidized ethanol each

year. These subsidies have grown to the point where they account for tax expenditures of over $500 million annually.

The subsidized product, ethanol, competes directly -- and unfairly -- with a non-subsidized free-market product, methanol. Methanol fuels can provide all of the clean-air benefits of ethanol, and more -- efficiently and with comparable or better energy-security effects -- if methanol is permitted to compete on a level playing field.

For these reasons, AMI believes that the proposal to reduce ethanol tax benefits is one that moves in the right direction but does not go to the heart of the problem. In our view, the ethanol tax subsidies need much greater scrutiny and reform than the limited proposal as described above would provide. Clearly, whether or not the miscellaneous tax provisions under consideration are the forum of choice for enacting such a measure, the ethanol-methanol tax disparity is one that is urgently and justifiably in need of fundamental reform.

AMI Supports Fuel-Neutral Tax Treatment for Fuel Cell Technology. Finally, AMI notes that Energy Tax Proposal No. 6 under consideration by the Committee would "extend the tax credit for electricity derived by wind and closed-loop biomass processes to electricity from certain gas-powered fuel cells." Release No. FC-8, supra, page 4. The accompanying material prepared by the staff of the Joint Committee on Taxation describes this proposal as applicable to "fuel cell power plants using gaseous fuel derived from biomass, and fuel cell power plants using natural gas as a fuel" in certain circumstances. Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-19-95), July 10, 1995, p. 80.

Such a proposal, if adopted, should not be confined to gaseous fuels. Fuel cell technology using methanol, a liquid, to produce pollution-free electricity is currently under serious examination and development. An announcement earlier this month by NASA's Jet Propulsion Laboratory (JPL), for example, reports major progress in developing a non-polluting energy source in the form of a "direct methanol liquid-feed fuel cell", which runs on methanol, water and air; JPL's announcement states that these liquid-feed fuel cells have "numerous advantages over the conventional fuel cell system based on gas-feed designs." JPL Announcement, "Newest Fuel Cells Show Great Potential for Energy Industry", July 6, 1995, p. 1. While AMI does not take a position on the overall merits of Energy Tax Proposal No. 6, we do urge that if the Committee determines to adopt it, a tax disparity between natural gas and methanol, or indeed among all clean fuels, should not be perpetuated in such a provision. Rather, any such provision should reflect the sound fuel-neutral principles that AMI has consistently supported: tax equality for non-petroleum fuels, a level playing field, and vigorous competition among all fuels in the marketplace.

The American Methanol Institute appreciates the opportunity to present this statement to the Ways and Means Committee as the Committee begins its consideration of a number of miscellaneous tax proposals. AMI would be pleased to provide any further information that might be helpful to the Committee and to be available to work with the Committee on these and other tax matters.

Exhibit I

Fuel	Tax Ctns/Gal.	Btu Energy Content	Calculations	Effective Rate Compared to Gasoline Based on Energy Content
Gasoline	18.4	115,000		18.4
Diesel	24.4	135,000	115K/135K x 24.4	20.8
M-100	11.4	56,560	115/56.56 x 11.4	23.18
M-85	11.4	65,323	.85 x 115/56.56 x 11.4	19.71
	11.4		.15 x 11.4	1.71
				21.42
E-100	12.95[1]	75,670	115/75.67 x 12.95	19.68
Tax Credit	(48.55)		115/75.67 x 48.55	(73.78)
				(54.10)
E-85	12.95	81,570	.15 x 12.95	1.94
			.85 x 115/75.67 x 12.95	16.73
Subtotal				18.67
Tax Credit	(48.55)		.85 x 115/75.67 x 48.55	(62.72)
				(44.05)
E-10 (Gasohol)	13.0	111,000	115/111 x 13.0	13.47
Propane	18.3	83,950	115/83.95 x 18.3	25.07
CNG	4.3[2]	Equivalent to Propane Gas	115/83.95 x 4.3	5.89
MTBE	18.4	93,500	115/93.5 x 18.4	22.63
ETBE w/o credit	18.4	96,9000	115/96.9 x 18.4	21.84
ETBE[3] (w/credit)	18.4	96,900	115/96.9 x 18.4	21.84
			.43 x 115/96.9 x 54.0	(27.56)
				(5.72)

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[1] Neat ethanol fuels are allowed a 5.45 cents/gallon reduction in excise tax. Section 4041(b)(2). This amount reduces the 54 cents/gallon subsidy under section 40(c). Overall, the subsidy for fuel ethanol in any concentration amounts to the full 54 cents/gallon provided under section 40.

[2] CNG is taxed at a rate of 48.54 cents/mcf. Assuming that one mcf of natural gas contains one million Btus, the calculation would be 48.54 x 115/1000 = 5.58.

[3] Under Treas. Reg. § 1.40-1, the ethanol feedstock in a chemical reaction that produces ETBE is also entitled to the 54 cents/gallon tax credit. This regulation is of questionable legal authority and is th subject of litigation. ETBE is now coming into commercial production. If the credit were available for the ethanol used to make ETBE, the credit would be 43% of 54¢ or 23.22¢/gallon, because the feedstocks reacted to produce ETBE consist of 43% ethanol and 57% isobutylene.

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HOUSE COMMITTEE ON WAYS AND MEANS
Hearing on Miscellaneous Tax Proposals
July 11 and 12, 1995

This statement is filed on behalf of the American Petroleum Institute (API) for the record of the July 11 and 12 Ways and Means Committee hearings on miscellaneous tax reforms. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. The statement will focus on a number of proposals which are of particular interest to API's members.

CORPORATE

Extend Carryforward for Capital Losses for Corporations (I.I.2)[*]

API commends the proposal as an equitable measure which would update and align the capital loss carryover rules with other carryover regimes of the Code. ERTA '81 brought the fifteen year carryforward period for net operating losses and the investment tax credit; this period was considered necessary to overcome any detrimental fallout from the conflict of the annual accounting period and the rhythms of profit cycles of a particular enterprise. Even though capital gains and losses are taxed, as a practical matter, as a separate "basket", the same rationale -- moving from accounting period taxation to imposing the levy on the business enterprise -- requires, as a long overdue measure, an alignment of the carryforward period for capital losses and net operating losses.

DEPRECIATION AND AMORTIZATION

Establish 15-Year Recovery Period for Small Retail Motor Fuel Outlet Stores (I.J.2)

API fully supports this proposal. Beginning with Bulletin F, service station buildings were treated specially, as part of the petroleum marketing effort. Before the recent IRS Coordinated Issue Paper there was never a suggestion of treating such structures like other nonresidential buildings. And, of course, the temptation for the IRS was not as great as it is now with the 15 years vs. 39 years depreciation lives, where the IRS position more than halves the present value of the depreciation deduction. Since the proposal would merely insure a continuation of the past and current classification practice, the proposal should be viewed as a clarification, effective for all open years of a taxpayer.

Changes such as the replacement of frequent, scheduled service work in today's cars by sporadic high-tech equipment applications (whose installation in gas stations quickly becomes too expensive) and gigantic improvements in the reliability and useful life of tires resulted in a change of the consumer demands the motoring public brings to a motor fuel retail outlet. The service bay lost its usefulness as a means to "serve" and attract gasoline retail customers; frequently it was replaced by an expansion of the effort to meet the growing demand of the public

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[*]The parenthetical references in the headings are to the issue identifications in the Description of the Tax Proposals JCS-19-95, July 10, 1995.

to combine the fueling of their vehicle with the purchase of one or two small convenience store items. Thus, in gas station buildings more and more floor space is used for the marketing of non-petroleum goods and products.

However, the continuing physical integration of this intensified convenience store activity into the gas station reflects the subservient function to the petroleum retail marketing effort. Of course, if the gas station building is taken out of the context of the gas station complex, a floor space allocation measurement will deceptively indicate a principal use for something other than petroleum marketing. But once the building is considered as part of the gas station location, the principal use for petroleum marketing is clear. Thus, such buildings must continue to be considered gas station buildings for depreciation purposes.

Clearly, if the location as such "is used only to an insubstantial extent in the retail marketing of petroleum or petroleum products" (see last sentence in JCS's Description of the Proposal) the non-residential building depreciation should apply: a gas pump in the front must not bestow a 15-year depreciation life on a super market. But it should be equally clear that the critical primary use is determined in the context of the gas station location and not within the "four walls" of the gas station building, as suggested by the IRS, an analysis which ignores the controlling petroleum marketing effort reflected by the gas station compound.

ENERGY

1. Allow §29 credit against the Alternative Minimum Tax (I.O.1.a)

The Nonconventional Fuel Tax Credit under section 29 of the Internal Revenue Code ("the §29 Credit") applies to certain qualified fuels such as: oil produced from shale and tar sands; gas produced from coal seams or tight formations; and liquid, gaseous, or solid synthetic fuels produced from coal. Under current law, the §29 Credit may not be used to offset Alternative Minimum Tax (AMT) liability.

Typically, in comparison to conventional fuels, nonconventional fuel resources involve higher capital and operating costs and/or lower production levels. Congress felt that a subsidy was necessary to encourage the development of such resources to the stage where they could be competitive with conventional fuels, thereby reducing the dependence of the United States on imported energy. In enacting the credit Congress was attempting to encourage the development of nonconventional fuels production technology, which has, in fact, become one of the few bright spots in the generally depressed domestic oil and gas industry over the last decade, resulting in the preservation of many oil and gas industry jobs that would otherwise have been lost.

Unfortunately, many producers of qualified fuels -- just as the majority of petroleum companies, in general -- are subject to the Alternative Minimum Tax. API supports the outright repeal of the AMT, and strongly endorsed the action of the Ways and Means Committee which included a phase out of the tax in its bill, H.R. 9, The Job Creation and Wage Enhancement Act, reported earlier this year.

So long as the AMT remains in effect, if the §29 credit is to be as fully effective as it was intended, it should be applicable against both the regular tax and the AMT. API supports the proposal to make the §29 credit applicable against the Alternative Minimum Tax. Furthermore, the minimum tax credit provisions should be amended to clarify that §29 credits that

cannot be used in the current year may be converted into minimum tax credits up to the amount of the taxpayers current regular tax or tentative minimum tax.

2. Definition of tar sands (I.O.1.d)

API applauds the clarification found in H.R. 379. Oil from tar sands is an abundant domestic resource, but one which is difficult to refine into products such as gasoline and jet fuel. For this reason, oil from tar sands does not command as high a price in the marketplace as conventional crude oils such as West Texas Intermediate. Additionally, oil from tar sands is physically and economically more difficult to produce than such conventional crude oils.

Section 29 of the tax code was enacted to encourage the production of domestic energy sources when the average price of domestic crude oil production falls below certain trigger prices. The credit is not available when the average price of domestic production is above a trigger price. The congressionally stated aim of section 29 is to reduce the cost of these domestic energy sources relative to the cost of imported oil against which they compete.

For over fifteen years, the IRS has published no guidance upon which the public can rely as to what constitutes oil from tar sands for purposes of the section 29 credit. The IRS has taken the position that some taxpayer's production constitutes oil from tar sands while others' production does not constitute oil from tar sands, on a case by case basis. However, the method by which the determination is made is vague and inadministerable. Additionally, the IRS' informal method of classifying oil from tar sands can create competitive disadvantages and penalize pioneers in the application of production technologies. For example, the IRS' informal method of determining whether a producer has oil from tar sands can result in a situation where two taxpayers unquestionably produce oil from the same reservoir and one will be treated as producing oil from tar sands and the other will be treated as not producing oil from tar sands. Moreover, an examination of the IRS' publication "The Statistics of Income" shows that the IRS' informal position has resulted in the credit not achieving the results expected by Congress as witnessed by the legislative history to the enactment of the predecessor to section 29. All of the uncertainty and the potential competitive disadvantage which surrounds the IRS' informal position has resulted in protracted litigation which not only makes the production of oil from tar sands more expensive, but could further frustrate the intent of the credit as it applies to oil from tar sands.

Enactment of H.R. 379 would clarify the application of section 29 as it applies to oil from tar sands to allow the credit to apply as originally intended. The extension of the time for the application of the credit is reasonable in view of a decade and a half of uncertainty surrounding the economics of producing oil from tar sands.

3. Allow geological and geophysical costs incurred in connection with oil and gas development to be expensed in the year incurred. (I.O.4)

Geological and geophysical costs (G&G) are costs associated with surveying and evaluating a potential oil and gas property. Geological studies and geophysical surveys are the initial steps in evaluating an oil and gas prospect. The costs of core drilling, seismic studies and other G&G activity are incurred for the purpose of ascertaining the existence, location, extent and quality of any deposit of oil or gas.

While there still is no technology that permits us to

reliably identify the location of oil and gas without drilling, recent improvements in seismic technology have provided a rapidly improving capability to visualize complicated geological structures. This provides more information than previously available to target drilling activity. The additional information can sometimes make it economic to seek out and successfully develop far smaller reservoirs than would have even been considered a decade ago. Such technology has effectively enabled the industry to substitute G&G for some drilling activity.

Ironically, however, the present tax treatment inhibits the development and application of such substitution. Under current treatment, a taxpayer typically cannot recover much more than half of the present value of the cost of successful G&G efforts over the course of a 20 year field life with cost depletion. Furthermore, the administrative costs of determining and tracking G&G expenditures are burdensome to both the industry and the IRS. The current tax treatment penalizes the utilization of these critical new technologies. API strongly supports the proposal to allow current expensing of G&G costs. In addition to allowing the current expensing of G&G, the domestic oil and gas industry's exploration efforts would be considerably bolstered by allowing a 36 month amortization period for suspended G&G balances in existence at the date of enactment. Such an amortization period would allow for an expedient resolution of IRS/taxpayer disputes involving the timing of deductions of suspended G&G expenditures.

EXCISE

1. Retail collection of tax on recreational boat fuel. (I.Q.1)

Application of the diesel tax to fuel used in recreational boats coupled with implementation of the diesel dyeing rules has worked an extreme hardship on recreational boaters in some areas. Many marinas serving both commercial and recreational boats have only one fuel tank. Because commercial boats are exempt from the diesel tax, they require dyed fuel. Therefore, if a marina uses its one tank for commercial customers, recreational boaters are unable to obtain fuel.

The proposal to permit recreational boaters to purchase dyed fuel, and to require the retail marina operator to collect the tax is a fair solution to a situation that was certainly not intended by Congress.

2. Treat kerosene as a diesel fuel for excise tax purposes. (I.Q.2)

The tax treatment of kerosene is a very complex issue because of the nature of the product and its multiple uses. There are two grades of Kerosene -- 1-K and 2-K. 1-K is a special low-sulfur grade kerosene suitable for use in nonflue-connected kerosene burner appliances and for use in wick-fed illuminating lamps. 2-K is a regular grade kerosene suitable for use in flue-connected burner appliances and for use in wick-fed illuminating lamps.

Both 1-K and 2-K are distillate fuel oils which are suitable for use in diesel-powered highway vehicles. The use of kerosene as a fuel for on highway use generally occurs if conditions require it. For example, during winter months kerosene is blended with diesel fuel to produce a mixture which is more fluid at low temperatures. Kerosene is also blended with heating oil in winter months. Either 1-K or 2-K can be used for this purpose. This blending may occur in terminals, in bulk plants, or in customer tanks.

1-K kerosene is also sold as a fuel for individual space heating. Typically, it will be sold to end users in small

volumes (5 gallons, e.g.) at service stations from special facilities with "blocked" dispensers (i.e., a barricaded pump with a short hose) that prevent the kerosene from being dispensed into the fuel tank of a vehicle. In these cases, ASTM product specifications, UL space heater guidelines, and several states require that the kerosene be sold in a "water-white" condition.

Under the current IRS regulations, kerosene is treated as aviation fuel, not subject to the diesel tax or dye rules. This is a holdover from the old regulations prior to the 1993 change in the diesel tax law and continues in effect because the IRS has not published new guidance regarding the treatment of kerosene. Therefore, any kerosene may be removed from a terminal free of tax and undyed. This creates a large loophole for tax evasion because the potential then exists that the kerosene may be diverted and blended with diesel for on road use, thereby escaping the diesel tax.

After much deliberation, API has concluded that kerosene should be deemed diesel fuel, thereby subject to the diesel tax or dye rules. This means that if either #1 or #2 Kerosene is withdrawn, it must be taxed unless it is dyed in accordance with the regulations. The burden placed on certain end users of 1-K could be ameliorated by revisions to the refund procedures.

The IRS has the authority to make this determination by regulation, but has thus far not taken any action. The industry is approaching another winter season and needs a resolution to the issue before the winter demand for kerosene increases. If the IRS does not act soon, we urge that Congress modify the statute to ensure that kerosene is treated like diesel for purposes of the tax or dye requirement.

3. Adjust certain fuels tax rates for BTU equivalency to gasoline. (I.Q.6)

API supports the concept that motor fuels tax policy should be neutral, taxing all motor fuels, including alcohol, compressed natural gas, liquified petroleum gases, and reformulated gasoline on an equivalent basis with gasoline.

One way to accomplish that objective would be to determine the tax rates of the alternative fuels based on their energy content (Btu) equivalence to gasoline. Acceptable standards for the average energy content of gasoline and each of the alternative motor fuels can be determined from readily available data. API would be pleased to work with the Committee to determine those standards.

4. Consolidate collection of aviation gasoline excise tax. (I.Q.8)

Consolidating the 18.4 cents per gallon presently collected when aviation gasoline is withdrawn from a terminal with the 1 cent that is collected at the retail level, and taxing the full 19.4 cents at the terminal removal level is a simplification that has long been sought by the industry. API supports the provision.

5. Reduce harbor maintenance excise tax. (I.Q.9)

API supports H.R. 1138, which would reduce the harbor maintenance tax by 0.02 percentage points each year for 3 years, beginning in 1996, and would reduce the tax by 0.01 percentage point for any calendar year following a year in which the Harbor Maintenance Trust Fund balance exceeds $100 million.

6. Refund for tax-paid diesel fuel which is commingled with dyed diesel fuel

H.R.1947, introduced by Cong. McCrery, Herger and Jacobs, would allow a refund in cases where tax-paid diesel fuel is commingled inadvertently with dyed diesel fuel, so long as adequate proof is provided to support the claim for refund.

API supports this proposal and believes it should be expanded to include cases where, for sound business reasons tax-paid diesel must be commingled with dyed fuel. A year and a half of experience under the new law and regulations has made it clear that these situations occur frequently, and legitimate taxpayers are being unfairly denied refunds to which they should be entitled.

Typical situations include: a load of clear tax paid diesel removed from a terminal and delivered by mistake into a dyed fuel tank; diesel that has been transported by truck from one terminal to another (a taxable event), being dyed at the second terminal for nontaxable use; or, a terminal served only by truck that has only one diesel tank, but must supply both dyed and undyed fuel to its market.

In each of these cases, tax has been paid on fuel which is destined for nontaxable use, and a refund should be provided for the overpayment of tax. API urges that the statute be modified to provide that in cases where a supplier is forced by market and operating conditions to dye tax paid fuel or where inadvertently mixed clear and dyed fuel is returned to the supplier, that the supplier be deemed to be the ultimate user of that fuel and entitled to a refund, provided the claim for refund is supported by sufficient proof. In cases where inadvertently mixed fuel is not returned to the supplier but is used by the customer for nontaxable purposes, the customer should be deemed the ultimate user entitled to a refund, provided the claim is supported by sufficient proof.

FOREIGN

1. Increase in Section 911 Exclusion from $70,000 to $100,000 with Indexing (I.T.1)

API endorses the proposal as a resurrection of, and improvement on, the exclusion levels enacted in ERTA '81, subsequently deferred in DRA '84 and finally repealed without much discussion in TRA '86. As enacted in ERTA '81 the exclusion would have reached by 1986 $95,000 which corresponds to $130,000 today. Thus, the proposal would not even reach the exclusion level which was found necessary in 1981 to "make American enterprises more competitive in foreign markets" when your committee felt "that a broad range of activities by Americans abroad benefit [sic] the U.S. economy and should be encouraged" (H.R. Rep. No. 92-21, 1st Sess., at 60). The change of the Nation's workers' profile towards the high-tech, know-how specialist, with the growing marketability of this intellectual property transfer capability, would seem to increase the applicability of the 1981 rationale. Laudably, in the indexation feature the new rule would be superior to the 1981 regime.

2. Recharacterization of Overall Domestic Loss for Foreign Tax Credit Limitation Purposes (I.T.4)

API has been advocating this proposal since the enactment of the overall foreign loss recapture rules. If foreign source income is reduced by U.S. source losses, there is currently no parallel system of recapture. The U.S. losses will reduce U.S. taxes on the foreign source income, which can give rise to excess Foreign Tax Credits (FTC). The amount of FTC that can be used each year is still subject to the Code §904 limitations. If future U.S. source income is not recharacterized as foreign source income the §904 ratio will not increase and the FTC carryover could eventually expire unused. To the extent they can

be carried forward or back, the loss of benefits is the time value of money. The proposal would eliminate or alleviate these problems by bringing symmetry to the treatment of overall losses, foreign or domestic.

An overall domestic loss recapture would give full effect to the intended operation of the FTC. The rationale for the overall foreign loss recapture of present law equally supports an overall domestic loss recapture, i.e., matching of FTCs with foreign source income.

Without an overall domestic loss recapture the intended function of the FTC, i.e., to avoid double taxation, is either completely frustrated or diluted (as mentioned above, even if the credit can be used through a carryover mechanism the time value of money is lost).

3. Election to Use Earnings and Profits Basis for Allocation of Interest Expense for Foreign Tax Credit Limitation Purposes (I.T.5)

Equity and simplicity favor this proposal. As pointed out repeatedly in the past, an allocation according to tax bases gives foreign assets a greater "force of attraction" for interest expense because of the typically slower recovery periods and methods for foreign used assets; the resulting reduction of the numerator of the FTC limitation fraction under Code section 904 may effect double taxation. The currently available allocation based on fair market value requires additional, often very costly appraisal efforts which are not definite and, as any opinion, are subject to challenge. None of these weaknesses and burdens taint the proposal, while it would still neutralize the "force of attraction" of the foreign assets, truly reflecting equity and simplicity.

4. Extension and Modification of Special Allocation of Research and Experimental Expenditures to U.S. Source Income for Foreign Tax Credit Purposes (I.T.6)

API fully supports this proposal. The repeated suspension by legislation or administrative action of the adverse allocation rules of the 1977 Treasury Regulations in ten incidences demonstrates that the IRS Regulations fail to implement the rationale of the tax benefit intended for domestic research and experimentation. The recently published Proposed Regulations [60 F.R. 27453, May 24, 1995] are a step in the right direction. However, we would also favor an approach that allows the apportionment of the remaining R&E (after the 50% exclusive apportionment) on the basis of either sales or gross income. Under Treasury's concurrently published Study "The Relationship Between U.S. Research and Development and Foreign Income" the adverse foreign allocation of domestic research under the Proposed Regulations is still 75% of the amount under the flawed 1977 Regulations (compared to 50% under the OBRA '93 regime).

The desirability of keeping research and experimentation in the U.S. and the effect on competitiveness of U.S companies in the global markets dictates that API support the proposed permanent, more liberal, domestically biased allocation rule.

5. Repeal of Foreign Tax Credit Basket for "10/50" Noncontrolled Corporations (I.T.7)

API fully supports this proposal, as set forth as item I.T.7 of JCS-19-95, previously proposed in H.R. 1690, and as distinguished from item I.T.14 which would make the look-through dependent on loss of deferral. Under present law the accounting for each qualified stock investment in a non-controlled section 902 corporation as a separate basket can be very complex; but more importantly, separate limitations do not reflect economic

realities of the foreign corporate joint venture scenarios of U.S. corporations. Unavoidable forms of foreign business participation must not result in a denial of crosscrediting for active business income.

For example, the new East Block markets are primarily accessible through corporate joint ventures with host country entities. Also, in many developing countries, a foreign direct investor is allowed only to take a minority interest in a new venture. In other situations, a multi-party consortium (frequently reflecting local market representation) is desirable under local law or policy, resulting in a minority holding for each venturer. Competitors from other countries will enjoy a significant advantage over U.S. corporations which are currently burdened with the separate basket regime (and its inherent high exposure to double taxation) as well as the related administrative effort.

The compliance simplification envisioned from the separate basket approach (when adopted in TRA '86, see H.R. Rep. No. 841 (Vol II), 99th Cong. 2d Sess. 583 (1986)) never materialized. For example, a taxpayer is already required to look-through to the noncontrolled section 902 corporation's earnings to determine if there is high withholding tax interest or foreign oil and gas extraction income (FOGEI). Moreover, a U.S. shareholder must analyze the accumulated E&P of the foreign corporation under U.S. principles for purposes of calculating the deemed paid FTC.

The replacement of the separate non-controlled section 902 corporation basket regime with a look-through approach, allowing use of FTCs according to the earnings underlying all dividends, would simplify compliance and remove a substantial competitive disadvantage since foreign competitors are not limited in structuring their venture participation by this adverse feature of the present law.

6. Extension of Period to Which Excess Foreign Tax Credit May Be Carried (I.T.8)

API fully supports this proposal. In addition to the limitation considered in JCS-19-95, parallel rules apply to taxes on foreign oil and gas extraction income under section 907(f) of the Code.

The current carryover rules were first enacted in 1958. In recent years, the problem of excess credits has become more acute, as a result of increasing limitations on the use of FTCs. Congress has also significantly expanded the period for carry-over of other items. (See extension of carryover period for Net Operating Losses and the Investment Tax Credit in ERTA, P.L. 97-34.) It would clearly be economically reasonable and within the rationale of the FTC to allow at least the same carryover period as is in the Code for Net Operating Losses. Moreover, in the interest of conformity and equity, any change must include an extension of the carryover period under Code section 907(f).

7. Exempt Controlled Foreign Corporations from Uniform Capitalization Rules (I.T.12)

API has repeatedly urged this proposal in the past. The application of the Uniform Capitalization Rules (UNICAP) to foreign persons was not a concern of Congress; it emanated from the Service's regulatory implementation (Preamble of Temp. Reg. section 1.263A-1T, 52 F.R. 10059) which violates all criteria of sound tax policy, i.e., simplicity, equity, efficiency and viability.

The superimposition of UNICAP compliance creates unnecessary additional complexity. While the rationale of UNICAP is equity, the attempt to equalize the tax postures of foreign persons is

futile because of the ever changing tax regimes imposed by the foreign sovereigns. Nor is the extension of UNICAP criteria to foreign persons, with no effectively connected U.S. income, cost effective; while the additional administrative costs are evident, U.S. tax revenue acceleration is extremely doubtful. In fact, the prevailing excess FTC position of U.S. taxpayers with foreign operations cancels out any U.S. tax acceleration from increased earnings and profits in foreign corporations due to a deferral of cost recovery because of an overreaching application of the capitalization rules. When it comes to testing the effectiveness in promoting the nation's economic goals, burdening foreign operations with UNICAP in addition to the local cost recovery regimes is counterproductive in that it places the foreign operations of U.S. taxpayers at a competitive disadvantage.

As a technical comment, we would like to add that the amendment as drafted in section 4 of H.R. 1690 is flawed because it would continue to apply UNICAP to the determination of subpart F income. Since a CFC has to keep its tax books with the capability of determining subpart F income, a failure to eliminate the application of UNICAP to subpart F income would render meaningless the exception of CFCs from UNICAP for foreign source income.

8. Reporting of Foreign Corporation Earnings and Profits on a U.S. GAAP Basis (I.T.13)

As in the past, API strongly supports this simplification. Consistent GAAP financial statements of Controlled Foreign Corporations are as a rule part of the U.S. parent's consolidated financial statement and are therefore readily available to U.S. taxpayers. The financial statements of the Controlled Foreign Corporations are reviewed by the independent auditors before they give their required opinion. Thus, they are a reliable basis, prepared consistently and in transparent manner.

Moreover, using GAAP financial statements as starting point for developing U.S. tax E&P is the normal approach of API companies, as opposed to starting with financial statements prepared under host country accounting principles or starting with host country taxable income. To relieve taxpayers from having to make the burdensome tax adjustments would be true and, for all practical purposes, revenue neutral simplification.

9. Permit Shareholder of a "10/50" Corporation to Elect to Treat it as a Controlled Foreign Corporation for Foreign Tax Credit and Subpart F Purposes (I.T.14)

API supports this proposal only as a fall back from proposal JCS-19-95 item I.T.7 which would repeal the separate "10/50" basket in a more equitable manner. While the proposed election would improve the present law regime, API believes that the availability of "look-through" for income streams from "10/50" companies should not be made dependent on the denial of deferral.

In view of the lack of U.S. shareholders' control over these companies, the loss of deferral would not seem to be justified by the rationale of the anti-deferral rules. It would be wrong to tax U.S. persons currently on income they may be powerless to secure. Deferral is an issue different and separate from income categorization for purposes of the computation of the FTC limitations.

10. Exemption of United States Shareholder of Controlled Foreign Corporations from Passive Foreign Investment Company Provisions (I.T.10)

As in the past, API fully supports this proposal. The Passive Foreign Investment Company (PFIC) regime was enacted to curtail perceived avoidance of the subpart F anti-deferral "net

or screen" through ownership arrangements which either undercut U.S. shareholder control or split single U.S. person holdings below the 10% ownership threshold.

For Controlled Foreign Corporations the superimposition of the PFIC regime represents generally a duplication of "deferral denial" and a sweeping extension of current taxation even to active business income, resulting in unjustified income acceleration, Byzantine record keeping and unnecessary compliance burdens, without producing any significant revenue. Even if one assumed the need for full income inclusion by U.S. shareholders of certain Controlled Foreign Corporations, the retention of two anti-deferral regimes is overkill; subpart F already contains a full income inclusion rule where over 70% of a Controlled Foreign Corporation's income falls within one of the subpart F categories.

11. Deferral of Tax on Income Earned Through Foreign Corporations and Exceptions to Deferral (I.T.4: Possible Modifications to Simplifications Provisions Contained in H.R. 3419, 103rd Congress)

API questions the effectiveness of the proposed passive foreign corporation (PFC) regime. Consolidation of the various U.S. tax rules covering perceived passive investments by individuals is worthwhile and simplifies the Code. However, such a simplification must not result in an expansion of current taxation for Controlled Foreign Corporations which are already subject to current taxation with respect to subpart F income. Similarly, a reduction of the passive income threshold from 75 to 60 percent of gross income is not simplification, but expands the reach of this complex regime and exacerbates the overlap problem with subpart F. Therefore, as discussed above, any reform of the PFIC regime must provide for the exclusion of U.S shareholders of CFCs from the PFIC or PFC regime.

12. Proposal of Treatment of Foreign Base Company Sales and Services Income of CFCs in the European Union Should be Extended to Foreign Oil Base Company Oil Related Income (I.T.10)

As proposed in H.R. 1690 the European Union would be treated as one country for purposes of determining Foreign Base Company Sales and Service Income. API strongly supports this proposal. However, the same rationale, the integrated market of the European Union which, economically, closely resembles one country, also applies for purposes of determining Foreign Base Company Oil Related Income. The proposal should be expanded accordingly.

13. Other Proposals

In addition, a number of other proposals included in the Hearing announcement have merits and warrant Congressional attention. Those include (a) the election to use earnings and profits as basis for the allocation of interest expense for FTC Limitation purposes; (b) the extension of the deemed paid FTC to dividends from CFCs below the third tier; and (c) the expansion of the Subpart F de minimis exception.

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

Statement for the Record of

AMERICAN TRUCKING ASSOCIATIONS

on

MISCELLANEOUS TAX PROPOSALS

July 27, 1995

The American Trucking Associations (ATA) submits these comments regarding tax proposals included in the Committee's hearing announcement of June 30, 1995. These comments are a supplement to our statement in support of legislation (H.R. 1003) to restore the deductibility of meal expenses for truck drivers and others subject to federal hours-of-service limitations.

Who We Are: Scope of Testimony

ATA is the national association of the trucking industry. Over 34,000 carriers, ranging from individual owner-operators to multinational companies, belong directly to ATA or to our 51 state and 12 specialized national affiliates. Collectively, ATA members operate every type of trucking equipment, with a variety of contractual and employment relationships, in local, intrastate and interstate operations. This diversity of operations means that our members are affected in varying degrees by a large number of income, employment excise and estate tax provisions, both general and trucking-specific.

Most ATA members are small to medium-sized companies, owned by a single family or a small number of individuals. All types of taxable entities are represented--C and S corporations, proprietorships and partnerships. Thus, a number of ATA members are likely to benefit from proposals that are designed to give relief to a general class of taxpayers.

We limit our comments below to proposals that have a special impact on trucking, but we recognize numerous other proposals may be beneficial to some ATA members. We discuss subjects in the same order as the Committee's hearing announcement.

Accounting

Allow deduction for intrastate operating rights of motor carriers

Section 601 of the Federal Aviation Administration Act of 1994 pre-empted and prohibited state economic regulation of motor carriers, effective January 1, 1995. The conference report stated, "The conferees recognize that this will eliminate the asset value of the operating authority of those affected motor carriers." That in fact has happened; carriers have been unable to sell operating authorities since passage of the Act, whereas such sales were commonplace previously. Moreover, hundreds of motor carriers have begun intrastate service since the end of 1994 in states that previously limited entry tightly. No state has successfully challenged the validity of the Act or the right of a carrier on economic grounds to begin intrastate operations.

Thus, the economic reality is that operating authorities have been worthless since passage of the Act, or (at the latest) since federal courts struck down state challenges to the Act on December 30, 1994. Nevertheless, states have varied in their legislative or regulatory response to the Act in terms of abolishing prior regulatory requirements or according temporary noneconomic "grandfather" rights to carriers already operating in those states.

Consequently, some carriers are concerned that the IRS will not allow a deduction for the now-worthless operating authorities, at least in states that have failed to abolish all vestiges of their former regulatory structures. In the past, the IRS has vigorously challenged efforts to write off loss of value of <u>inter</u>state operating authorities. Following enactment of the Motor Carrier Act of 1980, which vastly expanded the number of carriers operating interstate and loosened Interstate Commerce Commission (ICC) control over rates, Congress acted to resolve those tax challenges by including a provision in the 1981 tax act to allow carrier to deduct the loss of value (over 60 months, retroactive to July 1980).

To stave off the prospect of protracted federal tax litigation that would be needlessly costly to the government and carriers, we urge this Committee to pass language that makes clear that carriers have a right to claim an immediate deduction for the loss of value. Certainly, the case for such a deduction is strong, even more so than in 1980. That is because the 1994 Act immediately wiped out <u>all</u> state power to limit motor carrier entry and rates whereas the 1980 Act left many ICC functions in place.

In short, differences in the timing and manner in which states proceed to acknowledge the pre-emption of their regulatory authority may give the IRS a pretext for challenging some carriers' deduction, even though economic reality and Congressional intent as expressed by the legislative history of the 1994 Act show that a deduction is well-founded. We urge this Committee to clarify that the deduction is valid.

Energy

Allow a tax credit for lubricating oil produced from discarded motor oil

Currently, some motor carriers blend used motor oil into diesel fuel. They are liable for tax on the added liquid if it is used in a highway motor vehicle. Other carriers burn used oil in space heaters or store it until a reprocessor removes it; no tax is due in these cases. There is no tax credit for rerefining the oil. Thus, market conditions dictate how the carrier disposes of the used oil. All three methods of disposal are considered environmentally sound by the Environmental Protection Agency when properly conducted.

A tax credit would create a needless incentive for one method of disposing of used oil. In addition, under current revenue constraints, a tax credit would probably be offset by a revenue raiser that would be costly to the trucking industry. ATA does not support the proposal; we do not know of any carriers that do.

Excise Taxes

Modify the diesel motor fuel excise tax collection rules
and **Exempt from excise tax motor fuels used in highway engines to power non-highway equipment mounted on trucks**

ATA supported the change in collection point and institution of dyeing for nontaxable diesel fuel enacted in 1993 to improve compliance. The changes appear to have worked: the Treasury Department reportedly believes collections due to improved compliance alone rose nearly $1 billion in 1994. Moreover, IRS officials charged with administering the new regime have shown good faith and done a good job.

There are several unresolved issues with respect to the fuel tax regulations, however. The IRS published temporary and proposed regulations dealing with numerous aspects of the new system November 30, 1993 and held a public hearing March 22, 1994. Final regulations were to be out by June 30, 1994. Today, more than 18 months after the new law took effect, those regulations are nowhere in sight. We urge this Committee to insist that the Treasury Department without further delay publish final rules on any issues that have been resolved, and propose regulations on ones that are still unresolved.

There are three issues in particular that the final regulations should clear up, and that Congress should resolve if the regulations fail to do so. First is accidental mixing of dyed and undyed fuel. With over 100,000 tank truck deliveries of fuels occurring daily, there are inevitably cases in which dyed fuel is delivered into an underground tank containing undyed fuel, and vice-versa. Typically, the tank truck company buys the fuel and removes it for reprocessing. But no procedure has been specified to allow the carrier to claim a refund on the tax-paid portion of the mixture.

Second, the temporary regulations impose an unreasonable, discriminatory and unnecessary documentation burden on refund claimants such as owners of refrigerated trucks and trailers (reefers). Fuel used in reefer motors is not taxable since the motor is separate from that used to propel the truck on the highway. Most reefer fuel is bought at truckstops where the only fuel sold is tax-paid, undyed fuel. To claim a refund, the reefer operator must submit a copy of the fuel receipt that includes the seller's statement that there is no visible evidence of dye. But the typical reefer is filled 1-2 times per week, or up to 100 times per year. Some fleets have over 1000 reefers. Therefore, to get a refund, the operator must collect tens of thousands of receipts from drivers all over the country, copy the receipts and send them to an IRS service center. As one service center told a carrier, "We don't have room to store the receipts, let alone examine them, so we just throw them out." This rule is not only a colossal waste for taxpayer and IRS alike, it is unnecessary. The IRS should require taxpayers to keep documentation in their possession for inspection if needed, just as it does with all other refund claimants, but not send receipts with the refund claim.

In addition, there is an issue that the IRS has been unwilling to address through modifying its regulations and therefore may require Congressional intervention. The IRS allows refunds for highway users with a second motor such as the motor that powers refrigeration units in trailers. This fuel use is not taxed because it does not contribute to highway wear and tear. However, the IRS does not allow refunds for nonhighway use when that use is powered by the main motor, such as "power take-off" usage. This is an important equity issue for operations that take power off the main motor, for instance to pump liquid or dry bulk cargo from a tank, lift or compact trash, or mix and pour concrete. These vehicles and others use fuel to varying degrees for nonhighway purposes, just as reefers do, but under IRS rules cannot claim an exemption.

Equalize the rail diesel motor fuel excise tax rate to that imposed on competing transportation modes

Under the Revenue Reconciliation Act of 1990, fuel tax rates were raised by 5 cents per gallon for motor carriers, with 2.5 cents placed in the general fund, 2 cents in the highway account of the Highway Trust Fund (HTF), and 0.5 cents in the mass transit account of the HTF. Rail diesel fuel was taxed at a 2.5-cent rate, all placed in the general fund. The Revenue Reconciliation Act of 1993 directed that after September 30, 1995, the general fund portion of the 1990 highway fuel tax should be transferred to the HTF, again with 2 cents to go to the highway account and 0.5 cents to the mass transit account. The rail fuel tax rate was lowered to 1.25 cents. The 1993 Act also levied a 4.3-cent general fund fuel tax on both modes. Both modes also pay 0.1 cents per gallon to the Leaking Underground Storage Tank (LUST) Trust Fund.

Railroads argue that the 1.25-cent burden, which amounts to less than $40 million for the entire railroad industry, is unfair. However, the federal government currently spends over $1.1 billion on rail assistance, including freight rail. Under current law, beginning October 1 railroads will pay a total of 5.65 cents per gallon to the general fund and LUST

Trust Fund. Diesel-powered trucks will pay a total of 24.4 cents per gallon, of which 6.4 cents will be directed to the general fund, LUST fund and mass transit account; of the remaining 18 cents, some will be spent on grade crossings that benefit rail as well as highway users.

Given these facts, ATA opposes eliminating the 1.25-cent rail tax or spreading it among all modes so that the $40-billion railroad industry would pay only $1 million in total (their burden if the rate is lowered to 0.031 cents as the Association of American Railroads proposes). ATA would not oppose placing the 1.25-cent rail fuel tax in a separate trust fund.

Reduce the excise tax rates on propane, CNG, LNG, and methanol to reflect their BTU equivalence to gasoline

The Internal Revenue Code is encumbered with a bewildering variety of tax rates for different fuels. There is no consistent rationale for why these rates differ. ATA supports putting the rates on a consistent basis. We believe that taxing all existing and prospective alternative fuels on a BTU-equivalent basis makes sense. At a minimum, the amounts placed in the highway account of the HTF should be on a BTU-equivalent basis so that vehicles that make the same use of the highway and differ only in their means of propulsion pay the same amount to go a given distance.

Even if Congress does not choose to address all rates at this time, it should specify that the rate for natural gas should be equivalent on a BTU basis whether the natural gas is liquefied (LNG) or compressed (CNG). Currently, the law appears to be ambiguous, even though the logic of equivalency is clear.

Also, we recommend that the fuel tax sections of the Code be redrafted in order to make the rates, refunds, exemptions and other provisions easier to discern as well as more consistent. Last year, even publications from the Joint Committee on Taxation, the IRS and the Federal Highway Administration disagreed about some of these rates.

Move the point of collection of the heavy truck excise tax from retail sale to manufacture, and clarify activities which constitute taxable remanufacture of existing trucks

The truck excise tax (Code section 4051) has been contentious for many years. Any proposed change, whether in point of collection or more fundamental change to the structure of the tax, would create numerous winners and losers. Therefore, we urge the Committee to hold separate hearings on the tax before adopting any changes.

Pensions and Employee Benefits

Modify safe harbor rule for leased employees

Several legislative efforts have been made in the last few years to clarify who is a "leased employee" who must be counted by a service recipient organization along with its actual employees in applying 20-some Code provisions regarding pensions, "COBRA" continuation coverage eligibility, and other benefits. Many of the proposals would impose a test based on whether the recipient exercises "significant direction or control" over the service provider. (E.g., section 231 of H.R. 3419, 103d Congress.)

Unfortunately, these formulations as well as current law leave many independent contractors at risk of being classified as leased employees. In trucking and other industries, many individuals who are independent contractors under the common law for employment tax purposes perform services for a business substantially full-time for a year or longer. They may provide the services through a broker or other third party. The one-year and third-party requirements are enough to make them leased employees for pension and benefits purposes, even under the proposed changes. How can this occur? "Direction or control" is basically a subset of the 20 common-law factors. Truck owner-operators satisfy the factors dealing with investment, risk of loss, training and others, yet they necessarily receive a degree of direction from the recipient. If they are deemed to be leased employees, they must reveal to the recipient (for the recipient's pension nondiscrimination testing and other purposes) how much of their remuneration is wages, benefits, etc.--information that destroys their equal bargaining power in contracting with the recipient.

We believe a simpler and clearer test for these workers would be to include, either in Code section 414(n) itself or in legislative history a statement that independent contractors are not leased employees. Such a declaration would fit the expectation that recipients and the independent businesses that serve them have.

We would be glad to work with the Committee on any aspect of these proposals.

TESTIMONY OF ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

The Association of Local Housing Finance Agencies (ALHFA) appreciates this opportunity to present its views concerning miscellaneous issues which apply to tax-exempt bonds and Low-Income Housing Tax Credits.

By way of background, ALHFA is a nonprofit national association of professionals in the field of affordable housing finance. Its members are primarily city and county government agencies which finance from a variety of sources including federal tax code incentives home ownership and rental housing opportunities for low- and moderate-income households. Among its members are the Southeast Texas Housing Finance Corporation, the Houston Housing Finance Corporation, the New York City Housing Development Corporation, the City of Chicago Department of Housing, the San Francisco Mayor's Office of Housing and the Los Angeles County Community Development Commission and many, many more. ALHFA's purpose is to serve its members as an advocate before Congress and the Executive Branch on affordable housing policy issues and, through educational activities, to enhance the ability of local housing agencies to implement responsible and professionally administered affordable housing programs.

As Committee members are aware, in 1993 Congress passed, and the President signed, legislation to permanently extend the authority to issue tax-exempt Mortgage Revenue Bonds/Mortgage Credit Certificates and allocate Low-Income Housing Tax Credits. ALHFA members and staff worked closely with members of Congress in achieving these permanent extensions.

Mortgage Revenue Bonds and Mortgage Credit Certificates

Mortgage Revenue Bonds are issued by local and state housing finance agencies to provide mortgage assistance for low- and moderate-income, first-time home buyers -- the households which the conventional mortgage market leavers behind. Typically, tax-exempt bond-financed interest rates are 1.5 percent below the conventional mortgage interest rate. This translates into the ability to qualify households at lower incomes, as well as the ability to reduce the monthly mortgage payments of those assisted. Eligible households may have incomes no higher than 115 percent of the area median income for households of three or more persons (100 percent for those households with less than three persons). The purchase price of eligible homes may not exceed 90 percent of the average purchase price of homes in the area. Both the purchase price and income restrictions are relaxed in certain defined target areas as an incentive to entice higher income households to locate in such areas.

Local housing finance agencies issue Mortgage Revenue Bonds for one or more public purposes to:

- Provide home ownership opportunities for low- and moderate-income households;
- Promote new affordable housing construction (through builder set asides);
- Stimulate housing rehabilitation and home improvements;

- Promote substantial rehabilitation thereby encouraging neighborhood revitalization;
- Stabilize and improving neighborhoods through home ownership;
- Provide mortgage assistance to first-time home buyers acquiring foreclosed properties in the federal inventory, such as those held by the Resolution Trust Corporation and the Federal Housing Administration; and
- Utilize publicly held land inventory.

In 1994, local housing finance agencies issued $3.23 billion ($3.07 billion in lendable proceeds) of that year's $15.75 billion in Mortgage Revenue Bond volume. From this amount, an estimated 40,9752 loans were made. The average loan amount was $74,923, made to eligible households whose incomes averaged $31,034 -- 78 percent of the 1994 national median income of $39,900, and 34 percent lower than the income of the average first-time home buyer using conventional financing -- $48,642. The MRB-assisted average loan amount is 90 percent of the average amount of a first-time home buyer's conventionally financed $83,500 home. Thus, it is clear from these statistics that local agency MRB programs are sharply targeted, in keeping with Congressional intent.

The Mortgage Credit Certificate program, authorized by Congress in the Tax Reform Act of 1984, provides financial assistance to first-time home buyers for the purchases of single-family homes, townhouses, condominiums, and mobile homes on foundations.

An MCC gives the home buyer a federal income tax credit each year the buyer keeps the same mortgage loan and lives in the same house. Although variations are possible, the typical MCC tax credit equals 20 percent of the mortgage interest paid each year. The 20 percent is subtracted dollar-for-dollar from the home buyer's federal income tax. The remaining 80 percent of the interest is taken as a deduction from the gross income in the usual manner.

Local housing finance agencies make use of the MCC program where it is feasible and consistent with their housing needs and priorities. MCCs tend to be feasible in growing areas with relatively high incomes. MCC programs are particularly popular in California where local housing finance agencies often operate them as a component of their MRB programs.

While MCCs operate in some areas they do not work everywhere. In addition, MCCs do not generate mortgage capital since they rely solely on the available supply of market rate mortgages. Instead of the MRB front-end subsidy, MCCs are a back-end subsidy taken at the time a mortgagor files his or her income tax. In addition, MRBs can be used to provide capital for neighborhood revitalization through home improvement and qualified rehabilitation programs. Both the MRB and MCC programs are needed to respond in a comprehensive fashion to varying local housing needs.

Legislative Refinements to the Mortgage Revenue Bond Program

One of the issues before the Committee is a proposal to increase the maximum size of a qualified home improvement loan financed with Mortgage Revenue Bond proceeds from $15,000 to $25,000. The current limit was put in place in 1981 and has not been increased since, despite the increased cost of construction. Eligible improvements include addition of living space, installation and upgrading heating and air conditioning systems, renovation of plumbing and electrical systems, construction of a garage and kitchen renovation. Recreational facilities are not eligible. Increasing the loan limit to $25,000 would enable homeowners to use of FHA Title I mortgage insurance program as security for the loan. It would also permit the improvement of older homes whose rehabilitation needs could not be financed with the current ceiling. Finally, it would enable homeowners to undertake more complete energy efficient renovations.

There are several other refinements that ALHFA recommends be part of a miscellaneous revenue bill:

- Redefining the term "target area" in the program (wherein higher income limits are permitted) to include census tracts where 50 percent of the households have incomes below 90 percent of the area median (rather than the 70 percent below 80 percent currently). This will promote neighborhood stability by permitting moderate- and middle-income households to locate or remain in central cities. Issuers of Mortgage Revenue Bonds must set-aside 20 percent of each issue for a period of 18 months to make loans to households residing in target areas. In target areas two-thirds of those assisted may have incomes up to 140 percent of median income, while the other third can be used to assist those without regard to income limits. Many communities complain that the target area definition is too restrictive and does not qualify a sufficient number of census tracts. This means that the target areas set-aside goes unused in whole or in part for 18 months.

- Another refinement to the target area requirement which ALHFA recommends is to provide an additional means of satisfying the target area requirement by permitting issuers to reserve 20 percent of each issue's proceeds to be set-aside for 18 months for households whose income does not exceed 80 percent of median income and to allow these loans to be made anywhere in the issuer's jurisdiction. This would continue the spirit of the targeting principle of the Mortgage Revenue Bond program and facilitate use of the set-aside.

- Another refinement recommended by ALHFA is to expand the definition of first-time home buyers under the program to also include spouses who have not received the benefit of home sale proceeds, persons displaced by a natural disaster who must obtain a new mortgage, and persons relocated as a result of redevelopment of a blighted neighborhood. This expansion would enable those, who through no fault of their own, lose the benefits of home ownership, the opportunity to participate in the Mortgage Revenue Bond program.

- The last refinement ALHFA recommends is to allow Mortgage Revenue Bond proceeds to finance new construction of up-to four units. Currently, bond proceeds can finance up to two units. Allowing construction of up-to four units would enable the program to make efficient use of scarce land in central cities.

Tax-Exempt Multifamily Housing Bonds

One refinement which ALHFA recommends with respect to tax-exempt multifamily bonds is to provide, in the case of acquisition of an occupied multifamily project, a six-month grace period before the owner must meet the set-aside requirements (20 percent of the units reserved for those whose income does not exceed 50 percent of the area median, or 40 percent of the units reserved for those at 60 percent of the area median). This grace period is needed to allow a reasonable period of time for compliance to be achieved without requiring existing tenants to be evicted.

Tax-Exempt Bonds Generally

ALHFA is concerned about the pressure on the statewide tax-exempt volume cap in a number of states, Texas, California, Florida, and New York, in particular. The volume cap, which is the greater of $150 million or $50 per capita has not been increased since 1986. While it is true that some states have benefitted from an increase in their volume cap because of an increase in population, others states like New York whose population has not increased have not so benefitted, despite increased demand. Congress should take action to relieve the pressure on the cap where demand is far outstripping availability. It should also index the cap for inflation.

There are several other changes which ALHFA recommends be enacted:

- Simplifying and easing the arbitrage rebate requirements by allowing issuers of any tax-exempt bond to be exempt from the requirement to rebate to the Treasury arbitrage earnings if they expended 33.3 percent in the first year after issuance, 75 percent in the second year, and 100 percent by the end of the third year;

- Eliminating the Alternative Minimum Tax on tax-exempt housing bonds. The tax increases the cost of borrowing without a corresponding federal benefit. Little, if any, federal revenue is gained from the AMT on these housing bonds;

- Restoring the deductibility of carrying costs for bank purchases of tax-exempt housing bonds. This would serve to expand the market for these bonds.

Low-Income Housing Tax Credits

The Low-Income Housing Tax Credit program was enacted by Congress in 1986 to stimulate

private investment in the acquisition, rehabilitation, or construction of rental housing for low-income households. The Credit represents a legitimate use of the tax code to stimulate investment in an activity which would otherwise draw little, if any, investor interest. The reason, of course, is that rental housing projects serving low-income households are not an economic investment and must rely on other factors, such as tax benefits, to make them attractive.

States may allocate tax credits in an amount totaling $1.25 per capita annually. The credit is a credit or reduction in tax liability for 10 years for owners and investors in low-income rental housing that is based on the costs of development and the number of qualified low-income units. Projects receiving tax-exempt financing may receive tax credits without regard to the state ceiling. The tax credit rate is an amount having a present value of 30 percent of the qualified basis for acquisition, a present value of 70 percent of the qualified basis for rehabilitation and new construction costs, but only 4 percent if a project has federal subsidies (excluding Community Development Block Grants and, in certain cases, HOME funds). In defined high housing cost and difficult to develop areas, the present value of the Credit may be increased to 39 percent and 91 percent respectively. Projects eligible for the Credit include those with a minimum of 20 percent of the units set-aside for households whose income does not exceed 50 percent of the area median or those with a minimum of 40 percent of the units set-aside for those at 60 percent of the median income or less. State and local housing credit agencies select projects through adopted allocation plans, which must include certain priorities and criteria for selection. An agency must award only the amount of Credit a project needs to be feasible.

Since its enactment in 1986, the tax credit has produced over 700,000 units of rental housing. In 1992, it accounted for more than one-half of all multifamily construction activity, producing an estimated 50,000 jobs.

Legislative Refinements to the Low-Income Housing Tax Credit

One of the issues before the Committee is to modify current law to permit an increase in the value of the Credit in high cost or difficult to develop areas when the Credit is combined with HOME funds. Under current law, if HOME funds are used, the project must set-aside at least 40 percent of the units for those at 50 percent of median income or less. However, the maximum amount of the credit is 30 percent of the qualified basis when the project involves acquisition and 70 percent of the qualified basis when the project involves new construction or substantial rehabilitation. These projects cannot qualify for the upward adjustment in the value of the Credit to a present value of 39 percent and 91 percent of qualified basis. Since tax credit projects rely on a number of subsidy sources to make them financially feasible, HOME funds are often used in a project's financing. Project's using HOME that are located in high housing cost areas or difficult to develop areas should not be prohibited from receiving the upward adjustment. It is precisely because they are located in such areas that they need this adjustment. Since the statute precludes over-subsidizing a project, permitting the upward adjustment will not result in any windfall to the

project owner and investors. ALHFA urges the Committee to adopt this proposal.

Another issue before the Committee which ALHFA supports is the Credit stacking rule. The proposal would modify current law to allow Credits carried over from a previous year to be used before the current year's allocation. Under current law, if a state has Credits carried forward from the previous year but is unable to use all of its current year allocation, it is not able to used the Credits carried forward and they revert to a national pool. The proposed change would help insure that states do not lose Credits which are rightfully theirs.

Another refinement which ALHFA urges the Committee to approve is removing the penalty which reduces the value of the Credit from a present value of 70 percent to 30 percent if the project is financed with tax-exempt rental housing bonds. Congress has already removed the penalty in the case of Community Development Block and HOME funds. It should complete the cycle. Again, there is ample protection in present law to guard against over subsidizing such projects.

As with the tax-exempt state volume cap, there is also pressure on the credit volume cap in many states. The present $1.25 per capita limitation has been in place since 1986. Congress should consider increasing the cap and indexing it for inflation.

Tax-exempt bond financing and Low-Income Housing Tax Credits have been the main tools utilized by local housing finance agencies in financing low- and moderate-income housing and fostering partnerships with the private and nonprofit sectors. The recommendations made here would increase the effectiveness of these tools for ownership housing, strengthen the Credit and rental housing bonds as an investment incentive for rental housing, and strengthen the capability of MRBs to assist in inner city reinvestment. ALHFA urges the Congress to make these needed refinements.

STATEMENT SUBMITTED BY BROWNING-FERRIS INDUSTRIES, INC. WITH RESPECT TO WAYS AND MEANS COMMITTEE HEARINGS ON MISCELLANEOUS TAX PROPOSALS

July 27, 1995

Browning-Ferris Industries, Inc. ("BFI") is one of the largest publicly-held companies whose subsidiaries and affiliates collect, process for recycling, transport, and dispose of a wide range of commercial, industrial, medical and residential solid wastes. BFI subsidiaries are also engaged in operating resource recovery facilities, including the production of methane from landfills and the generation of electricity using methane as a fuel.

BFI supports the adoption of two tax proposals which are being considered by the committee in the context of tax reform. The first is item numbered 1b under the title "Energy" (p. 76 of the Joint Committee print JCS-19-95) that would repeal the related-party sales requirement of Section 29 in certain cases. The second is item numbered 5 under the title "Excise Taxes" (p. 113 of JCS-19-95) that would allow refunds or credits of highway fuel taxes PAID for fuel used to power the off-road use of special equipment.

I. Related-Party Rule

Under Section 29 of the code certain fuels produced from "nonconventional sources," including gas produced from biomass, are eligible for a tax credit of $3 (adjusted for inflation) for each barrel of oil equivalent. The credit is not available unless it is sold by the producer of the qualifying fuel to an unrelated purchaser.

Through the enactment of Section 29 the Congress has encouraged the use of methane gas from landfills as a valuable source of domestic fuel which can be turned into energy. With this tax credit landfill gas has become a practical fuel for generating electricity to the extent that, of the 143 landfill projects for the production of methane gas operating today, nearly three-quarters generate electricity and the remainder sell the fuel to nearby industrial users.

Under the Clean Air Act, the EPA is expected to promulgate new regulations this year that will mandate that new methane gas produced at landfills be collected and managed. These new federal mandates will require that landfill operators will be required to make substantial investments for collection systems. These costs could, in part, be offset through the sale of electricity generated on site provided the operators are able to take advantages of the Section 29 credit.

The related-party rule, perhaps in an excess of caution, was adopted to assure that producers would have records of sales to corroborate production reports. However, this rule has worked a hardship on companies such as BFI who produce methane gas from biomass in landfill sites. Landfill methane is a unique qualified fuel. Because there are no economical ways to store landfill methane, it is truly a "use it as you produce it" fuel. Using methane on site to generate electricity and marketing that electricity through existing transmission lines is much safer, more efficient and more economical than is processing the gas on site and transporting it through expensive pipelines to unrelated users. Note that pipelines are rarely available for the transmission of landfill gas and must typically be constructed in order to deliver the gas to the customer. Furthermore, recordkeeping is not a problem in the case of landfill methane production as it might be in the case of other fuels. In addition to metering of methane produced from a landfill, records are also retained of gas inputs into the electric generation facility. Note that in 1993 the Treasury Department, testifying with regard to a similar proposal, stated that it did not oppose the amendment and that there was "no compelling reason to limit the Section 29 credit sold to an unrelated person. The purpose of the credit is satisfied and there is little potential for abuse because the selling price is not related to the credit amount."

The proposal before this committee would amend the Section 29 related-party rule to provide that taxpayers who sell electricity generated from a qualified fuel to an unrelated party would be treated as if they sold the qualified fuel directly to an unrelated party. This clearly fits under the rubric of "tax simplification." BFI supports the enactment of this proposal.

II. Fuel Used to Power Special Equipment

Under Section 4041 and 4081 of the Code gasoline, diesel fuel and special motor fuels used in highway vehicles are subject to federal excise taxes. These taxes are generally paid over into the highway trust fund to finance highway construction. However, fuel used for non-highway use is exempt from tax and the taxpayer may receive a refund or credit for taxes paid on such fuel under Section 6421 of the Code. However, a problem arises in the case of the highway vehicles, such as those operated by BFI, where fuel is used in engines not only to power trucks used on highways, but also to operate non-highway equipment such as power take-offs mounted on trash disposal trucks. Treasury regulations provide that fuel used to operate power take-off and similar equipment is not taxable, but only if the engine powering the non-highway equipment is separate from the vehicle's highway engine. When a vehicle's highway engine is used to power both the truck and the power take-off equipment all fuel used in the engine is taxable.

The Treasury regulations separate engine rule is based upon the assumption that the IRS would be unable to determine to what extent fuel in a fuel tank is used to power a vehicle on a highway and to what extent it was used to power non-taxable equipment. While this assumption may have been true when the regulations were adopted some thirty years ago, existing technology can now be used to establish with precision the amount of fuel used for taxable and non-taxable purposes.

The proposal before the committee (item number 5 under the title "Excise Taxes") that would allow truck owners to claim a refund for fuels used in highway engines to power the non-highway use of take-offs even where the engines used for such purposes are also used to propel the trucks on highways.

BFI strongly supports this provision. Based on prior industry estimates, some 30-percent of fuel used on trucks carrying power take-off equipment is used in non-taxable activities. Nevertheless, the operators of such equipment are unable to obtain refunds or credits for uses that under the Code are clearly not taxable. The dilemma faced by the operators of these trucks is that, while the loss of the tax exemption is significant, it is not so large as to economically justify the cost of complying with the Treasury regulations by installing a second engine and fuel tank on each truck.

The hardship imposed on truck owners whose trucks carry power take-offs has been recognized by a number of states which now allow some form of rebate for fuel used to power off-highway equipment. The federal government should follow their lead by correcting the hardship imposed on such taxpayers under current law.

Submission of Frederic G. Corneel of Sullivan & Worcester
One Post Office Square, Boston, MA 02109
to House Ways and Means Committee
in connection with Committee's Hearings on Miscellaneous Tax Reforms

July 20, 1995

Certified Mail
Return Receipt Requested

Mr. Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Hearings on Miscellaneous Tax Reforms:
Section 503 of H.R. 3419

Dear Mr. Moseley:

In lieu of a personal appearance at the above hearings, I hereby submit this statement for the printed record, urging enactment of Section 503 of the Tax Simplification and Technical Corrections Bill of 1993 (HR 3419) in the 103rd Congress.

Section 503 would authorize ownership of S corporation stock by an "electing small business trust". This would make it possible for subchapter S stock to be held by so-called "spray trusts", that is, trusts which give the trustees discretion from time to time to allocate income or principal among designated family members in such a way as will best accomplish the purposes of the trust.

Discretionary spray trusts make it possible for the trustees to adjust distributions to beneficiaries to their varying needs and ability to handle money and to respond to situations that could not have been foreseen when the trust was established. Such trusts are part of the estate plans of most owners of closely held businesses. Where the business is organized as a partnership, ownership of an interest in the business by the spray trusts creates no problem. But if the entity is an S corporation, ownership by a spray trust is currently prohibited. It causes substantial difficulties for owners of S corporation stock that separate provision, not in accordance with the balance of their estate plan, must now be made for their stock.

We had prepared the legislative proposal which was previously set forth in the Senate version of H.R. 11 of the 1992 Congress and later in Section 503 to minimize or eliminate entirely any revenue loss. In the redrafting of our proposal by Congressional staff personnel our proposal was further tightened and, we believe that, as revised, no loss of revenue is anticipated. (This is due in substantial part to a provision in the proposed legislation requiring all income received by such a trust to be taxed at the highest individual rate, regardless of the tax bracket of the beneficiaries).

There are, of course, numerous proposals for a substantial revision of subchapter S pending before Congress. Many of these probably require a review of all aspects of subchapter S operation, now that limited partnerships and limited liability companies have come to play a very much larger role in the organization of business enterprises than they did when subchapter S was reviewed.

It may be that there is no time now for such general subchapter S review. However, the change proposed by Section 503 need not be part of such general review: It does not create a new class of stock, it does not permit a larger number of beneficial owners beyond the current 35 shareholder limit, it does not permit a new group of authorized owners, such as foreigners or partnerships, and, by subjecting all trust income to the highest individual tax rates, it assures that the spray provisions cannot be used to reduce current income taxes below what they would be if the S shares were held outright rather than in trust.

Because enactment of Section 503 would substantially facilitate estate planning for owners of closely held businesses and would do so without anticipated revenue loss and without making any basic change in the subchapter S regime, we respectfully urge inclusion of Section 503 in the projected miscellaneous tax reform legislation.

This letter is written on my own behalf as a tax professional long interested in the taxation of closely held businesses and their owners* and also on behalf of clients of this firm.

Yours very truly,

Frederic G. Corneel

Frederic G. Corneel

FGC/bg

cc: Congressman Richard E. Neal
131 Cannon House Office Building
Washington, DC 20515
ATT: Katherine Sullivan

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* I am former Chair of the ABA Tax Section Committee on Small Business; also former Chair of the Tax Section of the Massachusetts Bar Association and am now and have been for many years co-chair of the Annual ALI/ABA Program on Sophisticated Estate Planning. I also served two terms on the Commissioner's (IRS) Advisory Group. This letter is not written on behalf of any of these organizations. I am the senior partner in this firm's Tax Department and we have clients who support or would benefit from enactment of this legislation. However, I would not make this submission if the proposal did not make a great deal of sense to me personally.

STATEMENT OF REPRESENTATIVE JENNIFER DUNN
WAYS AND MEANS COMMITTEE
MISCELLANEOUS TAX REFORMS
JULY 11, 1995

Thank you Mr. Chairman. I commend you for holding this hearing to examine various revenue issues which have been brought to the attention of the Committee. As the Committee moves forward, I look forward to working with you and my colleagues to enact those minor tax provisions that will serve to improve the current tax laws.

Several provisions are of particular interest to the Eighth District of Washington state, and therefore to me.

Foreign Sales Corporation: **"Inclusion of computer software as foreign sales corporation export property"**

Congress enacted the FSC rules to level the playing field for U.S. exporters in competing with products made in other countries which have more favorable tax rules for exports. However, due to a narrow IRS interpretation of the FSC rules, the export of computer software, which is accompanied by the right to reproduce the software, is barred from receiving this export incentive. Although the Treasury Department recognized the inconsistency in providing FSC benefits to licenses of films, tapes and records but not to licenses of software, they stated their belief that this problem needed to be addressed in legislation rather than by regulation.

To illustrate the inequitable IRS interpretation of FSC rules with regard to software exports, suppose we have two CD ROMs -- one containing a musical recording, the other containing a multimedia software product that also provides music. If the "master" of the musical recording is exported with a right to reproduce it overseas, the export qualifies for FSC benefits. If the "master" of the computer software is exported with a right to reproduce it overseas, the export does not qualify for FSC benefits, a result that makes no sense from either a policy or practical perspective. The ability to export software, accompanied by a right to reproduce that software in the local market, is essential to the way the software industry does business. Denying the benefits of the FSC rules to software exported through established industry distribution networks poses an impediment to the competitiveness of U.S. manufactured software.

The United States is currently the world leader in software development, employing approximately 400,000 people in high-paying software development and servicing jobs. Much of the expansion of the industry is due to the growth of exports. The software industry, like other U.S. exporters, needs FSC benefits to remain competitive.

FSC benefits are extremely important in encouraging small and medium-sized software companies to enter the export market by helping them equalize the cost of exporting. In addition, FSC benefits are needed to help keep high-paying software development jobs in the United States at a time when foreign governments are actively soliciting software companies to move those jobs to their countries. If these exports are not given FSC benefits, I am very concerned that these jobs will begin moving to other countries. I firmly believe that it is in the best interest of our nation that we include technical clarification of the application of the foreign sales corporation (FSC) rules to software as part of tax legislation acted upon by the Ways and Means Committee this year.

Excise Tax on Automobiles: **"Modify or phaseout the excise tax on luxury automobiles"**

Enacted in 1990, the automobile excise tax imposes a 10-percent excise tax on the retail price of autos above $32,000. In 1993, Congress repealed similar excise taxes on boats, planes, jewelry and furs, but not on automobiles. Rather than repeal the auto excise tax, which is due to expire December 31, 1999, Congress indexed the tax threshold. I submit that the Congress made a serious error by not repealing the excise tax on automobiles. In lieu of such a repeal, I strongly encourage the Committee to consider a phase down of this onerous tax.

"Increase deferred compensation limit for group medical practices"

Our nation's not-for-profit medical group practices have a well-deserved, international reputation for medical excellence. They also provide significant charity care, offer some of the finest medical education and training in the world, are acknowledged leaders in medical research, and are devoted to community service. However, the not-for-profit providers face an inequitable situation when they try to attract top doctors. Current compensation rules for not-for-profit employers--including teaching hospitals, community clinics, and integrated health systems--are governed by stringent limits on reasonable compensation and private inurement which do not apply top physicians in private practice or in the for-profit sector. Medical professionals in tax-exempt practices already sacrifice substantial personal benefits in order to serve their communities. To compel them to further sacrifice, compared with their for-profit colleagues, is both unrealistic and unfair. Yet, the ultimate loss in such circumstances will not only be to the health care professional but also to the patient, who has a right to expect the best, most cost-efficient health care America's medical profession can provide.

Legislation I will introduced would provide a limited exemption from IRC Section 457 to eligible group medical practices. Such a change in the law would be good public policy. It would increase the dollar limitations for members and employees of those practices, index the deferral amount for inflation, and exempt eligible medical group practices from the limitations of Section 457 (c)(2).

Additional provisions

I also want to take the opportunity to express my support for a number of items on the hearing agenda that will go a long way toward improving current tax law. I urge the Committee to support changes to current tax law to encourage owners of closely-held businesses to donate their assets for charitable purposes and to insure that the benefits of such gifts are fully realized by the charity. Such changes would subject owners to the same tax treatment that they would be subject to if they held assets directly and donated the assets to the charity.

I also support legislation that would put U.S. mutual funds on a competitive footing with foreign funds by making the tax treatment of foreign investments in U.S. mutual funds comparable to that afforded foreign-based funds. Additionally, I encourage the Committee to adopt provisions to exempt certain income derived by insurance brokers or agents from PFIC rules and to allow deduction for intrastate rights of motor carriers.

I would like to thank the Chairman for the opportunity to express my support for various miscellaneous tax reforms. I look forward to hearing and reading the testimony submitted for these hearings and working with my colleagues to consider necessary changes to tax law.

Written Comments
of the
Edison Electric Institute
Regarding
Miscellaneous Tax Proposals
Before the
Committee on Ways and Means
U.S. House of Representatives
July 25, 1995

The Edison Electric Institute (EEI) appreciates the opportunity to submit these written comments in connection with the Committee's consideration of several miscellaneous tax reform proposals that were the subject of hearings held on July 11 and 12, 1995. EEI respectfully urges the Committee to enact those provisions that promote fair competition among taxpayers and those that eliminate wasteful and unnecessary compliance burdens on taxpayers. Our positions on those provisions most important to us are discussed in this statement.

BACKGROUND

EEI is the association representing the nation's investor-owned electric utility companies. Its members serve 99 percent of all customers served by the investor-owned segment of the electric utility industry. EEI's members generate approximately 79 percent of all the electricity produced in the United States and serve 76 percent of the nation's customers.

Our basic perspective in analyzing the Committee's proposals is driven by the fundamental changes occurring in the electric utility industry as it moves from a highly regulated environment toward a deregulated, competitive environment. EEI is extremely concerned about the effect that changes in the federal tax laws might have on its members, given the increasingly competitive nature of our industry. EEI applauds the Committee's efforts to amend the tax laws to promote fair competition and to reduce unnecessary government regulation.

A number of the miscellaneous tax reform proposals under consideration by the Committee would have either positive or negative effects upon our members. This statement is divided into two categories for the purpose of discussion: (1) those proposals that impact competition and fairness, and (2) those provisions that affect tax simplification.

I. TAX PROPOSALS IMPACTING COMPETITION AND FAIRNESS

1. Tax-Exempt Bonds

EEI is concerned about efforts to expand exceptions to the arbitrage rules and increase the capability to issue tax-exempt bonds for certain output property. This concern occurs because federal subsidies to tax-exempt entities provide our competitors with an unfair competitive advantage[1]. The discussion of the following three proposals regarding tax-exempt bonds addresses our primary concerns with those proposals under consideration by this Committee.

A. Expansion of arbitrage rebate exception for certain bonds (page 286)[2]

The proposal would expand the eligibility for the construction bond exception

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[1] Subsidies to tax-exempt utilities are approximately $8.4 billion annually. See Graves, Joe - "The $8.4 Billion Drain," Electric Perspectives (May/June 1995).

[2] All page references in this statement are to the Joint Committee on Taxation, Description of Miscellaneous Tax Proposals (JCS-19-95), July 10, 1995.

from arbitrage to all bonds and extend the 24-month requirement of the present law construction bond exception. The arbitrage rebate requirements were enacted as a result of abuses related to the use of arbitrage income to fund current operating expenses.

EEI opposes the expansion of the exception to the arbitrage rules to bonds other than construction-related bonds. In addition, we propose that the current law arbitrage exception for construction-related bonds be changed to provide that the arbitrage profits earned must be used either to pay construction expenses of the project or to reduce associated bonded indebtedness. This change in the proposal would reduce the potential revenue loss to the federal treasury and limit any opportunity for abuse whereby arbitrage profits might be used to offset current operating expenses. The proposal to expand the arbitrage rules to all bonds is contrary to an IRS program announced in February, 1994, of auditing tax-exempt bond issues suspected of abuse.

B. Bonds for certain output facilities
(page 287)

EEI wishes to express its opposition to legislation (H.R. 677) introduced by Representative Neal on January 25, 1995. This bill is identical to legislation he introduced in the 103rd Congress (H.R. 1938) on which EEI testified in opposition on July 12, 1993. The bill would repeal the $15 million cap on the use of tax-exempt municipal bonds for the purchase or acquisition of output facilities.

EEI is opposed to the bill because it would provide an additional competitive advantage (by providing an additional federal subsidy) to state and municipally-owned utilities; deter the development of fully competitive electric markets; and counteract efforts to promote energy conservation, because this financing artificially lowers the cost of energy below its true marginal cost.

In written testimony presented before this Committee on January 25, 1995, we emphasized that the electric utility industry is rapidly moving toward more competition as a result of energy policy changes at the federal and state levels, including the Energy Policy Act of 1992. Because of increasing competition, we need to ensure a level playing field for all competitors, including tax-exempt municipal utilities. As a result of their federal tax subsidies, these utilities have an unfair competitive advantage over tax-paying investor-owned utilities.

EEI opposes H.R. 677 because the federal government should not grant any single participant in a competitive market an advantage over other competitors. EEI opposes any relaxation of the current restrictions on the use of tax-exempt financing for the purchase or acquisition of output facilities.

Moreover, in addition to providing a competitive advantage to state and municipally-owned utilities, the removal of the $15 million restriction would create revenue losses for the federal government, further exacerbating the federal budget deficit. This would occur in two ways. First, state and municipally-owned utilities are likely to construct facilities larger than they otherwise would to facilitate sales beyond their existing customer base. This action would result in the issuance of additional tax-exempt debt. Second, since, as discussed above, the provision provides a subsidy to state and municipally-owned utilities, one would expect that as a result state and municipally-owned utilities would be able to make additional sales (the income on which would not be subject to income tax), preventing sales from tax-paying investor-owned electric utilities.

Treatment of contributions in aid of construction for water utilities
(page 5)

EEI supports the exclusion for contributions in aid of construction (CIAC) in Section 118(b), repealed by the Tax Reform Act of 1986. This provision, however,

should be modified to apply equally to regulated utilities providing electric or gas service[3] and not be limited to utilities providing water or sewage disposal services. We believe that CIAC constitutes a reimbursement of utility construction costs for which there is no economic income. Since the repeal of Section 118(b) in 1986, CIAC has become a complex and controversial area that has been the subject of unnecessary conflict involving utilities, the IRS and CIAC contributors. Under utility regulation, the incidence of tax generally falls on utility customers increasing the cost of customer contributions by an additional 30 percent to 40 percent.

The taxation of CIAC also results in an unfair barrier to open competition by creating an economic incentive for developers to locate projects in areas served by municipal utilities or to encourage municipal annexation of their development area in order to avoid the burden of a tax on their contribution to the cost of required utility infrastructure. All utility customers, including electric or gas customers, should be treated equally, regardless of the business form of the utility providing services. As a result, this provision should be expanded to reinstate the income exclusion for CIAC for regulated utilities providing electric, gas, water, or sewage services.

3. <u>Normalization of consolidated tax adjustments</u>
(page 48)

EEI supports the proposal that would clarify that consolidated tax adjustments violate the normalization requirements of Section 168. In enacting the normalization provisions, Congress was concerned that the capital formation incentives of accelerated depreciation were being undermined by being immediately passed through to utility customers. The election to file a consolidated tax return is an integral part of the U.S. income tax system available to corporate taxpayers. Regulated utility companies join in the filing of consolidated federal income tax returns with nonregulated affiliates. These affiliates may also receive capital formation incentives related to their investments such as accelerated depreciation, low-income housing credits and business energy credits.

Without the proposed clarification, certain regulators may continue to take advantage of the ambiguity in the current law by transferring such tax benefits generated by nonregulated subsidiaries to utility customers by reducing utility rates. The transfer of these benefits to utility customers, who neither participate in the risks nor burdens of the capital investment, negates the capital formation incentive intended by Congress and places these nonregulated subsidiaries at a significant competitive disadvantage by effectively denying them the opportunity to receive tax benefits. EEI recommends the proposed clarification be effective for a final consolidated tax adjustment imposed by a utility regulatory authority after the date of introduction of the proposed legislation.

4. <u>Foreign investments</u>
(pages 145-179)

It is EEI's belief that current law governing the taxation of international income does not reflect ongoing developments in the global economy. The last several years have witnessed a worldwide shift toward market-based economies. The privatization of infrastructures is a major component of this ongoing shift. This provides the utility industry with an opportunity to expand its operations and provide job growth. These developments were not anticipated when current law for foreign operations was enacted. As a result, many of the foreign provisions inhibit the ability of U.S. utilities to compete abroad. Certain provisions, such as the interest allocation rules, are particularly burdensome to capital intensive multinationals, including the public utility industry. Moreover, the time and cost of complying with the extremely complex foreign tax provisions have further inhibited the free flow of capital and, therefore, the

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[3] EEI does not endorse or support the limitation on depreciation method or lengthening of the recovery period provided in H.R. 957.

competitiveness of U.S. multinational businesses.

As a result of these factors, EEI supports the Committee's consideration of changes designed to improve, update and simplify the international tax provisions. Our comments on specific changes are listed below:

A. Election to use earnings and profits basis for allocation of interest expense for foreign tax credit provision
(page 149)

Under current law, debt incurred by a U.S. parent is treated as if it supports investment in foreign subsidiaries to the same extent that it supports investment in domestic activities (i.e., the so-called "waters edge fungibility" approach). This assumption ignores the economic reality that foreign subsidiaries borrow to support their own activities and thus can result in over apportionment of interest expense to foreign operations. The current law interest allocation rules disproportionately allocate interest expense because the tax bases of older domestic assets are much lower than the tax bases of recently purchased foreign assets. In addition, most foreign investments are not depreciable assets under the U.S. tax law. As a result, the percentage interest allocated to foreign income is abnormally inflated and will continue to inflate over time. The proposed earnings and profits method helps alleviate this inequity by making the measurement of foreign and domestic assets more comparable. Accordingly, EEI supports this proposal as movement towards a more equitable allocation method.

While this provision would help eliminate a specific bias that tends to allocate more interest towards foreign operations, the proposal still leaves unanswered the question concerning the economic reality of the "waters edge fungibility approach". To remedy this problem, EEI recommends the Committee also investigate the "worldwide fungibility method" which attempts to allocate worldwide as opposed to simply domestic interest.

B. Repeal foreign tax credit basket for 10/50 noncontrolled corporation
(page 151)

A large portion of utility expansion abroad has taken the form of governmental privatizations. In numerous cases, the privatizations require that local governmental control be maintained. Under current law, the investing company is forced into a "10/50" investment increasing the likelihood of double taxation and putting the company at a competitive disadvantage. From a policy perspective, treating "10/50" companies differently than controlled foreign corporations (CFC's) does not appear to be equitable or desirable. By eliminating this separate 10/50 basket and allowing such entities to be included in the active basket, this disadvantage is removed. In addition, planning to avoid the consequences of 10/50 noncontrolled corporations has essentially been sanctioned by example 3 of Treasury Regulations Section 1.701-2(f). Repeal would, therefore, merely be an expedient continuation of current law and not create revenue loss for the government.

C. Extension of period to which excess involve foreign tax credits may be carried
(page 152)

Foreign utility investments typically involve long-term projects. Generally, foreign income is low in the early years due to startup expenses. The small amount of foreign income in the early years limits the amount of foreign tax credits that can be claimed. As the project continues, income increases and more credits can be utilized. For long-term projects governed by the current 5-year carryforward rule, the credit often expires before increased revenues are recognized. Such a situation creates double taxation and makes the U.S. multinational less competitive. Increasing the carryover period to 15 years would make the international provisions consistent with the carryover period for net operating losses and minimize the double taxation problem often encountered in long-term projects.

D. Extend indirect foreign tax credit from the third to sixth tier. (Item 9 on the Committee's Advisory, foreign items)

In the case of privatization of public utilities, the ownership structure is often dictated by the foreign government. Such structures often require more than three tiers which, under current rules, create foreign taxes that can't be credited on the U.S. tax return. Philosophically, we can see no reason why a fourth tier subsidiary should be treated any differently than a third-tier subsidiary. In addition, extending the indirect credit provision to the sixth tier will simplify compliance by eliminating complex structures designed to circumvent the existing three-tier rule.

E. Simplification Proposals.

As stated earlier, the cost of foreign compliance to the utility industry necessitates that all simplification provisions be considered. If the Committee's efforts are successful in this area, the results will make U.S. multinationals more competitive abroad and will encourage them to investigate foreign investment opportunities. In particular, EEI believes the following simplification provisions will aid in this process.

1) Exemption of controlled foreign corporations from the passive foreign investment company provision (page 165). Current law includes two broad based overlapping rules for preventing deferral abuse, the passive foreign investment company provisions (PFIC rules) and the CFC provisions of the Internal Revenue Code. EEI believes that eliminating one of these provisions would greatly reduce the complexity of current law without creating a measurable loss in tax revenues.

2) The reporting of foreign corporation earnings and profits on U.S. GAAP basis (page 159).

3) Translation of foreign taxes into U.S. dollar amounts using an average exchange rate during that taxable year (Item 10 on the Committee's Advisory, foreign items).

5. Increase tax credit and modify other provisions with respect to electric vehicles (pages 24 and 119)

EEI supports the following tax provisions of the proposed "Clean Fuel Vehicle Stimulus Act of 1995," which will improve the competitive status of electric vehicles (EVs) and accelerate the expansion of domestic EVs:

A. provision of a flat $4,000 credit per vehicle (in place of 10 percent credit capped at $4,000) and allowance of a full credit offset against the alternative minimum tax,

B. exemption from the depreciation limitation provisions of Section 280F,

C. exclusion from the luxury tax imposed by Section 4001, and

D. removal of governmental use restriction for EVs leased to federal, state and local governments.

High initial costs are one of the most serious barriers to market acceptance of EVs and these tax provisions can assist in defraying some of that cost. By encouraging the purchase and use of clean vehicles, these tax provisions will increase the potential for realizing the goals of cleaner air and reduced dependency on imported oil.

6. Extend carryforward for capital losses of corporations
(page 45)

EEI supports the extension of the capital loss carryforward from 5 to 15 years. This extension should be enacted because it is good tax policy.

This provision will allow U.S. corporations to be more competitive. Under present law, corporations can deduct capital losses only to the extent that they offset capital gains, and only in the year that the capital loss is sustained (the three prior years or the succeeding five years). This limited utilization period and the need to generate offsetting capital gains serve as a disincentive for corporations to risk capital investments which create new jobs. Because of the difficulty of generating capital gains, a capital loss may require a corporation to sell a successful business prematurely to generate offsetting capital gains.

In addition, the proposal is equitable because the limited utilization period effectively disallows many corporations' deductions for capital losses[4], while taxing capital gains at the same rate as ordinary income[5]. The proposal standardizes the carryforward period for corporate net operating losses (15 years) and corporate capital losses[6]. Although the proposal does not completely eliminate the inequity in present tax law between individual's capital loss treatment (unlimited capital loss carryforward and preferential capital gain rates), it significantly decreases this inequity.

7. Energy tax credit proposals
(pages 19 and 75)

EEI supports the proposal that would allow the Section 29 credit to be claimed against the alternative minimum tax liability. Absent such legislative relief, "chronic" AMT taxpayers may be unable to utilize the credits on a timely basis, or in other cases, permanently lose the credits. EEI also supports the proposals to extend the Section 29 credit to qualified fuel used to generate electricity sold to an unrelated party. Most importantly, EEI believes that the incentives should apply equally to all taxpayers. For this reason, EEI supports the proposal to allow the solar and geothermal tax credits to be used to offset the alternative minimum tax provided that the current law definition of "energy property" is modified to eliminate the exclusion of public utility property.

8. Tax credit and tax-exempt financing for environmental remediation expenses
(page 25)

EEI believes that U.S. tax policy should encourage business efforts regarding environmental remediation. However, EEI opposes the tax proposal to provide for tax credits for remediation expenditures incurred in 24 HUD designated cities and 5 Department of Agriculture designated states because it would be a complex, costly, and arbitrary means of encouraging environmental clean-up efforts. The proposal appears to be contrary to the Congressional goal of tax simplification and could provide an unfair competitive advantage to certain taxpayers based solely on the city or state in which they

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4 Several provisions, such as Sections 291, 341, 1245, 1250, and 1258, operate to recharacterize what would otherwise be capital gain into ordinary income.

5 The Treasury Department's 1984 report to the President entitled "Tax Reform for Fairness, Simplicity and Economic Growth" proposed an unlimited capital loss carryforward period in connection with the repeal of the then-existing preferential rate for capital gains.

6 Present law allows a 5-year capital loss carryforward period for Subchapter C corporations and an extended capital loss carryforward period for foreign expropriation companies (10 years) and regulated investment companies (8 years).

are located. EEI also opposes the proposal to extend private activity bond treatment to finance environmental remediation expenses because they do not represent capital expenditures.

9. Depreciation and amortization
(pages 48-55)

EEI supports the proposal to provide a 10-year recovery life for "qualified commercial improvement property" and the provisions of H.R. 1171 which provide a recovery period of 10 years for qualified leasehold improvements. These provisions will remove a current economic barrier to the installation of energy efficient lighting, air conditioning and other improvements to commercial buildings which are currently restricted to a 39-year recovery period.

EEI believes this proposal should not be limited to qualified improvements to space used for the sale of goods or services to the public and should be available for qualified improvements to commercial property used in any trade or business.

II. TAX SIMPLIFICATION PROPOSALS

1. Pension and employee benefits
(pages 244-285)

EEI supports simplification of the pension and employee benefit provisions of the Internal Revenue Code. These provisions, in general, are so complex and confusing that many inadvertent violations occur with potentially significant penalties[7]. These complex provisions are counterproductive because they discourage many companies from establishing pension and other retirement benefit plans and penalize companies for making inadvertent errors in administering overly complex and burdensome tax rules.

Specifically, EEI supports the repeal of the special non-discrimination tests for qualified cash or deferred arrangements; the repeal of the top-heavy rules (Section 416); the repeal of the $150,000 compensation limit enacted as part of OBRA 1993; the repeal of the 15-percent excise tax on excess distributions; and the repeal of the combined plan limit for participants in both a defined contribution plan and a defined benefit plan.

EEI opposes the proposed modifications to the leased-employee rule because it unfairly shifts the liability for penalties due to an accumulated funding deficiency of certain leasing organizations' qualified plans to service recipients who have no knowledge or control over the plans or the funds.

2. Repeal Treasury ruling requirement for nuclear decommissioning funds
(page 12)

EEI supports the proposal encompassed in H.R. 1637 to repeal the ruling requirement required by Section 468A for nuclear decommissioning costs. This proposal will eliminate administrative costs that, under current law, are borne by the IRS and taxpayers alike, but will not cause any revenue loss to the government or any adverse effect on nuclear plant safety.

Section 468A requires a taxpayer to request and obtain the IRS's approval of the computation of the deduction in the form of a formal ruling before making any contributions to a qualified nuclear decommissioning fund. This is the only instance in

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[7] The IRS has implemented a VCR (voluntary compliance resolution) program where companies can voluntarily disclose inadvertent violations and pay reduced penalties.

which a taxpayer is required to obtain an advance ruling from the IRS before claiming a tax deduction.

The proposal would simply eliminate the advance ruling requirement. Neither the computation of the permissible deductions nor the rules governing the operation of qualified nuclear decommissioning funds would change. The current procedures for obtaining rulings from the IRS are extremely burdensome and expensive while providing absolutely no benefit to the government. Each ruling request must be accompanied by a $3,575 processing fee payable to the IRS. Because a separate ruling is required for each ownership interest in each plant, companies having ownership interests in multiple nuclear power plants must pay multiple processing fees, even if (as is usually the case) the documentation for the rulings is identical. Each ruling request also requires the taxpayer to incur administrative and legal costs. In addition, under current law, revised rulings must be sought and obtained repeatedly throughout the life of a qualified nuclear decommissioning fund. We are aware of no instance in which the IRS has denied a utility company's request for a ruling under Section 468A; therefore, it cannot be suggested that the ruling requirement enhances taxpayer compliance.

This proposal will eliminate unnecessary regulation that is costly for both taxpayers and the IRS. It will not compromise public health or safety; it makes good tax policy; and it should be enacted[8].

3. Allow taxpayers to estimate shrinkage for inventory accounting
(page 11)

EEI supports the proposal to allow taxpayers to estimate shrinkage for inventory accounting. This proposal would merely codify a rule of law established in Dayton Hudson Corp. v. Commissioner (101 T.C. 462 (1993)). Specifically the rule allows cost of goods sold to include an estimate of shrinkage without a physical count of goods on hand at year end, provided that inventory accounts are verified by physical inventories at reasonable intervals. We believe the proposal clarifies an existing rule thereby simplifying compliance for both the Service and taxpayers and does not jeopardize government revenue.

4. Deduction for regularly scheduled air transportation
(page 20)

EEI opposes the proposal to place a limit on the deduction for air travel incurred because it is counter to the goal of simplifying the tax law. The proposal would limit the deduction for air travel from the amount actually charged for regularly scheduled flights to the normal "tourist class fare". The proposal represents an unnecessary complexity to documenting a tax deduction. In addition, compliance with the proposal would be difficult and contentious in that airlines publish numerous and ever-changing rates for most flights. The compliance cost of this proposal would be disproportionately high compared to the additional revenue it may generate. For this reason, the subject proposal to limit the deduction for air travel should be rejected.

5. Repeal of charitable substantiation rule for contribution of $250 or more
(page 36)

EEI supports the proposal to repeal the substantiation requirements for charitable

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8 The description of the proposal by the staff of the Joint Committee on Taxation (JCS-19-95), at page 13, inadvertently mischaracterizes the proposal. The proposal does not repeal the provision that allows the IRS to disqualify a qualified nuclear decommissioning fund upon a showing that the fund's assets are not used for decommissioning or that there is self-dealing between the fund and the utility. EEI would not support such a repeal.

contributions of $250 or more. The present substantiation requirements place a significant administrative burden on corporations to gather and retain the required documentation. With respect to charitable contributions, corporations should only be required to document the donee and the amount of the expenditure. Charitable organizations should only be required to furnish the donor a statement of the value of goods or services, if provided, in return for the contribution. Enactment of this proposal would be a positive step toward simplification of the tax laws.

6. Repeal of information reporting on real estate transactions
(page 42)

EEI supports the proposal to repeal the information reporting requirements for real estate transactions. The proposal would represent an important step in simplifying the tax law and in reducing the costs of compliance with the present tax laws. The compliance costs of present law reporting requirements are not justified since they do not materially add accuracy in the determination of tax liabilities.

WRITTEN STATEMENT
OF THE
ELECTRIC TRANSPORTATION COALITION
REGARDING
FEDERAL EV TAX INCENTIVES
SUBMITTED FOR THE RECORD
HEARINGS ON MISCELLANEOUS TAX PROPOSALS -- JULY 11 & 12, 1995
WAYS AND MEANS COMMITTEE

INTRODUCTION AND BENEFITS OF ELECTRIC VEHICLES:

The Electric Transportation Coalition (Coalition) is a national nonprofit organization of public and private groups interested in the use of electricity as a transportation fuel. (A membership list is attached.) A principal activity of the Coalition is to encourage the adoption of federal government policies and programs to support the development and use of electricity as a transportation fuel in the United States.

Electricity offers significant advantages in transportation applications. From an energy security standpoint, electricity presents our nation with a very important means to reduce our dependency on foreign petroleum and to increase the diversity of fuels used in the transportation sector.

Electricity also holds the potential to significantly reduce emissions from the transportation sector. For urban areas especially, electric transportation is effective in substantially reducing emissions of major mobile source pollutants, including volatile organic compounds and oxides of nitrogen, that are the precursors of urban smog. In the heavy duty weight classes, the potential for emissions reductions derived from the substitution of electrically powered vehicles for conventionally fueled vehicles is particularly significant.

Finally, the advancement of electric transportation technologies presents opportunities for U.S. technological innovation and worldwide leadership. In particular, the development and advancement of electric transportation technologies offers opportunities for the defense and aerospace industries that have been heavily impacted by reductions in defense spending.

CURRENT FEDERAL TAX TREATMENT OF ELECTRIC VEHICLES:

Recognition of the environmental, energy security and economic benefits of electric transportation led to the inclusion of tax benefits for electric vehicles (EVs) in Title XIX of the Energy Policy Act of 1992. New Section 30 of the Code, providing an income tax credit of 10 percent of the cost of a qualified EV, capped at a maximum credit of $4,000, is perhaps the most significant incentive now available to encourage the introduction of this environmentally friendly transportation mode.

NEED FOR FURTHER FEDERAL TAX INCENTIVES TO ENCOURAGE EV DEVELOPMENT:

Industry efforts to assure a successful commercial launch for new electric vehicle technologies require that market demand for EVs be created. The electric utility industry and the automotive industry, through the Electric Transportation Coalition, have initiated a framework for assuring the successful commercial launch of electric vehicles prior to the turn of the century. The "EV Market Launch Framework" envisions the participation of the federal government in efforts to demonstrate the viability of the technology; the existence of a market for such technology; and, the deployment of the infrastructure systems necessary to support the vehicles in operation.

High initial costs are one of the most serious barriers to market entry of EVs. Unlike other clean-fuel vehicles, EVs represent a radical change in technology (i.e., no internal combustion engine, no liquid fuel). As with any new product that requires extensive modifications or new manufacturing, EVs initially will be more expensive. Initial, low-volume production also will contribute to the early, high incremental cost of EVs. Tax

incentives can assist in defraying some of these early, anticipated, additional costs until demand increases yielding greater production volumes and lower prices for these vehicles.

The Coalition seeks a set of incentives that will:

- # encourage the lowest priced vehicles possible at a time when the market is not fully developed;
- # encourage EVs be priced so that they might become competitive at some future time without tax incentives; and,
- # make incentives available to the broadest potential customer base that might purchase such vehicles to meet market, regulatory or environmental demands.

GENERAL DESCRIPTION OF EV TAX PACKAGE ADVOCATED BY THE COALITION:

The Coalition advocates adoption of a package of tax-related incentives for electric vehicles. This package of incentives would serve to fine-tune the existing EV tax credit, exempt EVs from taxes which actually raise the cost of ownership of an EV, and provide governmental entities -- a potentially large market for early EVs -- with the opportunity to benefit from lower EV prices resulting from favorable federal tax treatment. All of these changes would serve as important stimuli for the purchase and use of electric vehicles. In addition, the EV tax stimulus package provides important clarification of the tax incentive applicable to heavy duty EVs, including battery-powered buses. Importantly, the package of incentives advocated by the Coalition is designed to support industry efforts to commercialize EVs without a significant impact to the federal treasury.

SPECIFIC PROVISIONS OF THE PROPOSED EV STIMULUS PACKAGE:

Removal of Clean-Fuel Vehicles from Luxury Vehicle Classification.

Section 4001 of the Internal Revenue Code of 1986 (the "Code") imposes a 10% excise tax on the first retail sale of a vehicle for costs in excess of $32,000 (as adjusted for inflation). Secondly, section 280F of the Code limits the dollar value of depreciation available to luxury vehicles -- the so-called "luxury" depreciation cap -- by overriding the normal, faster depreciation schedule available for automobiles under Section 168 of the Code.

The Coalition urges the Committee to exclude EVs from the luxury tax imposed by section 4001 of the Code. Assessment of this tax against early-to-market EVs, which exceed the luxury tax threshold because of the costs to develop and produce new technology in low volume, is inconsistent with national policy to support and encourage the introduction of environmentally friendly EVs.

Further and importantly, imposing a luxury tax on EVs is inconsistent with the favorable tax treatment afforded EVs under the provisions of the Energy Policy Act of 1992.

As currently written, the Code does not distinguish between a gasoline-powered automobile that exceeds the luxury tax cost threshold and an automobile that exceeds the threshold solely because it operates on a nonconventional fuel source, such as electricity. The cost of some EVs will be expensive and thus will exceed the luxury tax threshold because these vehicles incorporate new, and currently expensive technology and the initial volumes of production do not reach suitable economies of scale to achieve lower costs.

Efforts to assure a successful commercial launch for new EV technologies require that market demand for EVs be created. Demonstration programs, including programs

funded by industry and industry/government cost-shared programs, are an important part of the EV commercialization effort, designed to increase user familiarity with EVs and to stimulate market demand. With respect to early EV demonstration programs that are in the process of being implemented today, the high costs already being borne by vehicle users is further exacerbated by the imposition of the luxury tax. The luxury tax penalizes consumers of initial EVs and operates to delay or deter EV market development efforts. Thus, imposition of a luxury tax is serving to dampen demand and limit the effectiveness of these early commercial demonstration programs which are designed, in part, to expand the market and bring about cost reductions.

Due to the limited number of EVs anticipated to be manufactured during the remaining years until the luxury tax expires (December 31, 1999), the proposed exclusion of EVs from the luxury tax is not likely to result in a significant loss of tax revenues. However, at the same time the exemption from the luxury tax could lower costs and accelerate market acceptance of these vehicles.

Code section 280F limits depreciation for automobiles to prescribed amounts over the first five years, currently $15,300, (the so-called "luxury" depreciation cap), with any undepreciated balance recoverable at a fixed rate (currently $1,775 annually) until the cost is fully depreciated. This overrides the normal faster depreciation otherwise available for automobiles under Code section 168. Applying the section 280F limits to EVs will increase their cost to businesses and thereby discourage their commercial use. This disincentive for business use of EVs should be eliminated.

<u>**Modification of the Governmental Use Restriction for EVs.**</u>

Under current law no credit is permitted for property used by the United States or any state or political subdivision thereof or any agency or instrumentality of the foregoing (sections 30(d)(3) and 50(b)(4)(A)(1)). Yet, state and local governments are likely candidates to take the lead in expanding the market for EVs through public transit and fleet use. The environmental and energy security benefits of EVs are attractive characteristics for governmental units. Removing the bar against governmental use would permit the <u>leasing</u> of EVs to governmental entities by, for example, private leasing companies. <u>**The benefit of the tax credit then could be passed through to state or local government lessees**</u> thereby encouraging use of EVs by this important market segment.

For these reasons, the Coalition recommends that Section 30(d)(3) of the Code be amended to remove the restriction of governmental use as a bar to utilization of the EV tax credit.

Further, to fully encourage private sector participation in the development of this initial market, the Coalition also recommends that the governmental use restriction be eliminated with respect to larger EVs that qualify for the clean-fuel vehicle deduction by amending Section 179A(e)(5).

<u>**Large Electric Trucks, Vans, and Buses Should Be Eligible for the Deduction for Clean-Fuel Vehicles.**</u>

Under the Energy Policy Act, heavy duty electric vehicles, including battery-powered buses, are provided a less generous tax benefit than all other heavy duty vehicles propelled by alternative fuels.

Section 179A of the Code provides a tax deduction for vehicles powered by clean fuels <u>other than electricity</u>. The amount of the deduction is graduated, based on the weight of the vehicle. Heavier vehicles, including trucks and vans with a gross vehicle weight rating of over 26,000 pounds, and buses with seating capacities of at least 20 adults, are permitted a $50,000 deduction under Section 179A(b)(1)(A)(iii) of the Code. However, the definition of a "qualified EV" entitled to the Section 30 income tax credit *does not reflect differences in vehicle weight or use.* As a result, no matter what the cost, or vehicle weight or use of an EV, the amount of the tax benefit under Section 30 is **limited to a maximum $4,000 tax credit.**

The Coalition does not believe that the disparity between benefit to heavy duty EVs and electric buses as compared to other clean fuel buses and heavy duty vehicles was intended by Congress. While the EV tax credit provides an important incentive for light duty EVs, the value of the benefit is far less for more costly heavy duty EVs and battery powered buses.

Electric buses can fill an important role in meeting air quality standards. As a result, environmental compliance considerations have led municipal transit operators to examine the use of clean fuel bus technologies, including battery powered electric buses. Battery powered electric buses, suitable for a variety of transit applications, are currently in limited, commercial operation in a number of communities around the country. If the costs of such electric buses were lower, it is expected that they would achieve greater market penetration.

Interest in the acquisition of battery powered electric buses also is expected from school districts, many of which are facing requirements to convert to the use of cleaner fuels. Other frequently identified potential applications for battery powered electric buses include on/off airport shuttles and transport vehicles used for educational and other institutional campuses.
The Coalition recommends that electric buses and heavy duty electric vehicles be granted the same eligibility to use the current tax deduction afforded other clean-fuel buses and heavy duty vehicles powered by other alternative fuels.

Modifications to Enhance the Benefit of the Current EV Credit.

As discussed above, the high initial purchase price of early EVs could be a significant deterrent to market acceptance. Therefore, a maximum incentive for the buyer is needed.

Section 30(a) of the Code provides a 10% credit for the cost of qualified EVs, but Section 30(b)(1) of the Code limits the credit to a maximum $4,000 per vehicle. The Coalition urges Congress to amend section 30 of the Code to **provide a flat $4,000 credit for EVs.**

The Coalition advocates the availability of a full $4,000 credit, regardless of the retail purchase price of the EV, to attract buyers who otherwise would be deterred by the high initial purchase price.

Section 30(b)(3) of the Code also provides that the tax credit may offset the regular, *but not the alternative minimum tax ("AMT").*

In many cases businesses that may be interested in acquiring electric vehicles are subject to the AMT and under current law would be unable to use the tax credit. This could pose a significant disincentive to purchase for those businesses. Widening the availability of the tax credit to businesses subject to the AMT could enlarge the potential early market for such vehicles.

The Coalition therefore also urges the Congress to eliminate the restriction on use of the EV tax credit against the AMT.

CONCLUSION:

The Electric Transportation Coalition appreciates the opportunity to comment upon the need for, and benefit of, a limited set of tax incentives to encourage the purchase and use of electric vehicles. The package of recommended incentives, while anticipated to have a relatively modest revenue impact, represents a most important means of assuring early market acceptance of electric vehicles which can in turn lead to the development of a *long-term, sustainable market for this environmentally significant mode of transportation.*

ELECTRIC TRANSPORTATION COALITION

MEMBERSHIP

July 25, 1995

Allegheny Power Service Corporation
American Electric Power Service Corporation
American Public Power Association
Arizona Public Service Company
Baltimore Gas & Electric Company
Bluebird Body Company
BMW of North America, Inc.
Boston Edison Company
California Trade and Commerce Agency
Centerior Energy Corporation
Chattanooga Area Regional Transportation Authority
Chrysler Corporation
City and County of Denver
City of Albuquerque
City of Chicago Department of Environment
City of Detroit
City of New York
City of Riverside Public Utilities Department
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Georgia Tech Research Institute
Greater Richmond Transit Company
Honolulu Public Transit Authority
Hughes Aircraft Company
International Lead Zinc Research Organization
Long Island Lighting Company
Los Angeles Department of Water & Power
Mercedes-Benz of North America, Inc.
National Electrical Manufacturers Association
National Rural Electric Cooperative Association
Nevada Power Company
Nevada State Energy Office
New York Power Authority
New York State Electric and Gas Corporation
Niagara Mohawk Power
Northeast Sustainable Energy Association (NESEA)
Northeast Utilities
Northern Indiana Public Service Company
Oklahoma Gas & Electric Company
PacifiCorp
Pacific Gas & Electric
Pennsylvania Energy Office
Pennsylvania Power & Light Company
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Potomac Electric Power Company
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Southern California Edison
State of Colorado
State of Hawaii/HTDC
Taylor-Dunn
Texas A&M University System
The Southern Company
Theodore Barry & Associates
Toyota Motor Corporation
Unique Mobility, Inc.
University of California, Davis
University of Oklahoma
University of South Florida
University of Washington, College of Engineering
Villanova University
Virginia Power
West Virginia University
York Technical College

FEDERATION OF TAX ADMINISTRATORS

444 North Capitol St., NW, Washington, D.C. 20001 • (202) 624-5890

July 17, 1995

The Honorable Bill Archer
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The Federation of Tax Administrators is an association of the primary tax administration agencies in the 50 states, the District of Columbia and New York City.

In accordance with your invitation for written testimony on "miscellaneous tax reforms" being considered by the Committee, attached are comments on five of the proposals, summarized as follows:

- We are objecting in strongest terms to the proposal to deny federal tax return information to states which apply their income taxes to pension and deferred income of former residents We object to both the inappropriate, counterproductive blackmail approach and to the concept of the federal government offering tax relief to a targeted group at significant cost to state governments. This broad provision flies in the face of attempts to limit unfunded mandates placed on states. Perhaps most importantly, the underlying issue of states taxing their former residents is being actively considered by the Judiciary Committee.

- We urge the Committee to adopt the proposal authorizing the offset of federal tax overpayments to satisfy delinquent state tax liabilities. Most states already offset state tax refunds to satisfy federal delinquencies, and it is only appropriate that the federal government establish a reciprocal program. The Joint Committee on Taxation has estimated that this provision will raise federal revenues by $8 million over five years.

- On the issue of authorizing the acceptance of credit cards for federal tax payments and the treatment of the related fees, we wish to share with the Committee the states' experiences in this matter. Some states statutes now specify that the state government is prohibited from paying the fees. States that have attempted to pass on Visa and MasterCard fees to their taxpayers have had their programs canceled by the participating banks. The credit card is expected to become an important tool with the growth of electronic and telephone filing of tax returns. If the Committee addresses the fee problem for the federal government in any manner other than simply prohibiting the government from absorbing the fee, we urge the Committee to include state and local governments within the scope of the protective provision.

- Circulated drafts of language establishing Tax Exempt Municipal Investment Conduits (TEMICs) contain a provision specifying the manner in which the TEMIC and its participants were to be treated for state income tax purposes. In particular, they specified that earnings from a TEMIC will be treated as if earned from a direct investment in each of the state and local securities owned by the TEMIC, unless a state enacted a law to the contrary. State tax administrators as a matter of principle are opposed to specifying state tax rules and treatment in federal law. Moreover, we are unconvinced federal rules are necessary in this instance to achieve the desired end of treating the TEMIC as a pass-through entity. In addition, to insure that TEMIC interest holders can satisfy their state tax obligations, it is important to include in any federal legislation a requirement that TEMICs report to TEMIC holders and the appropriate state tax authority that part of each payment deemed to be state or municipal bond interest, and whether it is derived from obligations of the holder's state of residence.

- We believe that certain of the proposed changes to the administration of the excise tax on diesel fuel will have an adverse effect on tax compliance at the federal and state level. We are especially concerned about proposals to allow undyed diesel fuel to be sold for home heating purposes. This would substantially undermine the improved compliance achieved in the diesel fuel area as a result of changes enacted in the Omnibus Budget Reconciliation Act (OBRA) of 1993.

Providing refunds for undyed fuel and other means of expanding the number of ultimate vender refunds defeat the purpose of the dyeing provisions in OBRA 1993. This would reduce the incentive for dealers and oil companies to produce and stock dyed fuels, turning the system into one where all taxes are paid early in the distribution chain and a refund is given for exempt uses. Such a system would more susceptible to evasion and fraud, as refund claims can be difficult to verify (particularly in 20-days). In addition, product destined for a tax free use (and granted a refund) can be easily diverted to taxable use with no checks.

Further detail on these five proposals is attached. If the Federation can be of any assistance in these matters, please do not hesitate to call us at (202) 624-5891.

Sincerely,

Billy Hamilton
FTA President and
Deputy Comptroller,
Texas Comptroller of Public Accounts

Harley T. Duncan
FTA Executive Director

BB. Pensions and Employee Benefits
8. Deny Federal tax information to States imposing a pension source tax.

FTA objects in strongest terms to the proposal to deny federal tax return information to states which apply their income taxes to pension and deferred income of former residents. Our objections fall in three areas: (1) the inappropriate and counterproductive use of federal tax return information to leverage state action; (2) the existence of other activities underway to resolve the issue; and (3) the improper tax policy choices in the substantive law part of the bill.

Federal tax return information
This measure (H.R. 1762) is an inappropriate and counterproductive attempt to use federal tax return information and current exchange of information programs to achieve a totally unrelated end. It is, frankly, blackmail -- holding federal tax data hostage in return for a desired change in state policies. State tax administrators are both shocked and deeply concerned by this approach. We see this as a direct attack upon the exchanges of information that are essential to fulfilling the missions of both the federal and state taxing authorities, and thus as a threat to compliance at both levels of government.

If this approach to securing state compliance with federal demands is allowed to advance, we believe it will be detrimental to both state and federal tax administration. States rely extensively on federal tax return information, the results of federal matches and examinations, and other return information in their tax compliance and service programs. At the same time, there is a substantial -- and increasing -- amount of information which flows from state governments to the IRS. For example, many states provide motor vehicle, sales and use tax, motor fuel tax, alcoholic beverage and professional licensing information to the IRS to support federal compliance activities. There is also a host of other cooperative compliance and service activities between state tax agencies and IRS districts.

All of these efforts are made possible by the ability to exchange return information in a reciprocal fashion. Threats to the reciprocal exchange of return information will inevitably lead states to retaliate by withholding state information from the federal government. We believe it unquestionable that the disruption of these exchanges will be harmful to administration and compliance at both the federal and state levels.

Other Activities to Resolve Issue
Equally important is the fact that the underlying issue of state taxation of the deferred income of former residents is being actively and constructively considered by the House Committee on the Judiciary. The Administrative and Commercial Law Subcommittee held a thorough hearing on this matter on June 28, 1995, and has indicated every intention of attempting to resolve this issue in the short term.

State tax administrators (including those from California, the state against which most objections are lodged) have worked in good faith with the sponsors and

interested parties of legislation to restrict state taxation of deferred income to former residents to find a satisfactory compromise. States, including California, indicated they were willing to accept the bill passed by the Judiciary Committee and the full House last year (H.R. 546, 103rd Congress); however, that bill was stopped in the Senate by large corporate and pension fund interests which, to that point, had exhibited little interest in the matter.

State administrators continue to work during this Congress to arrive at a solution to this issue through the Judiciary Committee.

Tax Policy

While the Federation was able to support legislation of the sort passed by the House last year, we do oppose H.R. 394 as introduced in the 104th Congress and the identical substantive law provisions of H.R. 1792 (beyond just the tax return information issue). H.R. 394 and 1792 (as compared to H.R. 546 of last year) would add to the list of protected income which states could not tax all distributions from nonqualified deferred compensation plans.

The addition of nonqualified plans creates the opportunity for substantial tax avoidance by highly compensated individuals. These plans are often not considered retirement plans and are generally available only to executives and highly compensated individuals. If states are preempted from taxing distributions from such plans, these individuals will be able to structure their earnings in a fashion which will allow them to avoid substantial amounts of state tax simply by moving to a non-income tax state. Moreover, the inclusion of nonqualified plans is not necessary to address the problem at hand, which is continually described as being to help "fixed-income seniors and normal Americans" who don't know about their state obligations. Finally, there has been no demonstrated need for including nonqualified within the preemption other than the fact that people don't want to pay tax, i.e. no demonstration of complexity from current practices.

We would also bring your attention to this comment from Chairman Archer, taken from the hearing announcement: "As the Committee moves forward, I intend to oppose any proposals which are targeted tax relief or which have significant cost." H.R. 1762 is both targeted relief from state taxation and has significant cost to state governments. As such, it flies in the face of attempts to limit placing unfunded mandates on states.

The Federation would urge the Committee to refrain from acting on this bill and leave the resolution of the matter to the Judiciary Committee which has jurisdiction over interstate taxation and has addressed the matter of state taxation of pension income to former residents seriously in each of the last two years. Further, we would urge the Committee to adopt and maintain a posture that all measures which tie the ability to receive federal tax return information to unrelated state actions are inappropriate and inherently counterproductive.

H. Compliance

1. Allow offset of State tax liability with overpayments of Federal tax

As the Committee considers ways to, in the Chairman's words, "clean up the code and fix some of its counterproductive ... provisions," we urge adoption of provisions which would authorize the offset of federal tax overpayments to satisfy state tax debts, as has been introduced in H.R. 757 by Committee members Rep. Jacobs and Rep. McCrery.

Briefly, 31 states already offset state tax overpayments to satisfy delinquent federal tax debts through their own refund offset compliance programs. These programs generate in excess of $50 million annually to the federal treasury. IRS lacks the authorizing legislation to include state tax delinquencies in its existing refund offset program. This provision provides that authorization and lays forth the necessary technical details.

This provision was the subject of a hearing before the Ways and Means Select Revenue Subcommittee in late 1994. At that hearing, the U.S. Treasury Department indicated its support for the concept of reciprocal refund offset. The Joint Committee on Taxation has estimated that the measure will raise federal revenues by $8 million over five years.

Equally notable is the issue of fairness and reciprocity. States for the most part voluntarily include the federal government in their refund offset programs; it is only proper that the federal government do the same for them. States are willing to pay for the cost of each offset, even though with minor exceptions they do not charge the federal government.

Most importantly, the state and federal tax authorities work closely together on a wide range of compliance and service activities. This is an efficient, modern approach to effective government. Thus, even for the states with no income taxes that will not see an immediate compliance benefit from H.R. 757, the refund offset provision is important as a symbol of reciprocity and of continued good working relationships.

A two-page explanation and history of H.R. 757 is included with this letter for your convenience.

II. Possible Modifications to Provisions Contained in H.R. 3419
1.a. Permit payment of taxes by credit card

Resolution of the issue concerning payment of the processing fee associated with using credit cards for the payment of taxes is an important issue for federal, state and local governments. State and local governments have for many years been testing the waters of using credit cards for the payment of taxes and other mandatory government payments. We have experienced firsthand the complications caused by the processing fee issue and wish to share our perspective with the Committee. Also, if the Committee chooses to prohibit credit card issuers from denying governments the ability to pass on the fee to customer-taxpayers, we urge the Committee to include state and local governments within the scope of that prohibition.

State and local governments at the moment are in a quandary. They are under increasing pressure from their taxpayers to accept credit cards as payment for any variety of taxes and fees, including motor vehicle registrations, driver's license renewals, payment of property taxes, and even the payment of current and delinquent sales and income taxes. These governments also recognize the efficiencies realized from incorporating these "electronic payment mechanisms" into their electronic filing programs for both individuals and businesses, particularly small businesses. For instance, a taxpayer who files a tax return by telephone should also have the opportunity to pay a balance due over the telephone by punching in a credit card number, rather than mailing in a paper check and voucher.

At the same time, the two leading credit card associations, Visa and MasterCard, have a policy against allowing governments and most types of retailers to pass on directly to the customer the fees they charge for use of the card (typically three to four percent of the charge amount). These two associations do allow the fee to be passed on by certain firms, including casinos, truck stops and companies located in the Bahamas.

The fee is not a minor matter. It usually is based on a percentage of the charge. A small purchase or tax payment may generate a fee that is comparable to the cost of processing a paper check. For all other amounts, the use of the card would be an expensive matter for governments, even if this expense is paid indirectly through compensating balances. Public policy considerations also dictate that the government not offer special accommodations to select taxpayers for which all taxpayers have to pay.

Some states statutes now specify that the state government is prohibited from paying the fees. Most recently, states and localities that have attempted to pass on Visa and MasterCard fees to their taxpayers have had their programs canceled by the participating banks. This is an ongoing and regular occurrence.

The only solution has been for state and local governments to limit credit card acceptance to the Discover card, which does not prohibit governments from passing

the fee on to customer-taxpayers. Also, that card company is willing to allow flat-fees, rather than percentage-based fees. One typical example is a $1 fee for taxes up to $400 and a $2 fee for amounts greater than $400.

In comparison, Iowa, before it was forced to suspend its credit card program last year, received 50 credit card payments for approximately $500,000. A 3 percent fee on those transactions would amount to $15,000 -- hardly comparable to the alternative cost of processing checks and handling cash.

State and local governments are intensely interested in expanding the use of credit cards in their processing systems, particularly as we move into the electronic age. However, the fee issue has effectively stymied that effort. If the Committee addresses the fee problem for the federal government (other than simply specifying a policy of prohibiting the federal government from absorbing the fee), we urge you to include state and local governments within the scope of that protection.

Z.4. Tax Exempt Municipal Investment Conduits (TEMICs)

To our knowledge, no bill has been introduced to establish Tax Exempt Municipal Investment Conduits (TEMICs). Thus, our comments are confined to draft legislation which has earlier been shared with us.

Those drafts contained provisions specifying the manner in which the TEMIC and its participants were to be treated for state income tax purposes. In particular, they specified that earnings from a TEMIC will be treated as if earned from a direct investment in each of the state and local securities owned by the TEMIC, unless a state enacted a law to the contrary. The draft also provided that a TEMIC could not be treated less favorably for state tax purposes than a Real Estate Mortgage Investment Conduit (REMIC). In other words, a TEMIC would not be taxable at the entity level and income from TEMICs would be exempt to the extent that the underlying bonds were exempt in each state, unless the state passed a law to the contrary in which case such law could only be applied prospectively.

State tax administrators as a matter of principle are opposed to specifying state tax rules and treatment in federal law. These are appropriate matters for state legislative action. Moreover, we are unconvinced federal rules are necessary in this instance to achieve the desired end of treating the TEMIC as a pass-through entity based on the state experience with and treatment of REMICs. We are unaware of any state which does not treat a REMIC in the same fashion as the federal income tax.

Representatives of the public securities industry have indicated that the intent of the federal rule specifying state income tax treatment of TEMICs is to insure that TEMICs are accorded pass-through status immediately and to avoid a long transition period. If it is deemed necessary to specify the initial state income tax treatment of TEMICs, the provision allowing a state to enact a law to the contrary must be included so that states can retain the authority to define their own tax bases.

In addition, to insure that TEMIC interest holders can satisfy their state tax obligations[1], state administrators believe it is important to include in any federal legislation a requirement that TEMICs report to TEMIC holders that part of each payment deemed to be state or municipal bond interest, and whether it is derived from obligations of the holder's state of residence. Similar reports should also be filed with the taxing authority in the state of residence. Regulated investment companies (mutual funds) investing in state and local securities currently provide such a statement to investors.

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[1] Most states exempt interest earned only on instruments issued by the State itself and its political subdivisions. Earnings on obligations issued by entities of other states are not generally exempt.

Q. Excise Tax Provisions
1. Modification to diesel fuel excise tax provisions

State administrators are concerned that certain of the proposed changes to the administration of the excise tax on diesel fuel will have an adverse effect on tax compliance at the federal level and at the state level. Administrators are particularly concerned with those proposals which would allow undyed diesel fuel to be sold for home heating purposes without payment of tax by the consumer and which would then allow the vendor (ultimate vendor) to claim a credit for the tax paid on diesel ultimately claimed to have been sold for home heating purposes.

In our estimation, enactment of these provisions would substantially undermine the improved compliance achieved in the diesel fuel area as a result of changes enacted in the Omnibus Budget Reconciliation Act of 1993. The combination of moving the point of taxation for diesel fuel to the "terminal rack" and requiring that all fuel be either tax paid or dyed for non-taxable use when it leaves the terminal has substantially improved compliance with the diesel fuel excise tax. The Department of Treasury estimates that these changes yielded an additional $600-700 million in revenues to the U.S. treasury in FY 1994.[2]

Because of the potential compliance improvements, states are emulating the change in point of taxation and diesel dyeing requirements enacted at the federal level. To this point, at least 16 states have enacted state laws requiring the dyeing of diesel fuel used for non-taxed purposes.[3] Many other states are using the federal dyeing requirement as an enforcement tool because their exemptions for non-highway use of diesel fuel closely parallel those at the federal level. States have been particularly active in undertaking cooperative enforcement programs with the Internal Revenue Service to inspect for the use of dyed diesel fuel in truck power units and retail outlets. Without a federal dyeing requirement, it is likely that a number of states would be required to forego the state dyeing requirement because of the complexity to marketers and the impact on obtaining dyed diesel fuel for the state market.

There is evidence that the state and federal efforts to improve compliance are paying off at the state level also. In 1994, taxable amounts of special fuel (primarily diesel fuel) reported at the state level increased by just over 6 percent, nearly 5 times the increase for gasoline. In addition, individual states are reporting significant improvement in the collection of diesel fuel taxes. For example, Indiana, which moved the point of taxation and implemented dyeing in 1993, estimates that its diesel fuel tax collections increased by nearly 14 percent over the previous year.

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[2] See Statement of Cynthia G. Beerbower, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Before the Senate Finance Committee, July 18, 1995,p. 8.

[3] These include California, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Maine, Minnesota, Montana, Nebraska, North Carolina, South Carolina, South Dakota, Virginia and Wisconsin

Providing refunds for undyed fuel and other means of expanding the number of ultimate vender refunds defeat the purpose of the dyeing provisions. This would reduce the incentive for dealers and oil companies to produce and stock dyed fuels, turning the system into one where all taxes are paid early in the distribution chain and a refund is given for exempt uses. However, this system is more susceptible to evasion and fraud, as refund claims can be difficult to verify (particularly in 20-days). In addition, product destined for a tax free use (and granted a refund) can be easily diverted to taxable use with no checks.

The purpose of the 1993 changes to diesel fuel excise tax administration were to reduce the number of opportunities for tax-free sales of product and to clearly segregate that fuel destined for taxable as opposed to non-taxable use. The proposed changes to allow the sale of undyed diesel fuel for home heating purposes and to allow the ultimate vendor to claim a refund for taxes paid on such fuel runs counter to those objectives. In so doing, it will create opportunities for tax evasion at both the federal and state levels.

Reciprocal Refund Offset Legislation

Current Law

The federal government may levy on -- essentially, seize -- state income tax refunds to satisfy delinquent federal tax debts. The IRS currently exercises its right to levy on state refunds in 31 states and the District of Columbia, working through those states' refund offset programs. This occurs under a cooperative arrangement between the state tax agency and the IRS district(s).[1]

There is no reciprocal authority for states to levy on federal income tax refunds. Neither is there authority for the federal government to offset federal income tax refunds to satisfy delinquent state tax debts.

In 1993, states returned about $61 million to the federal government under their refund offset programs; the state offsets generated roughly $25 million to $35 million annually in previous years.[2]

States are generally not compensated for these offsets.

The federal government has its own refund offset program. Under IRC § 6402, a specified agency that is owed a past-due, legally enforceable debt can collect it by having the IRS withhold or reduce the debtor's income tax refund if reasonable efforts have been made to collect the debt. Currently these offsets are available for delinquent federal tax debts, past-due child support that offsets public assistance, debts owed other federal agencies (such as student loans and VA housing), and child support owed a parent not receiving ADC, but who has asked for assistance in collecting support.

Federal agencies are charged for each offset, and IRS is permitted to disclose certain taxpayer information to the federal agency requesting the offset.

Reason for Change

Permitting federal refunds to be offset for state income tax debts would further cooperative efforts in joint federal/state tax administration. A number of cooperative efforts are currently underway. To a substantial degree, these efforts are reciprocal in that benefits accrue to both the federal and state governments. These cooperative efforts improve the efficiency of federal-state tax administration, increase compliance with the nation's tax laws, and reduce the burden on taxpayers. Examples of cooperative programs include two-way information exchanges, joint electronic filing of income tax returns, and joint taxpayer service and education programs. Permitting the offset of federal refunds would further this reciprocity and is consistent with the goals of the IRS Strategic Business Plan.

Offsetting federal refunds for state tax debts will be an effective method of collecting delinquent debts owed the states. The Federation of Tax Administrators (FTA) estimates that a federal offset program could increase state receipts by about $150 million to $200 million annually in the early years of a program and by somewhat lesser amounts as the current inventory of receivables is reduced. A reciprocal program would also be expected to increase federal receipts somewhat because it is anticipated that the remaining income tax states would begin to offset for the federal government in order to participate in the IRS offset (except in any state where the Secretary of Treasury chooses to not have federal debts offset). The Joint Committee on Taxation has estimated that reciprocal refund offset legislation would benefit the federal government by some $8 million.

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1 There are 41 states, including the District of Columbia, with a broad-based individual income tax. Included in the 31 states with an offset program for federal tax debts is Alaska, which has no individual income tax. It does, however, have a unique state refund program that works in a similar manner.

2 Recent growth in federal collections appears attributable to technical advancements within the program that make it more efficient and to an increase in the number of states that participate.

History of Proposal

Rep. Andrew Jacobs (D-Ind.) introduced H.R. 4138 in the 103rd Congress; the bipartisan bill had 20 cosponsors. The House Ways and Means Committee on Select Revenue Measures held a hearing on H.R. 4138 in October, 1994. Treasury formally voiced its support for the proposal and suggested four minor technical adjustments to the language, all of which are believed to have been incorporated into the bill now before the 104th Congress. **Neither during the hearing nor at any other time did the bill encounter opposition.**

Rep. Jacobs along with Rep. McCrery and Rep. Moran introduced the bipartisan H.R. 757 in February, 1995.

Senator Orrin Hatch has indicated he will be willing to sponsor similar legislation in the Senate.

Description of Proposal

The proposed legislation would amend IRC § 6402 by adding a new subsection allowing the Secretary of the Treasury to establish an offset program for legally enforceable, past due state tax obligations. To be eligible for the offset, the delinquency must be one that is no longer subject to administrative or legal appeal at the state level. As with other federal agencies, states would be further required to notify taxpayers of the obligation and that such debt will be referred to the IRS for offset if not satisfied in 60 days.

State tax debts would not be satisfied from an offset until all federal tax debts, assigned child support, non-assigned child support and debts due other federal agencies were satisfied.

The Secretary could charge the states for the costs of the offset program in the same manner as other federal agencies are charged.

Once an offset is made, taxpayers could still protest the amount due. The legislation also contains provisions allowing a joint federal refund to be split among both spouses if only one spouse owes the state tax debt. The legislation would also amend IRC § 6103 to permit the disclosure of information regarding the offset to state tax agencies when necessary.

Federation of Tax Administrators
July, 1995

Statement of

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On Behalf of

Friends of the Earth

Regarding

Miscellaneous Tax Proposals

Before the

Committee on Ways and Means
United States House of Representatives

July 11-13, 1995

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, Friends of the Earth (FoE) is a global environmental advocacy organization with affiliates in 52 other countries. My statement today is made on behalf of Friends of the Earth and our members and supporters.

Mr. Chairman, I thank you for the opportunity to express our enthusiastic support for ten miscellaneous tax proposals that are beneficial to environmental protection. I also thank you for the opportunity to express to the Committee our deep concern about seven additional proposals that would benefit discrete special interests and put the environment at further risk.

The Friends of the Earth team stands committed to eliminating fiscally irresponsible and environmentally threatening projects from the federal budget as well as identifying exclusions, deductions, credits, and other tax breaks that do not serve the public interest.

Included within the jurisdiction of this Committee are some of these tax expenditures. FoE urges the Committee to embrace the following ten proposals that safeguard our natural environment and to reject the seven proposals that put the interests of the public behind those of the special interests.

MISCELLANEOUS TAX PROPOSALS[1]

Do NOT Repeal Treasury ruling requirement for nuclear decommissioning costs

Repeal of the provision allowing the Internal Revenue Service to disqualify a nuclear decommissioning fund under certain conditions threatens the original purpose of the decommissioning funds. Currently, upon a showing that the fund's assets are not used for decommissioning or that there is self-dealing between the fund and the utility, the IRS may terminate the fund's qualification (in which case the amounts in the fund must be included in the income determination of the taxpayer). If this provision is repealed, self-dealing will increase the risk that, at

[1] For reasons of consistency I shall keep to the structure outlined in the Committee's Description of Miscellaneous Tax Proposals and use the titled phrases appearing in the aforementioned publication.

the time of decommissioning, the funds will not be available. Without these funds, any action will follow one of three likely scenarios. First, the nuclear power plant will not be adequately (if at all) decommissioned. Second, the cost of decommissioning will be born primarily by the taxpayer. Or perhaps third, future rate payers, who may never see the power from the nuclear power plant, will have to pay the costs.

None of these scenarios are in the taxpayer's or environment's best interest. FoE urges you to uphold the position of the IRS and to oppose this proposal.

YES to Allow Energy Tax Credits Against the Alternative Minimum Tax

Allowing energy tax credits for renewable energy to be used by firms paying the Alternative Minimum Tax (AMT) provides appropriate incentives to energy investors and the energy market. In addition, many renewable firms are start-up firms and therefore are liable for the AMT.

Given that conventional (i.e., oil and gas) energy sources are able to take advantage of special tax incentives while paying AMT, we believe it is only fair to allow the same opportunity for renewable energy. We believe the test for special tax breaks for energy sources should be that they provide public environmental benefits and also offer new technologies.

Our only concern with the proposal is the exclusion of wind energy and clean biomass energy from the definition of qualified energy property. Equally viable and environmentally friendly sources of energy, wind power should be included in the energy credit.

FoE urges the Committee to support this amendment and to send the message to energy producers and consumers that renewable technology is a public good worthy of federal support.

YES to Increase Tax Credit and Modify other Provisions with respect to Electric Vehicles

Increasing the tax credit for electric vehicles to a flat rate of $4,000 and exempting electric vehicles from depreciation limits and the luxury tax provide important incentives for seeking cleaner alternatives to conventional vehicles. However, the emphasis needs to be on encouraging cleaner-fueled vehicles rather than as a windfall for car purchases. The goal of the proposal, therefore, should be to ensure that clean vehicles are cheaper than conventional ones.

FoE urges the support of the Committee for this proposal and asks your consideration and encouragement of cleaner-fueled vehicles (in general) as an attractive alternative to conventional modes of transportation.

YES to Tax Credit and Tax-Exempt Financing for Environmental Remediation Expenses

Creating a 25% tax credit for the cost incurred for any qualified and owned environmental remediation site encourages revitalization of urban centers and clean-up of the contaminated property. Without the incentive to clean up environmentally degraded sites, businesses are encouraged to relocate to the "green fields" of the suburbs, causing increased urban sprawl and pockets of abandoned contaminated land.

The tax credit, together with the establishment of a new class of qualified contaminated site remediation bonds, would help to counter this trend. FoE urges your support for this proposal.

NO to Modifications to Tax Credit for Producing Fuel from a Nonconventional Source

Amending the credit for fuels derived from nonconventional sources allows the credit to be claimed against the AMT, expands the definition of a qualifying facility in the case of fuel derived from an underground coal gasification process, and redefines tar sands as a qualifying source. This is a step in the wrong direction. The current credit already hurts standard, conventional energy sources. There is no need to expand this pain.

We need to repeal, not expand this. FoE strongly urges the Committee to oppose this proposal.

YES to Tax Credit for Lubricating Oil Produced from Re-refined Oil

Allowing a tax credit for lubricating oil produced by re-refining used motor oil would encourage oil producers to consider a recycling alternative to the high costs of oil exploration and oil importation. As we become increasingly reliant on foreign oil deposits, the need to reduce our dependence as well as to seek alternatives to new oil reserves becomes increasingly poignant. This proposal helps to alleviate a small proportion of that reliance by establishing a profitable market for recycled motor oil.

FoE urges the Committee's support for the third energy proposal.

NO to Allowing Geological and Geophysical Costs Incurred in Connection with Oil and Gas Development to be Expensed in the Year Incurred

Allowing oil and gas producers to expense geological and geophysical expenses in the year incurred provides a basic tax break for more oil drilling. Such a proposal would only exacerbate the problem of rapidly declining oil reserves and raises questions of intergenerational equity as we consume more than our fair share of our national heritage, leaving our grandchildren "high and dry."

FoE is strongly opposed to the proposal and urges the Committee to maintain the nature of geological and geophysical costs as capital and as non-deductible ordinary and necessary business expenses.

YES to Extend the Renewable Electricity Production Credit to Electricity Produced from Certain Fuel Cell Power Plants

Extending the tax credit for electricity derived by wind and closed-loop biomass processes to electricity from biomass and natural gas-powered fuel cells is a necessary step in the promotion of renewable energy research and development. Our only concern arises in the definition of "biomass." If extended to include domestic-waste incineration, the tax credit could lead to an increase in the release of toxics into the air. Consisting of a variety of heavy metals, aerosols, and other contaminants, air pollution resulting from domestic-waste incineration could worsen our environmental condition. FoE, therefore, is in support of a tax credit for electricity derived from biomass so long as that biomass meets specific standards regarding its contents.

YES to Exempt Certain Land Subject to permanent Conservation Easement from Estate Tax

Exempting qualified land subject to a permanent land conservation easement from estate tax will have a direct positive impact on the land-rich, cash-poor farmer or landowner who is unable to pay his/her estate taxes without selling a portion of the owned property. Reducing the pressure to develop currently undeveloped property, particularly in areas that are in close proximity to either a National Park or a metropolitan area, is especially important both to combat the associated negative effects of urban sprawl and to maintain the existence of wildlife buffer zones around National Parks.

Without land conservation easements, private land ownership can only be protected by the wealthy farmer or landowner. FoE congratulates Rep. Houghton for his leadership and urges the Committee to support HR864.

YES to Estate Tax Credit for Conservation Property Donated to Federal Government

Allowing a non-refundable credit for the "fair market value" of inherited conservation property donated to the Federal Government against the estate tax is a positive step toward the conservation of land property and should be encouraged.

However, some of the implications are left unaddressed and it is, at this point, unclear under which agency jurisdiction the land would fall. This should be clarified.

In addition, it should be cautioned that the Federal government needs to want the land (for reasons of biological diversity, location to a National Park, etc.) in order to give the tax break. Otherwise we run the risk of overburdening the Federal government with the responsibilities involved in land stewardship.

Finally, we would like include land donated to non-profit conservation organizations in the qualifications for the credit. These organizations are dedicated to the conservation of land and can aid in sharing the responsibilities involved with stewardship.

We urge your support for this proposal.

YES to Modify Rail Diesel Motor Fuel Tax Rate

Exempting AMTRAK from the excise tax on rail diesel motor fuel encourages the use of rail travel which creates less pollution, requires less energy, and covers less land area. Rail travel, of all modes of transportation such as personal vehicles, has one of the most benign environmental impacts.

However, FoE would prefer to see a different tax incentive for rail travel rather than a reduction in the excise tax on rail diesel motor fuel. We would like to encourage the use of our rail system while at the same time reducing our consumption of rail diesel motor fuel.

We urge your support for this proposal.

NO to Modifications to the Excise Tax on Ozone-Depleting Chemicals

Although the proposal to exempt imported, recycled chemicals from the excise tax on ozone-depleting chemicals appears to be initially in favor of reducing ozone-depleting chemicals, it runs the dangerous risk of having quite the opposite effect. Sanctioning imported, recycled chemicals requires the establishment of an international definition of recycled as well as some sort of regulation and enforcement of that definition. Without that effort, we may ultimately endorse what has been suspected to have happened abroad: labeling of newly produced ozone-depleting chemicals as recycled. In a related instance, black market sales of chlorofluorocarbons prompted an April New York Times article detailing the extent of the problem. In the article, customs officials pointed to a hypothesis suspecting Russia of smuggling illicit chlorofluorocarbons into North Sea ports by barge for distribution in the United States[2].

In addition, ozone-depleting chemicals used in metered-dose inhalers should not be exempted from the aforementioned excise tax. While usage of metered-dose inhalers should not be overburdened and should be made available to every individual in need of the medication, the incentive should remain to seek alternative

[2] See The New York Times, Sunday April 30, 1995 National section.

chemicals to those that are ozone-depleting.

FoE urges you to oppose this proposal.

NO to Exemption from Gas Guzzler Excise Tax for Limousines

Exemption of stretch limousines from the gas-guzzler excise tax is an egregious violation of the government's commitment to the American people. The beneficiaries of this proposal are overwhelmingly higher income individuals, large corporations, and occasional government officials. Exempting stretch limousines from this tax has absolutely NO environmental benefit, NO national benefit, and is unfair to the American people and their natural environment.

We strongly urge you to oppose this proposal and to maintain the equity of the excise tax's reliance on vehicle size and efficiency. Any exemption of expensive, class-based vehicles from the tax will only undermine the our commitment to social fairness.

YES to Expand Credit to Lead Paint Removal

Expanding the low-income housing credit to include the costs of lead paint removal in qualified low-income housing areas would greatly reduce domestic exposure to lead poisoning. The Alliance to End Childhood Lead Poisoning (AECLP) has identified the drawback of this proposal as benefiting pockets of middle- to upper-class residing in qualified census tracts. However, this risk is extremely difficult to guard against and is not a significant enough drawback to warrant withdrawal of the proposal. The potential health benefits for low-income residents are significant and should be supported by including lead paint removal in the low-income housing credit.

However, we believe that "lead paint removal" should instead read "lead-based paint abatement". This would extend the protection from mere removal to include reductions in lead intensity and omission of lead in newly applied paints.

We urge your support for this proposal.

NO to Modify the Application of Passive Loss Rules to Timber Activities

Loosening the application of passive-loss rules to timber activities and relaxing the rules limiting deductions and credits on passive activities will only add to the special tax benefits enjoyed by the forest products industry. Currently, the industry, as well as timberland owners, can treat timber income as capital gains and can expense, if not immediately write off, capital costs even before the timber is sold. This proposal would add to these special tax benefits by creating a tax shelter for all activities where the taxpayer is not "involved in the operations of the activity on a basis which is regular, continuous, and substantial".

To receive this additional tax benefit does not require sustainable forestry practices or attention to environmental integrity and stability. FoE can favor the loosening of passive loss rules only if it is somehow made contingent upon environmental performance.

NO to Modify the Application of passive Loss Rules to Farming Activities

Very similar to the previous proposal, loosening the application of passive loss rules to farming activities creates a tax shelter that steers investment toward activity that is now pursued unsustainably. In addition, the proposal stands to benefit the wealthy landowner who is involved in equine activities on a basis that is irregular, non-continuous, and insubstantial and does not significantly apply to the small farm with few passive losses.

FoE strongly urges the Committee to oppose this proposal and maintain the strength of the passive loss rules.

YES to Bonds for Solar Energy Facility

Expanding the list of exempt-facility bonds to include bonds used to finance solar powered electricity generating facilities is only logical. Since tax-exempt status already applies to bonds in which at least 95% of their proceeds go to everything from the enhancement of airports to the encouragement of environmental improvements to hydroelectric facilities, it seems only just that solar electricity generation facilities should be included. Equally a "social good," solar electricity generation is more readily available than wind power, less polluting than conventional power, and creates no long-term uncertainties or high-level radioactive waste like nuclear power.

Solar energy is readily available and can produce consistent electricity for large geographical areas. Its major drawback is the high cost of initial equipment. Adding it to the list of exempt-facility bonds will encourage its use in the generation of electricity. FoE urges the Committee's support for this proposal.

Written Statement for the Record

submitted by

Government Finance Officers Association (GFOA)

concerning

House Committee on Ways and Means
Hearings on Miscellaneous Tax Reforms
July 11 and 12, 1995

This statement is submitted on behalf of the Government Finance Officers Association (GFOA), a professional association of more than 10,000 state and local government officials whose duties encompass all the disciplines of public finance, including the issuance of tax-exempt bonds. The miscellaneous tax proposals that are the subject of these hearings include a number of proposed changes to the provisions of the Internal Revenue Code governing tax-exempt bonds. This statement by GFOA relates to several of these proposals.

Introduction

Tax-exempt municipal bonds are the basic tool used by the states, cities, counties, towns and other governmental entities to fund the capital improvements necessary to provide utilities, roads and bridges, airports, health care, education, housing and other public services. The ability to sell debt with interest exempt from federal income taxes has been a significant benefit to state and local government borrowers, directly reducing the tax burdens that citizens would otherwise have to shoulder to finance essential public services.

In recent years, state and local governments' ability to raise funds efficiently has been significantly restricted by the federal government. The Tax Reform Act of 1986, in particular, placed restrictions and limitations on tax-exempt financing that have reduced the ability of state and local governments to access the tax-exempt bond market and made that access more costly.

GFOA has long advocated changes to the Internal Revenue Code that would ease some of the restrictions on tax-exempt financing, particularly as the era of substantial federal support for many state and local projects has ended. Some of the changes that GFOA has advocated are addressed in the miscellaneous tax proposals that are the subject of these hearings. It is those proposals that this statement addresses.

Several of the tax-exempt bond issues that are the subject of proposals before the Committee were addressed in a letter that was sent to all members of the Committee on May 18, 1995, and that was signed by representatives of eighteen national organizations representing state and local government officials. In order to remind Committee members of the issues that are important to state and local government officials in any miscellaneous tax reform and simplification measure, that letter is attached to this statement.

Tax Treatment of Tax-Exempt Bonds Purchased at a Market Discount

The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) amended the tax treatment of municipal securities purchased at a market discount. Market discount occurs when a bond is purchased in the secondary market at a price below par, or face value. Market discount is the difference between the purchase price of a bond and its stated redemption price at maturity. Prior to OBRA '93, gains realized on municipal bonds purchased at a discount were given capital gains tax treatment, the rates for which are lower than the rates for ordinary income. Under the new law, the accredited market discount on these bonds will still be taxed when the bonds are sold, redeemed or otherwise disposed of, but, except for a *de minimis* amount of discount (less than 0.25 percent of the face value of a bond times the number of years between the bond's acquisition and maturity), the tax is treated as ordinary income, not as capital gain.

H.R. 843 would exempt tax-exempt bonds from treatment as market discount bonds. Gain attributable to accrued market discount generally would be taxable as capital gain. GFOA supports H.R. 843 because the restoration of capital gains treatment of gains realized on tax-exempt market discount bonds would help restore liquidity and stability to the secondary market for tax-exempt bonds and result in increased efficiency in the market and lower costs to state and local government issuers.

The new market discount rules have had a harmful effect on the liquidity and stability of the secondary market for municipal bonds. Stability and liquidity are vital if this market is to operate efficiently and at the least cost to state and local governments. Since the new rules took effect, a two-tier secondary market has existed for municipal securities-- one tier consisting of bonds where market discount is treated as ordinary income and the other of securities where there is no discount or where *de minimis* discount is treated as capital gain. Under the new rule, investors can no longer in most cases offset capital gains on market discount bonds with capital losses on other investments.

The interaction between the two market segments has resulted in inconsistent, inefficient and misunderstood pricing of discounted municipal bonds -- ingredients of a highly volatile secondary market. In addition, there are fewer investors in market discount bonds, contributing to decreased liquidity in the secondary market. Many tax-exempt bond mutual funds and bank common trust funds have stopped buying discounted bonds altogether. Furthermore, because any bond during its lifetime could become a market discount bond investors in municipal securities are demanding higher rates of return as compensation for higher tax rates on discount bonds and for increased risk due to less liquidity.

GFOA urges the Committee to approve H.R. 843 in order to restore efficiency and liquidity in the secondary market for tax-exempt bonds, reduce volatility in that market, and help lower costs to state and local governments in issuing securities to pay for much-needed public investment.

Expansion of the Arbitrage Rebate Exception for Certain Bonds

Unused monies from proceeds of tax-exempt bonds are generally invested until they are needed and, if invested at rates higher than the borrower's rate of interest, they generate "excess" investment income. This differential is known as "arbitrage." Under the arbitrage rebate requirement of the federal tax laws enacted in 1984 and 1986, arbitrage profits are required to be paid to the federal government. Because many projects for which bonds are issued take many months or even years to build, Congress in 1989 provided some relief from the arbitrage rebate requirement by exempting from rebate the arbitrage earned on certain "construction bonds," if the proceeds are for construction and are spent in accordance with a spending schedule over a 24-month period. To satisfy this exception, 10 percent of available proceeds must be spent within six months after the bonds are issued, at least 45 percent within 12 months, at least 75 percent within 18 months, and at least 100 percent within 24 months. Eligibility for the construction bond exception is available for governmental bonds, qualified 501(c)(3) bonds, and private activity bonds to finance property owned by a governmental unit.

A proposal before the Committee would expand eligibility for the construction bond exception from arbitrage rebate to all bonds other than refunding issues and tax and revenue anticipation issues, and would extend the 24-month spending period of the present law construction bond exception to 36 months. The spending schedule would require that at least 33 1/3 percent of proceeds must be spent in 12 months after the bonds are issued, 75 percent within 24 months, and 100 percent within 36 months.

While GFOA generally favors repeal of the arbitrage rebate requirement in order to eliminate the complex bookkeeping and other compliance costs it imposes on issuers and to enable issuers to generate additional funds that could be used to reduce the costs of bond-financed projects, it nevertheless would strongly support the proposal before the Committee to expand eligibility for the construction bond exception from arbitrage rebate to all bonds and to extend the spending period to 36 months.

GFOA would also like to bring to the Committee's attention the merits of an increase in the small-issuer arbitrage rebate exemption which is addressed in the attached May 18, 1995, letter to Committee members. The complexities of the construction bond exception make this arbitrage rebate relief provision unavailable for many small issuers, and extending the spending period to three years would not alleviate this problem. Increasing the small-issuer arbitrage rebate exemption from its current $5 million to $25 million would provide needed relief to those issuers. The $5 million annual limit has been in effect since 1986 and has been effectively reduced because of inflation.

Private Use Limitations on Bonds for Certain Output Facilities

Under the federal tax code, the private use restriction on the proceeds of a tax-exempt bond that may be used by private persons is 10 percent. However, for certain output facilities -- public power and natural gas generation and transmission facilities -- the limitation is the lesser of 10 percent or $15 million. In determining whether the $15 million limit is exceeded, all prior issues related to the project are counted. H.R. 677 would repeal the $15 million limitation on these facilities.

GFOA supports H.R. 677 and urges the Committee to include its provisions in any miscellaneous tax reform or simplification measure. The general private use restrictions limiting the benefits available to private entities from publicly financed facilities are based on sound and appropriate public policy considerations and should apply equally to all governmentally financed and operated facilities. The special $15 million limitation that applies only to publicly owned electric and gas facilities is discriminatory and is not based on any public policy justification. Members of the Committee are reminded that this issue is addressed in the letter of May 18, 1995, that was sent to all Committee members and that is attached to this statement.

Modification of the Exception to the Bank Interest Deduction Disallowance for Qualified 501(c)(3) Bonds

Under federal tax laws, banks and other financial institutions are not permitted to deduct the portion of their interest expenses that are attributable to investment in tax-exempt bonds. An exception to this disallowance permits an 80 percent interest deduction for bonds issued by small issuers and small 501(c)(3) organizations that reasonably expect to issue no more than $10 million of such bonds during a calendar year (the "small-issuer exception").

Many 501(c)(3) organizations that borrow in the tax-exempt market issue bonds through a state or local agency or authority whose annual issuance usually exceeds $10 million. This limitation effectively prohibits bank investment in the bonds issued by many small, tax-exempt organizations, thus raising the cost of their projects. A proposal before the Committee would modify the small-issuer exception so that an issue could qualify for the exception if no 501(c)(3) organization borrowed more than $5 million in the calendar year regardless of the annual issuance of the governmental unit. In effect, the annual issuance limitation would be applied at the borrower rather than the issuer level.

GFOA favors expansion of the small-issuer exception to the bank interest deduction disallowance, and believes there is merit to the proposal that would apply the annual issuance limitation at the borrower rather than the issuer level. GFOA also believes that whatever treatment is accorded borrowers on behalf of 501(c)(3) organizations should also be accorded to issuers of tax-exempt securities for small <u>governmental</u> borrowers.

GFOA and other representatives of state and local government organizations have long advocated an expansion of the bank interest deduction exception. An increase would bring additional bank demand for tax-exempt securities and result in lower borrowing costs for issuers and greater stability and liquidity in the tax-exempt market. The $10 million annual issuance limitation was enacted as part of the Tax Reform Act of 1986 and it has not been increased since enactment of the 1986 Act, although an increase has been included in three tax bills since that time that did not become law. The $10 million limitation is simply too small and prevents a

large number of issues that account for only a small percentage of total market volume from taking advantage of this cost-saving, market-stabilizing mechanism. GFOA and the other organizations that signed the attached May 18, 1995, letter to the Committee have advocated raising the bank interest deduction exception annual issuance limitation to $25 million. Like the arbitrage rebate annual limit, this limitation has been effectively reduced since 1986 because it is not indexed for inflation. We continue to advocate this increase for issuers eligible for the exception.

Clarification of Definition of "Investment-Type Property"

Section 535 of H.R. 3419 contained a clarification of the definition of "investment-type property" related to tax-exempt financing. A proposal before the Committee would delete this language because the issue was clarified by a recent Treasury Department regulation (Treas. Reg. Section 1.148-1(b)). GFOA agrees that the clarification should be deleted since the Treasury Department dealt with the issue in its final regulations governing the arbitrage provisions of federal tax laws related to tax-exempt financing.

Attachment

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July 27, 1995

Airports Council International-North America (ACI-NA)
American Public Gas Association (APGA)
American Public Power Association (APPA)
American Public Works Association (APWA)
Association of Metropolitan Sewerage Agencies (AMSA)
Council of Development Finance Agencies (CDFA)
Council of Infrastructure Financing Authorities (CIFA)
Education Finance Councel (EFC)
Government Finance Officers Association (GFOA)
Municipal Treasurers' Association (MTA)
National Association of Counties (NACo)
National Association of Higher Educational Facilities Authorities (NAHEFA)
National Association State Treasurers (NAST)
National Association of Towns and Townships (NATaT)
National Council of Health Facilities Finance Authorities (NCHFFA)
National League of Cities (NLC)
National School Boards Association (NSBA)
U.S. Conference of Mayors (USCM)

May 18, 1995

Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

RE: Tax-exempt Bond Simplification Provisions

We are writing on behalf of our members who are state and local government officials who rely on the issuance of tax-exempt bonds to finance infrastructure and other public facilities.

You have recently indicated a willingness to develop tax legislation that would include miscellaneous reforms of a technical nature and simplification provisions. We urge you to include five tax-exempt bond provisions in this tax legislation that conform to the criteria you have established for consideration. These provisions, which are described below, have been the subject of Congressional hearings; have been seriously considered or approved several

times by Congress; and have broad support from state and local government officials, members of Congress, federal agencies, the municipal bond industry, and various study commissions.

Each year, approximately 10,000 tax-exempt municipal bond issues are sold. The changes we support in the bond area will benefit small and large issuers and issuers nationwide. These provisions are not wholesale changes to the municipal bond laws, but instead would modify or remove overly burdensome and costly regulatory requirements that stand in the way of efficient and cost effective municipal bond financings. These changes are an important first step in improving tax-exempt bond policies and mitigating the overly burdensome regulatory structure that serves no federal purpose, costs state and local governments billions of dollars in compliance costs, and benefits the array of consultants hired by state and local governments to interpret overly complex and intrusive tax law provisions. They are not comprehensive, complicated or controversial changes. They simply provide a modicum of relief for state and local governments that are charged with increased demand for essential public services.

We would welcome the opportunity to work with you and your staff on the following five key provisions:

1. Increase the small-issuer arbitrage rebate exemption.

The arbitrage rebate requirement was perhaps the most intrusive and ultimately costly provision for state and local governments included in the 1986 Tax Reform Act. Although the concept of "rebating" earnings on the investment of bond proceeds to the federal government may seem simple, its implementation indisputably is not. The small-issuer rebate exemption currently is $5 million and has not been increased since the enactment of the rebate on governmental and 501(c)(3) issuers in 1986. An increase from $5 million to $25 million was recommended by the Anthony Commission on Public Finance and would provide relief for a significant number of issuers not currently eligible at very little cost to the federal government. This occurs because a large number of issues (approximately 80 percent of the total) account for a small percentage of total tax-exempt volume (approximately 20 percent).

Such a change would give small state and local government issuers more flexibility to finance necessary public projects without cumbersome restrictions that were intended to prevent abusive transactions engaged in by other types of issuers. Moreover, an increase in the small-issuer rebate exemption has passed Congress on two separate occasions, but never

signed into law because of unrelated issues. It also was included in H.R. 3419, the Technical Corrections and Simplification Act of 1993 and H.R. 13, the Tax Simplification Act of 1993.

It is particularly important to provide small-issuer rebate relief because the present-law two year construction bond exception to the arbitrage rebate is too complex for small issuers and imposes overly harsh financial penalties if unanticipated events prevent an issuer from meeting spending targets.

2. Increase the small-issuer bank interest deduction limit.

Current law permits banks to take an 80 percent interest deduction for bonds issued by small government issuers and small 501(c)(3) issuers. Bonds issued by such issuers are eligible for the bank interest deduction if the issuer does not issue more than $10 million in volume on an annual basis. Prior to 1986, this deduction was available for all bonds held in banks' portfolios. This tax law change has significantly reduced bank demand for tax-exempt securities and resulted in higher borrowing costs for issuers, greater market volatility and less liquidity.

Increasing this small issuer exemption would provide relief for a large number of issues that account for only a small percentage of total volume in the market. The provision should also be changed to allow issuers to elect whether to apply the exemption at the issuer level or the borrower level. This $10 million limit has not been increased since enactment of the 1986 Tax Reform Act. The Anthony Commission on Public Finance called for the limit to increase to $25 million in 1989 and the provision has been included in three tax bills since that time, but because of unrelated concerns, those bills did not become law. In the interest of simplicity, this small-issuer limitation and the arbitrage rebate small-issuer exemption should be set at the same dollar amount.

3. Repeal of the five percent unrelated and disproportionate use rule.

This requirement apparently stems from Congressional concern that significant amounts of bond proceeds from governmental issues were being used to finance private activities unrelated to the public activity being financed with a governmental tax-exempt bond and for which Congress had not specifically authorized tax-exempt financing. Under current law, not more than five percent of bond proceeds may be used for facilities "unrelated' to the financed public facility. Additionally, the related use must also be proportionate to the governmental or public use financed with the bond proceeds.

Problems arise in applying this test because of (1) the unavoidable vagueness inherent in the concept of "relatedness" and the application of a "facts and circumstances" standard, (2) the infinite number of factual situations that arise, and (3) the problems of attempting to allocate mixed-use facilities between related and unrelated uses and governmental and private uses. There is also no demonstrable need for the imposition of the related-use requirement, particularly in light of the fact that the private loan financing test imposes a five percent limit on the loan of bond proceeds to a nongovernmental person.

This provision is a perfect example of an unworkable section of the code. It has never met its intended purpose and therefore leads to confusion and increases in legal fees. It has been included in three different tax bills, two of which were vetoed by President Bush for unrelated reasons. More recently, it was included in H.R. 3419 and H.R. 13.

4. Repeal $15 Million Private-Use Restriction on "Output" Facilities

In addition to the 1986 reduction of the private-use limitation from 25 percent to 10 percent, the federal tax code also provides that for certain output facilities--public power and public natural gas generation and transmission facilities--the private-use limit is the lesser of 10 percent or $15 million. Private use restrictions limiting the benefits available to private entities from publicly financed facilities are based on sound and appropriate public policy considerations. However, the restrictions should apply equally to all governmentally financed and operated facilities.

The special $15 million private-use limitation that applies only to publicly owned electric and gas facilities is not supported by any public policy justification. It may force local governments that provide generating and transmitting facilities to have their surplus capacity sit idle rather than having it sold to others in order to avoid the private-use limitation. This provision should be repealed because it is discriminatory and it encourages practices that are not environmentally or economically sound.

5. Modify Six-Month Rebate Exemption

Under current law, issuers are not required to rebate arbitrage earnings if bond proceeds are spent within six months of the date of issuance. However, the rebate exemption period may be extended to one year for proceeds held in a bona fide debt service fund or a reasonably required reserve or replacement fund and in other limited instances if the unspent portion does not exceed the lesser of five percent of the proceeds or $100,000. Modifying this

provision to eliminate the flat-dollar limit of $100,000 on unspent proceeds would remove the unwarranted penalty on larger issuers who should also be eligible to take advantage of the extension provided by current law.

If you or your staff have any questions concerning these issues, please do not hesitate to contact any of the organizational representatives listed below:

CONTACTS:

ACI-NA	Rob Wigington	(202) 293-8500
APGA	Robert Cave	(703) 352-3890
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STATEMENT BY SAMUEL C. JOHNSON AS TRUSTEE

OF THE H.F. JOHNSON FAMILY TRUST

IN SUPPORT OF THE PROPOSAL TO PERMIT OWNERSHIP OF S

CORPORATION SHARES BY ELECTING DISCRETIONARY TRUSTS

Hearings on Miscellaneous Tax Proposals
House Ways and Means Committee
July 11-12, 1995

Mr. Chairman and Members of the Committee:

The H.F. Johnson Family Trust greatly appreciates your willingness to consider the various proposals for reform of Subchapter S of the Internal Revenue Code. The Trust would like to commend Mr. Shaw and others for introducing H.R. 2039 and for working so vigorously for its passage. In particular, the Trust supports the provision contained in H.R. 2039 to permit certain discretionary trusts to elect to hold S Corporation shares under certain conditions.

CURRENT LAW

Under current law, only certain types of trusts are permitted to hold shares in an S Corporation. In particular, both grantor trusts and qualified Subchapter S trusts (QSSTs) are allowed to hold S Corporation shares. In addition to other requirements, a QSST cannot have more than one current income beneficiary at a time.

As a result, a corporation will not qualify as an S Corporation under current law if its shares are owned by a discretionary (or "spray") trust. A spray trust is one in which the trustee is given discretion to distribute income between some number (greater than one) of potential beneficiaries or to retain the income in the trust.

USE OF SPRAY TRUSTS IN ESTATE PLANNING

Spray trusts are valuable estate planning devices. They allow assets of the estate to be consolidated in one trust for the benefit of multiple beneficiaries rather than dividing the estate into specific shares for each beneficiary (most often, the surviving spouse, children and grandchildren). Instead of multiple trust arrangements (with their attendant administrative complexity and duplication of costs), the trustee of a spray trust is given discretion to distribute income or principal to the beneficiaries depending upon their needs. Generally, the trustee also has discretion to accumulate income in the trust should the income of the trust exceed the needs of the various beneficiaries. This type of arrangement maximizes flexibility, enhances investment potential (by consolidating all the estate assets in one trust), and minimizes administrative costs. It is easy to see why spray trusts are often the planning tool of choice.

The current law prohibition on spray trusts holding S Corporation stock often results in multiple trusts being created instead. Owners of S Corporation stock will not sacrifice their company's S status merely to take advantage of spray trusts; instead, the shareholders will create multiple trusts, one or more for each beneficiary. While this technique accomplishes their estate planning goals, it does so at the cost of increased trust administration fees and complexity. All for the sake of non-tax motivated goals.

EXPLANATION OF PROPOSED AMENDMENT

The proposal contained in H.R. 2039 would permit spray trusts to be S Corporation shareholders under certain conditions. These limitations are designed to eliminate possible abuses that might otherwise occur if discretionary trusts could hold S Corporation stock.

First, in order to be an "electing small business trust," only individuals, estates, or organizations described in sections 401(a) or 501(c)(3) could be beneficiaries of the trust. Second, each potential current beneficiary would count as one shareholder for purposes of the 35-(or 50) shareholder rule. This would insure that the 35-(or 50) shareholder limit could not be circumvented by using a spray trust.

Finally, and most importantly, all the income of the trust attributable to the S Corporation stock would be taxed to the trust at the highest individual tax rate. The individual beneficiaries receiving distributions of income would not, themselves, be taxed. This limitation would eliminate the potential ability of the trustee to distribute income among beneficiaries in a way that minimizes the overall income tax liability on the trust's income.

Therefore, these limitations eliminate any potential abuses that could occur if spray trusts were permitted to hold S Corporation stock. At the same time, these limitations also eliminate any reason to prohibit discretionary trusts from holding S Corporation stock.

Of course, not everyone will choose to use spray trusts. These rules will often result in <u>higher</u> income taxes than if separate trusts were used. Those that value the tax savings over the flexibility of a spray trust will likely forego use of a spray trust in favor of a multiple trust arrangement. On the other hand, those whose planning goals are not tax-motivated will likely opt for the flexibility and administrative cost savings that spray trusts can provide.

It is conceivable that the proposal would actually raise revenue over current law. For example, an electing trust would still be required to pay tax at the highest individual rate even though the trustee eventually distributes income to some beneficiaries who fall within lower tax brackets. This would even be the case with respect to a trust where <u>all</u> of the beneficiaries were in lower tax brackets.

This provision was included in the Senate version of the Revenue Act of 1992 (H.R. 11), as well as H.R. 3419, the Tax Simplification and Technical Corrections Act of 1994, which was passed by the House of Representatives in that year. These previous endorsements of the provision by both Houses of Congress demonstrate that it is non-controversial and would result in significant simplification of Subchapter S.

MODIFICATION FOR TIERED TRUSTS

While the Trust strongly supports the proposal as drafted, we urge the Committee to consider a modification that we believe would enhance significantly the effectiveness of the provision. Often, for estate planning purposes, trust grantors will provide that income and principal of the trust they create (the "primary trust") shall be payable to separate sub-trusts for the benefit of certain individuals. These sub-trusts act as conduits through which income and principal of the primary trust is distributed.

As drafted, it is not clear that the primary trust under such a tiered trust arrangement could be an electing small business trust. On the other hand, so long as the beneficiaries of the sub-trusts would be eligible to be beneficiaries of an electing small business trust, there is no policy reason to

prohibit the primary trust from doing so. Therefore, we recommend that the provision be modified to permit a trust to be an electing small business trust where its current beneficiaries are trusts, the beneficiaries of which are individuals, estates, or organizations described in sections 401(a) or 501(c)(3).

CONCLUSION

This proposal would enhance the ability of individuals to plan their estates as they see fit in a manner consistent with the tax policy principles of Subchapter S. The H.F. Johnson Family Trust urges the Committee to approve its enactment.

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

WRITTEN SUBMISSION
OF THE
INVESTMENT COMPANY INSTITUTE

ON MISCELLANEOUS TAX REFORMS

BEFORE THE
COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

July 27, 1995

The Investment Company Institute ("the Institute")[1] appreciates the opportunity to present the Committee with suggestions for modernizing and reforming the Internal Revenue Code[2]. We commend the thoughtful consideration given by the Committee earlier this year to initiatives designed to enhance market efficiency, to reduce the level of government involvement in daily activities and to encourage the American people to enhance their retirement security.

Today, we urge consideration of legislative proposals that would:

- repeal the "30 percent test" of section 851(b)(3);
- acknowledge that market competition has eliminated the need for legislation requiring mutual funds to provide cost basis reports to redeeming shareholders;
- expand the proposed nondiscrimination rules for cash or deferred arrangements to cover salary reduction simplified employee pensions ("SARSEPs");
- enhance the individual retirement account ("IRA");
- modify the treatment of market discount on tax-exempt bonds held by regulated investment companies ("RICs");
- subject foreign investors in RICs to no more U.S. withholding tax than is collected from foreigners who invest in U.S. obligations directly or through foreign funds;
- permit bank common trust funds to convert tax-free to one or more RICs; and
- deny federal tax information to states imposing a pension source tax.

Some of these proposals have been included in bipartisan tax simplification legislation that passed the House of Representatives last year. All of the proposals are consistent with the Committee's goals of improving efficiencies, reducing government-imposed burdens and encouraging Americans to enhance their retirement security.

I. Repeal the 30 Percent Test

Several times in recent years, this Committee has reported favorably tax simplification bills repealing the 30 percent test of section 851(b)(3). Under this test, which is one of the requirements that a mutual fund must satisfy to qualify for taxation as a RIC, a fund generally must receive less than 30 percent of its gross income from the sale or disposition of securities held for less than 3 months.

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,604 open-end investment companies ("mutual funds"), 470 closed-end investment companies and 11 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.325 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

[2] All references to "sections" are to sections of the Internal Revenue Code.

The 30 percent test was enacted almost 60 years ago as part of the Revenue Act of 1936. The legislative history to the 1936 Act provides no explanation of why the 30 percent test was adopted. Presumably, the restriction imposed by this test was consistent with what was deemed 60 years ago to be prudent investment philosophy. Because the securities markets today are vastly different from the markets of the 1930s, however, the imposition of this restriction today harms fund investors, reduces market efficiencies and imposes unnecessary administration burdens and costs.

Mutual fund shareholders are disadvantaged in at least three ways by the imposition of the 30 percent test. First, mutual funds can be forced to engage in uneconomic, tax-motivated transactions to ensure compliance with the test. Second, compliance-monitoring efforts require funds to incur otherwise-unnecessary administrative costs. Finally, the test precludes mutual fund shareholders, who are typically middle-class investors, from receiving tax treatment comparable to that provided to the more wealthy, direct investor and to the investor in competing pooled investment vehicles, which are not subject to the 30 percent test.

For a number of years, the Institute has urged Congress to repeal the 30 percent test and has provided examples of how the 30 percent test can operate against shareholders' interests.[1] Rather than repeat prior testimony, this submission provides one recent illustration of why the 30 percent test should be repealed. On April 20 of this year, a relatively new mutual fund investing in small company "growth" stocks purchased over 10,000 Lotus Development Corporation shares for $33.375 per share. Less than 2 months later, IBM announced a tender offer, to expire on July 3, for all Lotus shares at a price of $64.00 per share. Because the fund invests principally in stocks with low dividend payouts, the fund was concerned that the 92 percent gain on its Lotus shares, which would be held for less than 3 months as of July 3, would be so large that the fund might not be able to satisfy the 30 percent test for its taxable year.

The fund's concern with possible failure to comply with the 30 percent test first led it to incur approximately $10,000 in legal and accounting fees in an attempt to identify a means by which the fund could tender its shares after they had been held for 3 months. After concluding that participating in the tender would result in less-than-3-month gain, the fund was forced to decide whether accepting the tender offer, and risking disqualification as a RIC, was consistent with its shareholders' best interest. Ultimately, the fund decided to tender its Lotus shares, even though it now will be forced to undertake measures intended to generate sufficient additional income to make its less-than-3-month gain for the year fall below 30 percent of its gross income. These measures will result in otherwise-unnecessary administrative costs and may cause the fund's portfolio manager to change his investment strategies or engage in transactions for the purpose of reducing the percentage of less-than-3-month gain. None of these "corrective" measures are in the best interest of the fund's shareholders.

Repeal of this provision would permit fund managers in these and similar circumstances, to act in the best interest of their shareholders free from the arcane and capricious dictate of the 30 percent test imposed under current tax law. It would also reduce the administrative burdens of fund tax compliance.

II. Eliminate the Mandatory Information Reporting Requirement from Tax Simplification Proposals

Since 1991, when cost basis reporting was first included in tax simplification legislation, the Institute has expressed its concern about mandated shareholder basis reporting and has provided other, technical comments. While some of our technical concerns with legislatively-mandated cost basis reporting have been addressed, the Institute remains concerned that the proposal could lead to investor confusion and significant administrative costs. In addition to our concerns, we would note that the need for legislation mandating shareholder basis reporting has been substantially obviated by the marketplace and the highly competitive nature of the mutual fund industry. Today, most major mutual fund complexes already provide average cost basis information to redeeming shareholders.

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[1] See e.g., Statement of Matthew P. Fink, Investment Company Institute, Before the House Ways and Means Subcommittee on Select Revenue Measures, on H.R. 2735, Relating to the Tax Treatment of Mutual Funds (Sept. 17, 1991); Statement of Matthew P. Fink, Investment Company Institute, Before the Senate Finance Subcommittee on Taxation, on S. 530 (September 12, 1991).

The Institute strongly supports an approach to cost basis reporting that would allow market forces, rather than government regulators, to guide the industry's provision of cost basis reports. The industry's response to investor needs demonstrates that legislatively-mandated cost basis reporting is unnecessary. In our view, the market will ensure that fund shareholders opening new accounts receive simple, easy-to-use cost basis reports. We, therefore, urge the Committee not to include a mandatory information reporting requirement in tax simplification legislation.

III. Expand the Proposed Nondiscrimination Rules for Qualified Cash or Deferred Arrangements to Cover SARSEPs

The Institute strongly endorses the proposal to expand nondiscrimination rules for qualified cash or deferred arrangements to cover salary reduction simplified employee pensions ("SARSEPs"). Pension plan coverage in the small employer market is woefully inadequate and requires urgent attention. As of 1993, only 29 percent of employees who worked for a small employer (i.e., one with 100 or fewer employees) worked for a company that offered a retirement plan. This may be compared with 83 percent of those working in larger companies. Improving pension coverage among small employers would address a major contributing factor to our national retirement saving shortfall.

For these reasons, the Institute strongly supports provisions passed by the House in 1994 that would have increased retirement plan coverage in the small employer market. Specifically, the bill would have simplified the nondiscrimination rules applicable to 401(k) and other cash or deferred arrangements, thereby relieving employers of the administrative burden of complying with these complex rules. In addition, the bill would have expanded the availability of SARSEPs by permitting employers with 100 or fewer employees to establish these plans and by eliminating the 50 percent participation requirement for SARSEPs.

While these measures represent significant progress toward the creation of an easy-to-administer retirement plan ideally suited for the small employer market, one addition is critical. The Institute, therefore, urges the Committee to apply simplified nondiscrimination rules passed in 1994 to SARSEPs as well as the other cash or deferred arrangements.

Our particular concern is that the recent legislation would have retained the current non-discrimination rules that require sponsors of SARSEPs to periodically compare the average deferral percentage ("ADP") of highly compensated employees and adjust plan contributions, if neces ary. The necessity of performing these cumbersome tasks may deter small employers from adopting SARSEPs. Because the bill would have provided simplified nondiscrimination rules for 401(k) and other cash or deferred arrangements, but not for SARSEPs, enactment of this legislation without modification would make the rules for SARSEPs more complex and burdensome than those for large employer plans

IV. H.R. 682, the "Savings and Investment Incentive Act of 1995"

The Institute strongly supports the provisions of H.R. 682. This bill would reestablish universal access to a fully deductible IRA and create a new type of nondeductible IRA similar to the American Dream Saving Account of H.R. 1215. It would further provide that an individual will not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is an active participant.

H.R. 682 responds directly to the clear need for Congress to establish more powerful incentives to increase retirement saving. As the "baby boom" generation approaches retirement age, doubts regarding the availability of social security have grown. Moreover, notwithstanding a lessening of confidence in our social security system, the personal saving rate in the U.S. has fallen over the last decade from a high of 8.0 percent in 1984 to a low of 4.0 percent in 1993.

The In titute believes that expansion of the IRA, through measures such as H.R. 682 and the Ame can Dream Saving Account of H.R. 1215, should be adopted to alleviate the impendin tirement saving crisis. In our view, there is strong academic support for the

conclusion that IRAs do increase saving and do result in the creation of a "saving habit." Thus, an expanded IRA would represent a significant step toward increasing personal retirement saving.

In addition, this legislation benefits middle-income American families. At the IRA program's peak in 1986, 75 percent of all IRA contributions were accounted for by families with annual incomes of less than $50,000. Moreover, before its discontinuance in 1986, the universal IRA was increasingly attracting contributions from lower income brackets.

Although a variety of proposals to expand the IRA enjoy broad bipartisan support in both the House and Senate, we believe that a bill such as H.R. 682 responds most directly to the need to increase personal saving. This proposal gives Americans a choice of IRA vehicles. That way, individuals can choose to structure an IRA investment program that best suits their particular needs.

The Institute strongly endorses the enactment of H.R. 682 as a significant step toward helping millions of families secure their retirement future.

V. Excise Tax Treatment of Market Discount on a RIC's Tax-Exempt Bonds

In 1993, Congressional modification of the taxation of accrued market discount on tax-exempt bonds inadvertently imposed additional burdens on RICs seeking to comply with the section 4982 minimum distribution requirements. The Institute urges a technical modification to alleviate these burdens.

The excise tax distribution requirements of section 4982 effectively require that a RIC distribute as taxable dividends by the close of each calendar year at least 98 percent of its ordinary taxable income received during the calendar year and 98 percent of its capital gain net income realized during the 12-month period ending on October 31. As a practical matter, a RIC generally can declare as a dividend and distribute by December 31 essentially all of its calendar-year ordinary income, because this income is relatively predictable as to timing and amount. An October 31 cut-off date for capital gain net income is provided, however, because this income is recognized sporadically and intermittently.

Prior to the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), gain on the disposition of a tax-exempt bond generally was treated as capital gain, whether or not any of the gain was attributable to accrued market discount. OBRA 1993 modified this treatment to provide that disposition gain on a tax-exempt bond acquired after April 30, 1993 is treated as ordinary income to the extent of any accrued market discount.

By converting accrued market discount on tax-exempt obligations from capital gain to ordinary income, OBRA 1993 effectively required that a RIC distribute by calendar year-end 98 percent of its accrued market discount on tax-exempt bonds disposed of through December 31, rather than through October 31. This result was unintended and is quite problematic. For example, assume that a RIC investing only in tax-exempt bonds disposes of several tax-exempt bonds with substantial accrued market discount in December. Because the RIC has no taxable bond investments, and hence no ordinary income other than the accrued market discount, the RIC will have little if any "leeway" to assure compliance with the 98 percent ordinary income distribution requirement. Unlike a RIC investing in taxable bonds, which typically will have a sizable "leeway" to satisfy the 98 percent ordinary income distribution requirement because of the large amount of ordinary taxable income it receives, a RIC investing in tax-exempt bonds may have very significant difficulties in determining, declaring and distributing by calendar year-end 98 percent of its ordinary income.

H.R. 843, introduced by Representatives Shaw and Cardin, would repeal the OBRA 1993 change to the accrued market discount rules and restore the capital gain treatment of market discount realized upon the disposition of tax-exempt bonds. This change would improve market efficiencies and restore liquidity to tax-exempt bonds trading at a discount. It would also eliminate the technical RIC excise tax problem described above. The Institute supports H.R. 843.

Should H.R. 843 not be enacted, however, we urge that the technical excise tax distribution problem created for RICs by OBRA 1993 be alleviated. As noted above, Congress

never intended, when it modified the market discount rules in 1993, to make the RIC excise tax rules more difficult to satisfy. Consequently, a technical modification should be adopted that would require that the accrued market discount on tax-exempt bonds held by RICs be distributed on a November 1 - October 31 basis rather than a calendar-year basis. This treatment is consistent with the excise tax rules for foreign currency gains and losses, which are treated as ordinary income under section 988, but which are subject to the excise tax distribution requirements on a November 1 - October 31 basis.

VI. H.R. 2045, the "Investment Competitiveness Act of 1995"

The Internal Revenue Code presently, and we believe inadvertently, encourages non-U.S. investors seeking to invest in U.S. securities to choose foreign mutual funds or direct investments over U.S. mutual funds. Under the Code, these non-U.S. investors incur no U.S. withholding tax on either interest income or capital gain received from the investment. In contrast, non-U.S. investors who make the same investment through a U.S. fund are subject to U.S. withholding tax on any interest income or short-term gain earned by the fund. This perverse result occurs because the interest income and short-term gain received by a U.S. fund are recharacterized as dividend income subject to U.S. withholding when distributed to non-U.S. investors.

H.R. 2045, the Investment Competitiveness Act of 1995, which was introduced earlier this month by Representatives Crane, Gibbons and Dunn, would remove these disincentives to investing in U.S. securities through U.S. funds.[4] Specifically, U.S.-source interest income and short-term capital gains generally would retain their character when distributed to a U.S. fund's non-U.S. investors. Under H.R. 2045, any U.S.-source interest income that would have been exempt from U.S. withholding tax if received directly by a non-U.S. investor or a foreign fund could be designated by the U.S. fund as an interest-related dividend exempt from U.S. withholding tax when distributed to the fund's non-U.S. investors. Similarly, the fund could designate its net short-term gains distributed to non-U.S. investors as a short-term capital gain dividend exempt from U.S. withholding tax.

The Institute strongly supports the Investment Competitiveness Act of 1995 and urges its enactment. H.R. 2045 would eliminate an unintended and inappropriate bias created by the tax code that encourages overseas investors seeking to invest in U.S. securities to use foreign funds or direct investment rather than U.S. funds. The bill thus would make U.S. funds more competitive in the global market, and in so doing would benefit U.S. firms that provide portfolio management, custodial, administrative and other ancillary services to U.S. funds.

The investment potential of non-U.S. investors is substantial. In the past five years, assets of foreign mutual funds have increased over 100 percent, from $1.1 trillion to $2.3 trillion. The expectation of a continually growing middle class in many industrialized and developing markets throughout the world is likely to lead to even greater global expansion of mutual fund sales.

The U.S. mutual fund industry is ideally suited to export its services and products throughout the global marketplace. Approximately half of the world's mutual fund assets are held by funds registered in the U.S. and operated within our borders. The U.S. industry is widely acknowledged as the world leader in mutual fund performance, service and innovation. This leadership role has been clearly demonstrated by the growth of U.S. industry assets from $135 billion in 1980 to $2.3 trillion today.

Unfortunately, our success here at home has not translated into success abroad, because U.S. tax laws provide a powerful disincentive to investing in the U.S. through U.S. funds. For that reason, it is not surprising that non-U.S. investors today represent less than one half of one percent of all U.S. mutual fund investors.

H.R. 2045 would permit U.S. funds to offer a competitive investment vehicle in the global markets. Growing worldwide acceptance of mutual funds provides the U.S. industry with a unique opportunity to expand its market to investors outside the U.S. We urge

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[4] Comparable legislation introduced in 1991 and 1993 has been actively supported by the Institute. Most recently, the Institute testified in June 1993 before the House Ways and Means Select Revenue Measures Subcommittee in support of H.R. 1891, the Investment Competitiveness Act of 1993.

enactment of H.R. 2045 to permit the fund industry to realize this potential opportunity and to ameliorate the current tax law provisions that make U.S. funds a "second class" product.

VII. Permit Tax-Free Conversions of Bank Common Trust Funds

Pursuant to section 584, bank common trust funds are afforded conduit tax treatment under which the common trust fund is not subject to entity level tax. Instead, each participant in a common trust fund includes in income his or her proportionate share of the common trust fund's income, whether or not the income is distributed. In addition, common trust fund participants are subject to tax under section 584(e) on any gain realized upon the withdrawal of any part of their interest in a fund. The conversion of a common trust fund into a RIC is a taxable event under present law, because the conversion is deemed to involve a taxable withdrawal by the participants from the common trust fund.

Tax simplification proposals approved by the House of Representatives in prior years would have modified section 584 to permit a bank common trust fund to convert to a single RIC on a tax-free basis. This provision has received strong bipartisan support, and we urge its enactment.

A proposal also has been advanced to amend this proposed bank common trust fund conversion provision to permit a bank common trust fund to transfer on a tax-free basis substantially all of its assets to one or more RICs pursuant to a single plan. The Institute supports this proposed amendment. Regulations under section 584 currently permit a common trust fund to divide into two or more new common trust funds, without regard to which of the original fund's assets are transferred to each new fund, so long as each participant has the same proportionate beneficial interest in each of the new common trust funds as he or she had in the original. Since current law would permit the tax-free division of a common trust fund and the tax simplification bill would have permitted the tax-free conversion of a common trust fund to a RIC, there appears to be no policy justification for prohibiting a common trust fund from accomplishing each of these objectives in a single step. Thus, the conversion of a single common trust fund into more than one RIC should be permitted, so long as each participant in the common trust fund has the same proportionate interest in each RIC into which the trust fund converts that he or she held in the original common trust fund.

VIII. Proposal to Deny Federal Tax Information to States Imposing a Pension Source Tax

Under H.R. 1762, the disclosure of Federal tax return information to certain state officials would not be permitted during any period that the State imposed a pension source tax.

The Institute supports this proposal as a means to deter the application of source state taxation.[5] In addition, the Institute remains supportive of H.R. 394, a bill that would directly prohibit source state taxation. Both of these measures would address the Institute's concern that multiple state taxing authorities not require mutual funds to file reports or withhold source state taxes in situations where the funds do not have access to the information needed to comply. Mutual funds typically have no means of tracking the states in which pension plan participants and IRA owners earn their retirement distributions and the amount earned in each state. Inasmuch as those determinations are central to source state tax calculations, mutual funds are ordinarily not able to allocate retirement plan distributions by source state.

Because mutual funds and similar financial institutions simply are not able to serve as vehicles for collection of state income taxes on pension distributions made to nonresidents, we strongly support H.R. 1762 to the extent that it would deter the imposition of source state taxation.

[5] Source state taxation is the assessment of state income tax on pension distributions made to a nonresident on the basis of the portion of the total pension that was earned while the retiree worked in that state.

IX. Conclusion

The Investment Company Institute shares the Committee's goals of enhancing market efficiency, reducing the level of government involvement in daily activities and encouraging Americans to enhance their retirement security. The proposals that we advance today are consistent with your initiatives. We support your efforts to achieve these goals.

Statement of Terry Lewis
President
National Association of Housing Cooperatives
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U. S. House of Representatives

July 11, 1995

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to submit testimony in support of three pending measures of interest to housing cooperatives and their members, each of which will have neutral or minimal revenue effect.

H.R. 1546 is a tax simplification proposal twice passed by both houses of Congress (though vetoed, for unrelated reasons, by former President Bush) and included, in November of 1993, as part of H.R. 3419. The bill's purpose is to clarify that section 277 of the Internal Revenue Code does not apply to housing cooperatives, and also to clarify how certain income of a housing cooperative is to be taxed under subchapter T of the Code. It is a straightforward codification of what the National Association of Housing Cooperatives (NAHC) considers to be existing law. Since its passage (in prospective form) by both houses of Congress, the interpretation of cooperative taxation codified in H.R. 1546 has been thrice vindicated by the courts (see *Landmark, Inc. v. Commissioner*, 25 Cl. Ct. 100 (1992), *Buckeye Countrymark, Inc. v. Commissioner*, 103 T. C. 547 (1994), and the very recent *Trump Village Section 3, Inc. v. Commissioner*, T.C. Memo. 1995-281 issued June 22, 1995).

The *Landmark* and *Buckeye* cases involved agricultural cooperatives, while *Trump Village III* involved a limited equity cooperative housing corporation as defined in H.R. 1546. All three opinions are thorough in their discussion and persuasive in their reasoning that subchapter T of the Code, which governs the taxation of cooperative corporations, is inconsistent with and precludes the application of section 277. These decisions are entirely consistent with the proposed legislation and, in fact, adopt the reasoning upon which it is based. *Trump Village III* consolidates the result in *Park Place, Inc. v. Commissioner*, 57 T.C. 767 (1972), which held that the term "corporation operating on a cooperative basis" (which determines the applicability of subchapter T) "necessarily includes a section 216 cooperative housing corporation", with the decisions in *Landmark* and *Buckeye*, that subchapter T preempts the application of section 277.

As early as 1975, this Committee took the position that the result to be achieved by H.R. 1546 is the correct interpretation of existing law. A 1975 Committee Report regarding pending legislation which, if passed, would have allowed certain cooperatives, condominium associations, and home-owner associations to elect tax-exempt status, contains the following language:

> If the provisions of the bill are not met, then a cooperative housing corporation is to continue to be taxed under the existing rules established by the courts, e.g. *Park Place, Inc.*, 57 T.C. 767 (1972), the Internal Revenue Service, and by subchapter T of the code.
> (H.R. No. 94-658, 94th Cong. 1st Sess. 329 n.6 (1975))

Once enacted, H.R. 1546 will eliminate the need for further costly litigation extending the *Park Place/Trump Village III* line of cases and clarifying the taxation of housing cooperatives under subchapter T. It will end the erroneous attempt

by the IRS to break apart the cooperative enterprise and separately tax sources of income which, though functionally tied to the provision of housing, would, when set apart, have few or no offsetting deductions.

Given that H.R. 1546 simply codifies existing law, its express retroactivity is amply justified, as is an estimate of zero revenue effect.

Another measure with zero revenue effect which NAHC supports is the expansion of the Low Income Housing Tax Credit (LIHTC) to include cooperatively-owned housing. Resident ownership of housing in the cooperative format has been demonstrated to be the most effective means of utilizing two earlier federal affordable housing programs (see Calhoun and Walker, *Loan Performance of Management Cooperatives*, The Urban Institute (April, 1994)). In a like manner, limited equity cooperative ownership of housing created with the help of the LIHTC may be the most effective means available to maintain its affordability during the Section 42 extended affordability period. We would urge the modification of the LIHTC program to facilitate its use by housing cooperatives.

Finally, we support H.R. 737, a measure introduced by Representative Lowey to extend the mortgage interest and property tax deductions available to all other home-owners to the resident-owners of land-only cooperatives. It can be anticipated to have a minimal revenue effect.

The only distinction between the homeowners addressed in H.R. 737 and the members of the cooperative housing corporations entitled to a pass-through of mortgage-interest and property tax deductions by section 216 of the Code is that they, individually, own the buildings in which they reside while their cooperatives own only the improved land. This seldom-used ownership structure ought not, in equity, to deprive cooperators of the tax benefits of home-ownership.

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July 27, 1995

Phillip Moseley
Chief of Staff
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Moseley:

The National Association of Realtors (NAR) has the following comments on the items described in Ways and Means Advisory No. FC-8.

Accounting

Proposal:

4. Repeal 1986 provision requiring contributions in aid of construction to be included in gross income.

NAR supports this proposal and the efforts of the National Association of Water Companies to repeal the 1986 additions to Section 118. The contributions in aid of construction (CIAC) provisions have created harsh impediments to development in many regions of the country. The impact of these rules is particularly onerous for homebuyers, because the CIAC provisions can add as much as $2000 to the cost of a new home. If the cost of these provisions is not passed along to consumers in the price of new construction, the cost is borne by the existing customer base. In either event, the provisions become, in effect, a barrier to home ownership, as the cost of purchasing a home increases. NAR opposes barriers to home ownership, and therefore urges the Committee to adopt this provision. It has passed the Senate on several occasions. It is time for the Ways and Means Committee to act and to adopt this proposal.

Depreciation and amortization

Proposals:

5. Establish 10-year recovery period for "qualified commercial improvement property"

6. Establish 10-year recovery period for leasehold improvements.

NAR supports changes to the current depreciation regime to allow recognition of the true economic depreciation of a building's internal elements. Under current law, the depreciable life for a nonresidential building is 39 years. This term is non-economic, and no longer reflects the useful life of a structure and its components. This is particularly true of tenant improvements. Under pre-1981 law, the costs of those improvements were amortized over the life of the lease. Since 1981, the costs have been recovered over a period the life of the building. That period has now escalated to 39 years, well beyond the average duration of almost all commercial leases, and well beyond the economic life of either the building's interior or the tenant improvements.

NAR supports both legislative and regulatory solutions to the problems that face landlords who make improvements for their tenants. Congressmen Shaw, Rangel, Crane, Nancy Johnson, Thomas, Hancock, Neal, English, Sam Johnson, Herger, and John Lewis introduced H.R. 1171 to address this issue by providing a recovery period and class life of 10 years for certain property placed in service by a lessee or a lessor pursuant to a lease. NAR applauds their leadership on this issue. In addition, HR 1215, the Contract with America Tax Relief Act, contains a favorable leasehold improvement provision that passed the House before H.R. 1171 could be considered.

The provision in H.R. 1215 provides an administrative solution to the tenant improvement problem. Current regulations require that, on expiration of the lease, the landlord continue to amortize tenant improvement costs over the balance of the 39 year term. No "close out" of the account is permitted. H.R. 1215 provides that, at the expiration of the lease, the existing balance remaining in the tenant improvement accounts may simply be written off. For example, if tenant improvements of $39,000 were made, then $1,000 would be written off over each year of the lease ($39,000 / 39 year life). If the lease terminated after 7 years, then the remaining $32,000 in the account could be written off, or deducted, rather than carried for the remaining 32 years.

The improved recognition of the economic life of tenant improvements contained in H.R. 1171 builds upon the relief set forth by H.R. 1215, and NAR supports both these legislative initiatives.

Estate and Gift Tax

Proposal:

8. Package of proposals to simplify and improve estate and gift taxation.

NAR does not have specific policy on these matters of estate and gift tax administration. However, our review of the proposals suggests that the estate, gift and trust rules would be more symmetrical if a number of these proposals were enacted. Thus, we wish to express support for the goals of simplification and ease of administration that these proposals embody.

Passive Losses

While NAR does not have a specific position on modifying the passive loss rules as they apply to timber and farming activities, our members do have continuing concerns regarding proposed passive loss regulations under Section 469(c)(7). NAR has filed specific comments and testified before the Internal Revenue Service regarding the regulations. While we support and even applaud most features of the proposed regulations, we would like to take this opportunity to address one specific objection to the regulations as currently proposed. As a practical matter, the IRS has disregarded the clear intentions of Congress in its 1993 efforts to modify the passive loss rules so that they would apply fairly to individuals engaged in real estate trades and businesses.

NAR strongly objects to the disallowance of aggregation of rental and non-rental activities under the rules. Indeed, NAR contends that the very purpose of enacting new Section 467(c)(7) in 1993 was to facilitate the joining of rental and non-rental activities for individuals in the real estate business. The economic reality of a typical NAR member's business is that all real estate activities, including rental real estate, are performed as part of one continuous, integrated whole.

When the Clinton Administration proposed passive loss relief and the creation of Section 469(c)(7), the Administration noted the fundamental unfairness of then-current law that prohibited a real estate business person from doing what all other business persons could do, namely, reflect the economic activities of a single business unit as just that -- a single business unit. The Committee's report states that "the Committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from non rental real estate activities or against other types of income such as portfolio investment income. The Committee bill modifies the passive loss rule to alleviate this unfairness."

NAR urges that should the Internal Revenue Service persist in promulgating regulations with the effect of vitiating the passive loss relief accorded real estate professionals in the Omnibus Budget Reconciliation Act of 1993 Congress should consider legislation restoring the original intent of Section 467(c)(7) to allow aggregation of rental and non-rental activities for individuals in the real estate business.

Pass-through entities

Proposals:

1. Subchapter S reform proposals to expand availability of Subchapter S and improve its operation.

2. Subchapter S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers.

NAR supports meaningful S corporation reform as embodied in H.R. 2039 and S. 758. Congressmen Shaw, Matsui, and Portman and Senators Hatch and Pryor are to be commended for their leadership in drafting legislation that would provide critical and direct improvements to the competitive ability of more than 1.9 million Subchapter S corporations nationwide. Many of our members are family-owned and operated businesses or otherwise closely held organizations that operate as S corporations, and these entities have been reliable engines of job growth and productivity for the U.S. economy. But the rules drafted in 1958, when S corporations were created, and amended in 1982 are out of synch with modern economic realities. Subsequently, S corporations are hindered from realizing their economic potential and making greater contributions to the domestic economy.

NAR believes that H.R. 2039 and S. 759 will remove barriers so that S corporations can have better capital access, expand and streamline their businesses, simplify tax and estate planning, maintain family ownership and other traditional structures, and avoid the consequences of unnecessary, obsolete tax traps.

NAR also supports H.R. 1214, Congressman Stark's legislation to allow the present-law capital gains presumption in the case of property held by an S corporation. This change would remove the current law's inequitable treatment of S corporations that invest in a lot or parcel of land compared to individual taxpayers.

Proposal:

5. Package of proposals to simplify and improve REIT provisions.

NAR supports H.R. 2121, Congressman Shaw's bill to simplify and improve tax laws pertaining to Real Estate Investment Trusts (REITs). Our membership believes that REITs are economically effective financial instruments for creating secondary markets in real estate equity and that the current tax law's excessive complexity hinders the economic benefit of these products.

Tax-exempt bonds

Proposals:

10. Qualified mortgage bonds -- home improvement loans

11. Qualified veterans' mortgage bonds

NAR has long supported these bond programs as essential elements of affordable housing programs. NAR also supports the provisions that permit owners of these properties to improve their homes through the benefits of insured home improvement loans. The current $15,000 limit on these loans has not been adjusted since 1981. We believe that this limit should now be raised to $25,000. This would make the loan limit congruent with the FHA home improvement limit. This would enable lower income families to maintain their homes and preserve their equity and improve the existing housing stock. We believe that these homeowners should be permitted to make improvements to upgrade the livability, utility and/or energy efficiency of their homes. An increase of the loan limit to an amount that more nearly reflects market reality would be a significant improvement to their quality of life.

Pension Simplification

Proposal:

1. Tax-exempt organizations eligible under section 401(k) (section 212 of H.R. 3419 from the 103rd Congress)

NAR supports changes to current tax law to permit nongovernmental tax-exempt organizations to maintain qualified cash or deferred arrangements (i.e., 401(k) plans) for their employees. NAR believes that such plans help tax-exempt organizations provide retirement security for their employees.

In addition, NAR believes that the $7,500 deferred compensation plan cap for tax-exempt organizations in IRC Section 457(b)(3)(A) should be indexed for inflation. This change would achieve parity between taxable and tax-exempt organizations in terms of retirement planning options. Taxable organizations are able under current law to adjust for inflation the cap on deferred compensation arrangements.

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NAR appreciates the opportunity to comment on these proposals, and looks forward to working with the Committee in formulating a package that can move to the House floor.

Should you need further comments on these items, please call Linda Goold or Tom Morgan at the Association's Washington office. They can be reached at (202) 383-1083 and (202) 383-1078, respectively.

Sincerely,

Richard Woodbury /lg

Richard Woodbury, Chairman
Federal Taxation Committee

July 27, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Phil:

The housing agencies of the 50 states, and their national organization, the National Council of State Housing Agencies (NCSHA), appreciate this opportunity to comment on certain provisions before the Committee which relate to the Low Income Housing Tax Credit (Tax Credit) and Mortgage Revenue Bond (MRB) programs. The state Housing Finance Agencies (HFAs) have financed more than 1.6 million families' home purchases with MRBs and over 700,000 rental apartments for lower income families with the Tax Credit. These are highly successful examples of affordable housing programs, enacted with broad bipartisan support, which meet the goals Congress has set for them, operate with minimum federal bureaucracy, and produce results for lower income families.

With the adoption of the proposals before the Committee to reverse the Tax Credit stacking rule, to permit use of the 91 percent Tax Credit with HOME funds, and to increase the MRB home improvement loan limit, these programs can be made even more flexible and responsive to low income housing needs. These changes are supported by Committee members Charles Rangel and Barbara Kennelly, lead advocates of the Tax Credit and MRB programs, respectively. In addition, these proposals would cost the federal government little or nothing. In fact, the Tax Credit stacking rule change would generate, according to recent Joint Tax Committee estimates, more than $60 million over seven years, enough to offset any minimal cost of the other provisions.

We also hope to work with the Committee over time to address probably the most serious problem the Tax Credit and MRB programs face, the erosion of their value. Neither the $1.25 per capita annual state Tax Credit allocation nor the $50 per capita ($150 million minimum) state private activity bond cap has been adjusted, even to reflect the cost of inflation, since its establishment in 1986. Since then, their value has diminished by 35 percent. Appreciating the budget constraints within which the Committee must operate, the HFAs are confident that together we can find a solution to this problem which is cost-efficient and helps those states, such as Texas, California, Illinois, New York, and Florida, which exhaust their authority each year and desperately need more to meet pressing housing needs.

The Low Income Housing Tax Credit

Demand for Tax Credits vastly outstrips supply in most states. In 1994, the states allocated a record $496 million in Tax Credits, more than 95 percent of available credits. Forty-one agencies allocated all of their credits, and are therefore eligible to participate in the 1995 national pool. Only $10 million in unused Tax Credit authority was carried forward by eight states to utilize in 1995.

The demand for Tax Credits in 1995 is even greater. Due to very limited amounts of carryforward, returned, and national pool credits, total credit available nationwide is 25 percent less than the amount available in 1994. As of last month, many states had already allocated all of their available credits.

Amendment to the Tax Credit Stacking Rule

Given this intensely competitive environment, states cannot afford to lose a single dollar's worth of credit. For this reason, NCSHA vigorously supports the reversal of the stacking rule -- which establishes the sequence in which credits must be allocated -- to allow carryforward and pool credits to be allocated before per capita and returned credits. Without this change, states will continue to unfairly lose Tax Credits to the national pool or the Treasury. This provision has had particularly devastating effects in several states ravaged by natural disasters, particularly the 1993 Midwestern floods.

Missouri, for example, in 1993 suffered a loss of nearly $5.8 million in Tax Credit authority due to the flood's severe disruption of housing planning and development which made it impossible for the agency to allocate the credit. The following year, the state had just $8.4 million in credit, instead of the $14.2 million it would have had were it not for the stacking rule. That year, struggling to recover from the flood, the state received over $20 million in requests for Tax Credits. Tax Credits were lost in Iowa, Nebraska, and South Dakota for similar reasons. This unfortunate situation could be replicated in any state at any time due to unforeseeable events if the stacking rule is not amended to allow states 24 months to allocate credits as Congress intended.

In the 1990 Tax Act, Congress gave the states authority to carry forward their unused per capita and returned Tax Credits for allocation in the next calendar year. Tax Credits carried forward but not allocated by the end of the second year would be lost to a national pool and redistributed to states which allocated all of their available credit. Before 1990, states were required to use all per capita and returned credits in the year they received them or lose them to the Treasury. There was no provision for carryforward and no national pool.

The carryforward provision was intended to give states 24 months to allocate per capita and returned Tax Credits to allow a more reasonable timeframe within which housing development could proceed and to remove the "use it or lose it" pressure states felt at year-end. Due to the way the provision was drafted, however, the IRS requires states to fully allocate their per capita and returned credits before allocating credits carried forward from the previous year or credits received from the national pool.

The result of this interpretation is that states effectively lose the opportunity to carry forward per capita credits unless they fully allocate all other available credit. This, in effect, creates an every-other-year carryforward and does not give states a full 24 months to allocate their per capita and returned credits as Congress intended.

Amendment of the stacking rule is critical to maintaining fairness and flexibility in state administration of the Tax Credit program. Without this change, those states which do not fully utilize their Tax Credit authority in a given year, even for reasons completely beyond their control, could lose per capita credit authority through the national pool to other states. Unused pool credit will be lost from the Tax Credit program altogether.

Use of HOME Funds with the 91 Percent Tax Credit

NCSHA also vigorously supports the proposal to extend eligibility for the 91 percent present value credit to otherwise qualified buildings financed with HOME funds.

The 1993 Tax Act includes a provision to allow use of the 70 percent present value credit in Tax Credit projects assisted with HOME funds, if 40 percent or more of the units are occupied by households earning less than 50 percent of area median income. This provision was enacted to allow the Tax Credit to reach the lowest income families possible by facilitating its combination with HOME funds. The Act provided that such projects are not eligible, however, for the 91 percent present value credit available to projects located in HUD designated qualified census tracts (QCTs) or difficult development areas (DDAs).

Prior to passage of the 1993 Tax Act, Tax Credit projects utilizing HOME funds were considered federally subsidized and therefore limited to the 30 percent present value credit. This limit was imposed by the original Tax Credit statute before states were required by the 1989 Tax Act to underwrite projects to ensure that they receive only the amount of subsidy necessary for financial feasibility and long-term viability.

Prohibiting HOME-assisted projects located in QCTs and DDAs from receiving the 91 percent credit fails to recognize that states are responsible for ensuring that only the minimum amount of credit necessary for financial feasibility is allocated to a particular project. With a limited amount of credits, demand for which increases every year, states have not only a legal responsibility but also a tremendous incentive to make the maximum use of these credits. Congress demonstrated its confidence in the states to carefully ration Tax Credits when in 1992 it delegated to them responsibility for conducting the subsidy layering reviews for Tax Credit projects which receive HUD subsidies.

Furthermore, allowing the 91 percent credit in QCTs and DDAs is in keeping with the intention of the 1993 Act provision which allowed use of the 70 percent Credit with HOME funds to direct those subsidies to needy households in very low income neighborhoods.

Use of the 70-Percent Tax Credit With Tax-Exempt Bond Proceeds

Consistent with the HOME change, we urge the Committee to allow use of the 70 percent present value credit in projects financed with tax-exempt bond proceeds. Under current law, Tax Credit projects utilizing tax-exempt bond proceeds are limited to the 30 percent, rather than the 70 percent, present value credit. Again, this limit was included in the original Tax Credit statute before states were required to underwrite projects to ensure that they receive only the minimum amount of subsidy necessary for feasibility.

This provision would empower states with greater flexibility in using existing resources. In addition, the provision would revitalize multifamily housing development, which would generate jobs and taxes, and stimulate a low-interest form of financing, which would benefit low-income renters. The ability to use Tax Credits with tax-exempt bond proceeds is particularly important today because developers, both nonprofit and for profit, are finding it increasingly difficult to secure mortgage financing for Tax Credit projects.

Mortgage Revenue Bonds

MRBs have helped more than two million lower income people become homeowners for the first time. Every year more than 100,000 new families join them. The income of the average MRB borrower is only 73 percent of the national median income, 67 percent of average conventionally financed first-time buyers' incomes and 58 percent of average of conventionally financed buyer's income. The average price of an MRB assisted home is only 76 percent of the average price of conventionally financed first-time houses and 53 percent of the price of all conventionally financed houses.

The proposal before the Committee to increase the maximum size of qualified home improvement loans under the Qualified Mortgage Bond and Mortgage Credit Certificate programs from $15,000 to $25,000 per borrower would make these programs work more effectively to help lower income homeowners maintain their homes as decent, safe places to live. We strongly urge the Committee to adopt this increase and to index it for inflation, so that its value will not diminish over time.

The Internal Revenue Code defines a "qualified home improvement loan" as one financing alterations, repairs and improvements on or in connection with an existing owner-occupied residence by the owner thereof if such items substantially protect or improve the basic livability or energy efficiency of the residence. Qualified improvements include renovation of plumbing or electric systems, installation of improved heating or air conditioning systems, addition of living space and kitchen renovation. Construction of an attached or detached garage is also qualified. Recreational or entertainment facilities, such as swimming pools, tennis courts or saunas, are not qualified.

The loan limit has never been adjusted for inflation or rising home repair and improvement costs. Since 1981, inflation has shrunk the value of the loan amount almost 60 percent, while residential improvement costs have risen by 30 to 50 percent, depending of the area and type of improvement. The loan limit also no longer corresponds with the maximum amount of FHA Title I home insurance, as was ostensibly intended in the 1981 correction to the Code that imposed the current $15,000 loan limit. FHA raised its Title I insurance limit to $25,000 in 1992.

Raising the limit would not require an increase in a state's per capita amount of tax exempt bond authority, but would give those states with home improvement programs more flexibility in allocating existing bond authority. Raising the limit also would facilitate use of home improvement loans in revitalization initiatives in central city and inner suburban neighborhoods. Those areas often have a large number of owner-occupied, one-to-four unit buildings which need more extensive improvement than can be accomplished for $15,000. And the higher limit would enable more complete repair and improvement of single family homes, enhancing accessibility, increasing energy-efficiency and maintaining long-term value for homeowners.

The bottom line is that home improvement financing helps keep low and middle-income homeowners in their homes. Many such families lack sufficient home equity during their first few years of ownership to qualify for conventional improvement loans. Preventative maintenance and improvement is essential to maintaining the home as both a decent place to live and an appreciating family asset.

Thank you for the Committee's consideration of these comments. If you have any questions or need further information, please do not hesitate to contact me.

Sincerely,

Barbara J. Thompson
Director of Policy & Government Affairs

cc: Jim Clark

WRITTEN STATEMENT OF THE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036

For the Printed Record of the Hearings held
July 11 and 12, 1995
by the
Committee on Ways and Means
of the
U.S. House of Representatives

Introduction

This addendum to previous testimony is submitted on behalf of the National Rural Electric Cooperative Association ("NRECA").

The July 11 and 12 hearing dealt with several issues that impact rural electric cooperative. We commend the committee under the leadership of Chairman Archer for tackling these important issues that for far too long have been on the backburner.

This addendum to our testimony presents our views on four different issues.

NRECA

NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems serve over 30 million people in 2,600 of our nation's 3,100 counties.

I. Treatment of Contributions in Aid of Construction for Water Companies

NRECA supports the exclusion of contributions in aid of construction (CIAC) from the gross income. The nature of CIAC is not an income item; in fact, financial accounting rules and accounting and ratemaking requirements of utility regulators prohibit the reporting of CIAC as income. This tax proposal would make the tax treatment of CIAC more consistent with financial accounting and regulatory treatments.

As currently drafted, however, this proposal to exclude CIAC from gross income would apply only to water and sewer companies. NRECA believes that the tax change should be expanded such that for all utilities enterprises (electric, gas, water, sewer, cable), CIAC is not considered gross income.

II. Repeal Treasury Ruling Requirements for Nuclear Decommissioning Funds

NRECA supports the proposal which would modify Sec. 468A to eliminate the requirement that a utility obtain an IRS ruling in order to claim a deduction for contributions to a nuclear decommissioning fund. The amount of the deduction is limited by law. The current requirement mandates that the IRS issue an advance ruling. The proposed change does not affect the amount of the deduction, it merely eliminates a costly and wholly unnecessary step.

III. Normalization of Consolidated Tax Adjustments with Respect to Non-Regulated Subsidiary of a Regulated Public Utility

NRECA opposes the proposal which would specify that consolidated tax adjustments violate the normalization requirements of Sec. 168. Currently, investor-owned utilities (IOUs) reduce their tax liabilities by using losses from subsidiaries to offset profits from the electric utility portion on their consolidated income tax returns. Presently state and federal regulators are permitted to consider the entire consolidated operations for the purpose of determining the amount of taxes that can go into the rate base. This proposal which has the support of the IOUs would force regulators to only consider the profits of the electric utility operation. The practical effect is to allow for more taxes to be figured into the rate base, increasing the amounts consumers pay with no increase in the amount these companies remit in taxes to the government.

Currently, pursuant to existing normalization provisions in tax law, IOUs charge taxes to customers in one year, but do not remit these taxes to the government until many years later. These companies realize tremendous subsidies in the form of interest-free loans from the Federal government which result from normalization of accelerated depreciation deductions on utility plant. [Attachment "A"]. This proposed tax law change would unfairly increase the level of subsidies to investor owned utilities, at a time when Federal assistance to the cooperative segment of the electric utility industry, and, indeed, most Federal assistance in general, is being continuously curtailed.

NRECA believes that state and Federal utility regulators are in the best position to decide, on a utility by utility basis, the rate treatment of consolidated tax adjustments, permitting flexibility according to varying facts and circumstances. Federal tax law should not tie utility ratemakers' hands.

IV. Treatment of Rural Electric Cooperatives

NRECA supports the proposal which would clarify that payment by a joint owner or operator of a generating plant for incremental production expenses resulting from the joint owner's or operator's use of plant capacity owned by a rural electric cooperative (REC) should not be considered in the calculation of the REC's 85% member income test. These payments are only for the fuel and related costs directly associated with the sale of power. These amounts would not include payments for fixed costs or any profit or margin.

RECs are required to annually pass this 85% member income test in order to maintain their tax-exempt status. In the past, the IRS has attempted to impute income to RECs associated with such payments by joint plant owners, even though the REC derives no economic benefit from these joint owner payments.

This proposed clarification would simply require that tax treatment be consistent with economic reality: The joint owner or operator is using the REC's plant capacity to produce electricity to be used by the joint owner or operator. The incremental production expenses which the joint owner or operator incurs to generate electricity for its own use and which do not economically benefit the REC should logically not be considered income to the REC.

Who's at the Subsidy Trough?

Subsidies, subsidies, who's got the subsidies? The **Edison Electric Institute** has weighed in again on the touchy issue of who gets most from the public trough—investor-owned utilities, municipal utilities, or the rural electric cooperatives. Not surprisingly, EEI's calculation finds that the IOUs barely have their snout in, while the public power utilities are wallowing in subsidies.

EEI says it is using the methodology the **National Rural Electric Cooperative Association** has been using to compare subsidies. On this basis, says EEI, shareholder-owned utilities get $39.42 per year per customer in subsidies, most of it deferred taxes, worth some $66.5 billion.

The cooperatives, on the other hand, with their $12 billion in federal rural electrification loans outstanding, are doing well in the search for subsidies, at $221.67 per customer. The other major subsidy for the co-ops is some $2.2 billion in foregone federal, state and local income and other taxes.

But the munis are the kings of the subsidy hill, with their $74.7 billion in tax exempt bonds outstanding. The muni subsidy works out to $337.18 per customer, according to EEI. The munis also get $2.8 billion in foregone taxes, says EEI.

Electricity Daily
7/21/95

TESTIMONY SUBMITTED BY MICHAEL E. BRUNNER
EXECUTIVE VICE PRESIDENT
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION
REGARDING MISCELLANEOUS TAX PROPOSALS

U.S. HOUSE WAYS AND MEANS COMMITTEE
SUBMITTED FOR THE RECORD OF HEARINGS HELD JULY 11-12, 1995

Thank you Mr. Chairman for the opportunity to submit for the record my comments with respect to certain tax and pension simplification proposals of interest to the National Telephone Cooperative Association (NTCA). NTCA is encouraged by your willingness to hold hearings on these miscellaneous tax proposals and is optimistic that the measures which I comment on today will be recognized for the sound policy objectives that they promote.

Principally my testimony focuses on proposed legislation of critical significance to the approximately 250 telephone cooperatives that NTCA represents across the country. NTCA views the proposed legislation as an appropriate correction to a 1991 Technical Advice Memorandum of the Internal Revenue Service (the Service) which misinterpreted the provisions of the Internal Revenue Code dealing with telephone cooperatives. At the same time, the legislation adopts the Code to the major revisions in the telephone industry which have occurred since the amendments of 1978. In so doing, the bill strikes a fair compromise between the traditional interpretations of the operations of cooperatively structured telephone systems dating from at least 1924 and the new world of telecommunications.

The 1991 IRS ruling addresses certain income received by a cooperative telephone company and the relation that income has to the cooperative's federal tax status. The result of the 1991 ruling has been that most of this nation's telephone cooperatives can not pass the IRS's version of the 85 percent member income test. NTCA is optimistic that a legislative resolution to the situation faced by these telephone cooperatives can be achieved in the 104th Congress.

Secondly, as a sponsor of qualified retirement plans which benefit thousands of rural Americans and their families, NTCA promotes the simplification of laws affecting these deferred arrangements. NTCA extends its support for several pension simplification proposals which cumulatively would ease in the administration of the plans that it offers. Additionally, NTCA believes that by removing many of the obstacles in the administration of qualified retirement plans and replacing them with a more simplified methods of regulation, a significant growth in these vehicles will result.

I. History of Telephone Cooperatives

Telephone cooperatives were established in the early part of the century to fill a void created by the refusal of large telephone companies to serve the unprofitable low density areas that would not naturally satisfy a profitable demand for service. Telephone cooperatives introduced and continue to provide a vital public service in these rural areas.

These rural cooperatives are in business to provide their subscribers telecommunications services at rates and quality levels that are comparable to those received by their urban counterparts. This is a challenge of great magnitude, given the sparse population, remoteness and difficult terrain of these areas.

Congress, in recognizing the need to foster formation and expansion of rural telephone services, granted telephone cooperatives an exemption from federal income tax in 1916. In 1924 a member income test was devised under section 501(c)(12) of the Code, whereby the exemption was granted only if 85 percent or more of the income consisted of amounts collected from members for the sole purpose of meeting losses and expenses -- the exempt activity. The legislative history indicates that Congress was concerned that not more than 15 percent of a cooperative's gross income should be derived from sources such as bank interest or rental contracts. These original provisions of the Code also served an additional purpose by providing administrative ease. Telephone cooperatives are subject to unrelated business income tax on business activities not substantially related to the provision of communication services.

In the late 70's and early 80's the Code was amended again. Of significance in today's concern, is the 1978 amendment which provided that income received by a nonmember telephone company for the performance of a communication function that involved members, would be excluded from the test altogether.

Conversion to Access

Major changes in the telephone industry in the mid 1980's resulted in changes in the form and structure of the revenue streams of all telephone companies, including the cooperatives who serve approximately 1% of the nation's subscribers.

Prior to 1984, telephone subscribers were served by a uniform nationwide, FCC approved interstate toll rate structure and a system of industry agreements for dividing the toll revenues, know as settlements, which had been established before 1924. The structure helped to ensure that universal basic telephone service was available throughout the country at reasonable rates. Under the system, exchange telephone companies collected long distance charges from their customers and divided these revenues with the long distance carrier. The exchange company's share of the revenues was then determined according to a formula based on the cost, as defined by FCC allocation rules, of the local portion of long distance service. For small rural systems which have high capital costs relative to the number of subscribers they serve and which cannot benefit from economies of scale, the cost of providing telecommunications facilities was high. For such systems, their share of the toll revenues represented a considerable portion of their gross income.

In 1984 the system was changed to accommodate multiple long distance carriers. In the new "access charge" environment, local carriers filed tariffs with regulators to specify the charges of providing the local piece of long distance calls, which was known as access. Under the plan developed by the FCC and followed generally by the states, access rates were in three categories: common line, traffic sensitive and billing and collection. The FCC decided, effective 1987, that it would no longer require tariffs for billing and collection service, and that such service was not a communications service. The FCC subsequently reversed itself and ruled that billing and collection remained a communications service, even though tariffs were not required.

Ruling at Issue

In its 1991 Technical Advice Memorandum (made applicable to all telephone cooperatives in a 1992 "Notice") the IRS determined that billing and collection revenue constituted non-member income for the purposes of the 85 percent test, and was not substantially related to the exempt purposes of a telephone cooperative. The IRS also found, although in confused language, that cooperatives could no longer consider the revenue from toll calls billed to their subscribers as member income.

Provisions of the Bill

On the opening day of the 104th Congress, Senate Minority Leader Tom Daschle (D-SD) introduced S. 112, legislation to re-clarify the treatment of the access and billing and collection revenues. The bill is co-sponsored by several members of the Senate Finance Committee and others.

S. 112 would amend section 501(c)(12) of the Code to provide that 50 percent of the income received by a telephone cooperative from a nonmember telephone company for performing a communications service, i.e., originating or terminating a long distance phone call to or from a member, would be treated as collected from members for the purpose of the 85 percent member income test. The remaining 50 percent of the access income received by the cooperative would be excluded from the 85 percent test as under present law.

S. 112 would also exclude from the 85 percent test amounts received by a cooperative for the billing and collection service performed by another telephone cooperative. This provision recognizes the reality that billing and collection service is an integral part of providing access to long distance service and should be treated the same under the law as all other access services. The compensation the cooperative then receives for performing this vital communications service would be excluded from the test requirements under the provisions of S. 112.

In addition, the bill would provide that telephone cooperatives will not lose their exemption if they earn reserve income in excess of 15 percent of their total income. However, the reserve income cannot exceed 35 percent of the cooperatives gross revenue. Reserve income is defined as that derived from investments set aside for the repair or replacement of the telephone system facilities of the cooperative. UBIT would be applied between the 15-35 percent limits.

Justification for Adoption of S. 112

Throughout the audit and technical advice process, NTCA's main criticism is that the Service has failed to recognize in its conclusions that it is the role of Congress to make the laws, and that of the Service to interpret the laws as approved by Congress. The Service's ruling is contrary to the express terms and legislative intent of section 501(c)(12) of the Internal Revenue Code.

In a 1993 training manual for auditors of telephone and electric cooperatives, the Service acknowledged that the FCC decision on which the Service's position on billing and collection revenue was based was subsequently reversed. Notwithstanding the FCC's determination that billing and collection services are properly characterized as communications services, the Service resolved it would continue to view these revenues as nonmember sourced revenue, and derived from unrelated business. The IRS takes the position that an FCC determination of communications issues is determinative when it matches its preconceptions, but a reversal of the FCC position can be ignored.

Additionally, S.112 recognizes the changing environment of the telephone industry. The proposal is in effect a compromise of the manner in which what was access revenues are treated by the cooperatives in their business operations. The bill instead provides that 50 percent of the access revenues received by a cooperative will be treated as member-sourced income. In developing the original language during the 102nd Congress with congressional staff, NTCA yielded to this clear compromise.

Lastly, S. 112 encourages investment in the "Information Superhighway." Rural areas cannot be expected to participate in a national seamless network if the investment in such areas is diminished. Programs funded by the federal government via the Departments of Agriculture and Commerce recognize the need for a continued commitment to modern communications in rural areas. The exemption from federal

income tax also promotes the public interest in the provision of services to rural and remote areas because it allows for investment in plant and equipment. These are assets that are essential to America if the common goal is to increase productivity, modernize and maintain competitiveness both within and outside of our borders. NTCA urges the Committee to consider that higher costs for telephone service are a detriment to all users of the network, but it is especially so for to the rural agriculture economy.

II. **Pension Simplification**

Since 1959, NTCA has sponsored the Retirement and Security Program (R&S) which is the main defined benefit pension plan for 378 employers in the telephone industry. Currently the program covers 7,419 active employees and disburses monthly benefits to over 975 retirees and survivors. In addition approximately 575 individuals are currently separated from employment but vested in the program, for a total plan participation of nearly 9,000. The NTCA Savings Plan, a qualified defined contribution plan, benefits approximately 8,400 active employees and has been in operation since 1970.

Generally, many employees of small employers are not as fortunate as those who benefit from NTCA's R&S and Saving Plan programs. The level of small employers who sponsor retirement plan coverage for their employees has experienced stagnation since the mid 1970's. Studies have shown that this can be directly attributed to the cost associated with establishing and administering these plans. The simplification of the laws governing these plans would greatly reduce these costs to allow for both greater sponsorship levels and participation rates.

In particular, NTCA supports the repeal of nondiscrimination testing rules for deferred arrangements and employer matching contributions and the proposal to eliminate the one officer rule used in defining participants who are "highly compensated". Of course laws should be maintained to limit abuses that exist primarily to benefit employees whose salaries are in the higher end of any particular employer's wage scheme. However, the present law rules defining highly compensated employees are overly complex. A more simplified definition incorporating the elimination of the one officer rule would satisfy the same policy objectives while at the same time lifting burdensome calculation requirements from employer sponsors.

NTCA also supports the elimination of the combined plan limits (Sec. 415) for participants in both defined benefit and defined contribution plans maintained by the same employer. These rules are also very bursonsome to administer because they require maintaining compensation records for every year of service for each and every employee. But more than that there is no reason that an individual's decison to save for retirement should be reduced by such limits considering the overall benefits to society that retirement investments provide.

Combined, these pension simplification proposals would: provide for greater plans sponsorship, assist in the encouragement of investment savings on the part of individual participants and would ultimately have a profound effect on the economy. NTCA is encouraged that the Administration has also embraced the policy objectives that pension simplification legislation will provide and looks forward to working with both the Administration and Congress as the debate on simplification moves forward.

TESTIMONY OF PRICE WATERHOUSE LLP ENERGY GROUP PUBLIC UTILITY INDUSTRY SERVICES

The Price Waterhouse LLP Energy Group, Public Utility Services, respectfully submits this statement for the written record of the Committee on Ways and Means hearings relating to Miscellaneous Tax Reforms held on July 11-12, 1995. Price Waterhouse LLP provides audit, tax, and various business consulting services for a large number of companies within the regulated public utility industry. We appreciate the opportunity to present for the record Price Waterhouse LLP's views on four public utility industry provisions considered during the House Ways and Means Committee hearings on July 11-12, 1995 and in the related July 10 Joint Committee Staff Print Description of Miscellaneous Tax Proposals.

FOREIGN TAXATION OF FOREIGN ACTIVITIES OF U.S. ENERGY AND POWER COMPANIES

The public utility industry is entering a new era. Electric utilities are at the dawn of open-access, market driven competition for electric power. Developing countries are theaters of rapid economic growth, high demand for energy and power generation, and "privatization" of capital intensive power production. These conditions present unprecedented opportunity for the U.S. public utility industry. These opportunities involve both significant political and financial risk. Moreover, U.S. companies will be competing with their counterparts from other developed industrial democracies. U.S. companies can be successful in negotiating the inherent risks of competing in worldwide energy and power markets, but U.S. tax policy must recognize the exigencies of this competitive market place. Tax policies which hamstring U.S. taxpayers and directly or indirectly benefit foreign investors thereby preventing U.S. companies from participating in the newly developing country markets. We believe that efforts by the Ways and Means Committee to simplify and rationalize the rules governing U.S. taxation of international ventures are very important to help create a climate in which U.S. energy and power companies can compete effectively in international markets without costly and inefficient administrative burdens.

In the context of this new era for U.S. energy and power companies, we believe that four of the foreign tax proposals listed in the committee's hearing notice are particularly important in the Congress. First, companies should be allowed to elect to allocate interest expense for purposes of computing the foreign tax credit ("FTC") limitation by using adjusted asset basis under the earnings and profits rules. This would reduce the potential for distortions that can result under current law from the allocation of interest expense. Second, it is recommended that the committee provide "look-through" treatment for dividends from "section 902 non-controlled foreign companies." As such, income from these entities would be computed for purposes of the FTC limitation based on the underlying character of the income earned by such corporations, as is the case for income earned through controlled foreign corporations. Where companies are willing and able to obtain the necessary information for these calculations, no current policy reasons exist which should deny them "look through" treatment. Third, the current expense allocation rules reduce a company's ability to fully utilize FTCs in any one year. Varying foreign country and U.S. depreciation rates for the capital intensive utility industry also cause a mismatch between foreign taxes paid versus foreign taxes which may be claimed as credits. Because of the short carryover period for FTCs, these factors can result in double taxation. Extending the carryover period for FTCs to conform to the NOL carryover periods would increase the likelihood that the credits would be used and reduce potential for double taxation. Fourth, to provide certainly in structuring foreign energy investments, we fully support the proposal to exempt shareholders of Controlled Foreign Corporations (CFCs) from Passive Foreign Investment Company (PFIC) provisions.

DEPRECIATION AND AMORTIZATION - NORMALIZATION OF CONSOLIDATED TAX ADJUSTMENTS WITH RESPECT TO NON-REGULATED SUBSIDIARY OF A REGULATED PUBLIC UTILITY

As noted in the Joint Committee Staff Print, regulated public utilities are allowed to utilize the benefits of accelerated depreciation as long as these benefits are normalized, that is, deferred taxes are permitted to be provided for rate making purposes. Through the use of straight line depreciation for cost-of-service and rate base reduction of the related deferred tax liability, the accelerated depreciation benefits are then spread over the life of the property for rate making purposes.

When a regulated public utility joins in the filing of a consolidated federal income tax return with affiliated companies that are not regulated utilities, the issue often arises as to how the normalization requirements of the Code should be applied in the case of tax benefits from losses and credits, or tax charges, related to the nonregulated or nonutility members of the consolidated return group.

It has been the consistent view of the public utility industry that the tax provision of the regulated members of the consolidated return group is properly computed on a separate or "stand-alone" basis for nonregulated members. While most Public Utility Commissions (PUCs) have followed this "stand-alone" approach, some PUCs have taken the position that the benefits of a reduced consolidated tax liability as the result of inclusion of nonregulated members should be shared with ratepayers by use of a consolidated tax adjustment (CTA). Private letter rulings in the late 1980s holding the use of CTAs would constitute a normalization violation were revoked as part of a proposed regulation project in 1990 to provide additional guidance in this area. Because of controversy as to the validity of the proposed regulations, they were withdrawn pending Congressional guidance.

It is the view of Price Waterhouse LLP that, from both a technical tax standpoint and as a matter of tax policy, Congress should make it clear by statute that the use of a CTA is a normalization violation.

As noted in our prior statement for the record of the Subcommittee on Select Revenue Measures, Committee on Ways and Means dated September 11, 1991, we believe a CTA requires an inconsistent estimate or projection which is specifically prohibited by Code Section 168(i)(9)(B). The consistency requirements insure that the use of various ratemaking techniques, like CTAs, will not cause a direct or indirect sharing of the accelerated depreciation tax benefits other than through proper normalization techniques. As noted in our 1991 statement, regulations focus on the determination of <u>deferred</u> taxes. We believe it appropriate to make clear by statute that the consistency requirement is violated if, for regulatory cost-of-service purposes, a different rate is applied to the <u>current</u> position of total tax expense, as a result of the statutory rate being adjusted for losses and credits of nonregulated activities.

In addition to the technical basis for the statutory clarification, we believe CTAs should not be allowed on the basis of tax policy. In our experience, without exception, PUCs have consistently held that regulated public utility activities will not be allowed to subsidize nonregulated ventures or investments. This being the case, it is ultimately unfair to permit, through the use of a CTA, tax benefits of a nonregulated activity to be shared with ratepayers when losses and risks related to nonregulated activities are only shared by stockholders.

ACCOUNTING - TREATMENT OF CONTRIBUTIONS IN AID OF CONSTRUCTION FOR WATER UTILITIES

By way of background, utilities often defray the cost of extending facilities into a new service area by the receipt of contributions in aid of construction (CIAC) from customers or municipalities. The Tax Reform Act of 1986 reversed the long standing traditional concept that had treated such contributions as nontaxable. After the 1986 Act, instead of CIAC being treated as nontaxable, and the cost basis

of the property reduced, CIAC was required to be reported as taxable income with recovery only through higher future depreciation deductions.

H.R. 957, introduced in February, 1995 would restore the nontaxable treatment of CIAC for regulated public utilities that provide water or sewage disposal services. We support the efforts of the National Association of Water Companies (NAWC), in seeking this legislative change. The long depreciable lives for water utility property, and the inability to receive "upfront gross-up" recovery of the tax cost related to CIAC, present serious tax and cash flow planning problems. Similar problems exist with respect to other types of public utility property. At the appropriate time, the Committee should also resolve these problems for others in the public utility industry.

ACCOUNTING - REPEAL TREASURY RULING REQUIREMENT FOR NUCLEAR DECOMMISSIONING FUNDS

A public utility with nuclear facilities may fund its future plant decommissioning costs by making tax deductible contributions to a qualified nuclear decommissioning fund where these amounts are collected from customers as a part of cost of service. Presently, these taxpayers are required to first secure a ruling from the Internal Revenue Service (IRS) that determines maximum contributions to the fund. This procedure is intended to insure that no excess amounts are being accumulated and that only level funding is being provided over the remaining life of the nuclear plant.

We fully support the legislative proposal which would eliminate the IRS ruling requirement in order to allow a deduction for contributions to a nuclear decommissioning fund. The elimination of this requirement, which provides no benefit to the government in terms of raising revenue or enhancing compliance, will reduce operating costs for both the taxpayers and the IRS. Valuable resources will be freed to pursue more productive activities. Further, with the ongoing scrutiny as to the proper level of contributions to a trust to fund the future liability by (1) management of the responsible utility, (2) the PUCs for cost of service purposes, (3) outside auditors, and (4) other federal agencies which regulate the nuclear public utility industry, the elimination of an additional level of regulation by the IRS clearly is in order.

Thank you for the opportunity to present the views of Price Waterhouse LLP in these areas important to the regulated public utilities industry.

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PSA

Statement of the Public Securities Association before the House Committee on Ways and Means

Submitted for the Record July 11, 1995

The Public Securities Association (PSA) is pleased to comment on various miscellaneous tax proposals currently before the Ways and Means Committee. PSA represents banks and securities firms involved in the markets for municipal securities, U. S. Treasury and federal government agency securities, mortgage-backed securities and money market instruments.

The securities markets represented by PSA are unique in that they exist principally to serve public policy goals. The municipal securities market provides financing for capital investment by state and local governments for projects such as roads, schools, water and sewer systems, hospitals, solid waste facilities, bridges, airports, colleges and universities and numerous other projects in the public interest. The Treasury securities market allows the federal government to finance the budget deficit efficiently and at lowest possible cost. The government agency market allows federal agencies and government-sponsored enterprises to raise capital for targeted uses. The mortgage-backed securities market provides liquidity for home mortgages and helps to reduce the cost of home ownership. It is through the public securities markets that government at all levels is able to raise large amounts of capital for productive investment.

Tax policy plays an important role in the continued efficiency of the public securities markets. Several of the proposals before the committee would significantly affect how federal, state and local governments raise capital. We commend Chairman Archer for his leadership in raising these issues, and we appreciate the opportunity to comment.[1]

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[1] This statement provides comment on proposals outlined in Ways and Means Committee release number FC-8 dated June 30, 1995. At the time that this document was being drafted, few details were available on several proposals of apparent interest to PSA. As details of these proposals are made public, PSA may choose to submit additional comments to the committee by the July 27, 1995 deadline.

Tax-exempt Municipal Investment Trusts (TEMICs) and Financial Asset Securitization Investment Trusts (FASITs)

Two proposals under consideration by the committee would establish new pass-through entities for the securitization of tax-exempt municipal securities and financial assets.[2] PSA strongly supports both provisions.

"Securitization" refers to the ability of capital markets participants to repackage and customize the cash flows generated by financial assets. The best example of securitization is in the market for home mortgages. It is common in the home mortgage market for thrifts, banks, mortgage companies and other mortgage originators to sell mortgages into the secondary market, often to one of the federally sponsored corporations that specialize in mortgage securitization. In the secondary market, mortgages are assembled into large pools, deposited into a pass-through trust, and securities — mortgage-backed securities, or MBSs — are issued. MBS investors are paid from the cash flows generated from mortgage payments made by home owners whose mortgages are in the pools. Of the nearly $754 billion in home mortgages originated in 1994, over $422 billion, or approximately 56 percent, have been securitized.

Mortgage securitization helps home buyers by providing liquidity in the home mortgage market. Because of securitization, a ready market exists for mortgage originators to sell loans to raise capital for more loans. Securitization has permitted investors that likely would never participate in the home mortgage market, such as pension funds and foreign investors, to provide capital for mortgage loans. It is estimated that the liquidity provided by the securitization of home mortgages saves home buyers as much as 50 basis points (0.5 percentage point) on mortgage borrowing rates.

Mortgage securitization has been helped by the enactment of real estate mortgage investment conduit (REMIC) provisions of the Tax Reform Act of 1986. Before the existence of REMICs, mortgage securitization was hampered by tax provisions that prohibited certain types of MBSs. Certain structures carried the risk that mortgage interest income would be taxed twice, once at the level of the pass-through trust and once at the level of the investor. The REMIC provisions of the 1986 act eliminated the unfavorable tax treatment of structured MBSs, and, as a result, mortgage securitization has blossomed.

MBS issuers have become especially adept at restructuring mortgage cash flows into securities customized to meet the needs of particular investors, thereby further improving mortgage market liquidity. For example, the most common type of mortgage loan is a 30-year, fixed-rate mortgage prepayable at any time. However, such a structure is not usually compatible with the investment goals and strategies of most investors. REMICs allow

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[2] See items three and four under the "Pass-through entities" section of Ways and Means Committee release number FC-8, June 30, 1995.

MBS issuers to tailor the cash flows generated by pools of "plain vanilla" mortgages to take advantage of particular market demand.

TEMICs

Similar types of customized cash flows are slowly gaining popularity in the municipal securities market. Larger, more sophisticated state and local governments have begun experimenting with the issuance of securities with customized structures designed to exploit market conditions that favor certain types of cash flows. However, despite advantages for state and local governments, structured municipal securities are still relatively rare, due largely to legal restrictions on local government debt issuance or a general reluctance among unsophisticated issuers to engage in structured transactions.

The ability of market participants to create structured tax-exempt securities in the secondary market would provide state and local governments with much of the economic benefit of customization without being directly involved as issuers. Secondary market securitization of municipal securities does occur. However, current tax rules related to trusts and partnerships make such arrangements cumbersome and inefficient. For example, under a trust arrangement it is not possible to structure a fixed-rate cash flow into floating rate and inverse floating rate classes. Other common structures are also effectively prohibited in a grantor trust arrangement. Partnership arrangements also raise complications in the secondary market securitization of municipal bonds, such as unfavorable economic conditions for various classes of partnership. As a result, little secondary market securitization of municipal securities takes place, and that which does entails needless complication and inefficiency.

The solution is to enact legislation to allow the creation of pass-through trusts for the purpose of securitizing cash flows from pools of tax-exempt municipal bonds. These trusts would share much in common with REMICs. However, because of the tax-exempt nature of municipal bond interest, TEMICs would be required to have certain unique characteristics.

- TEMICs could hold only qualified tax-exempt bonds.

- TEMICs would be permitted to allocate principal and accrued tax-exempt interest among various classes in any way, as long as over any given period, the amount of tax-exempt interest paid by a TEMIC did not exceed the amount received.

- Taxable income earned by a TEMIC as a result of taxable market discount would be treated as taxable original issue discount (OID) and would be sold only to taxable investors.

Additional rules related to the taxation of TEMIC residual interests and other rules related to accrual of OID would also be required.

TEMICs would be beneficial to state and local governments because they would increase demand and improve market liquidity for municipal securities. Investors are often willing to pay premium prices for securities with cash flows tailored to their needs. By allowing market participants to create such securities in the secondary market, state and local issuers can benefit from investor demand for specific types of structures. Investors would also benefit, since they would receive a tax-exempt cash flow tailored to their specific needs. Often, institutional investors are able to use structured securities to mitigate their exposure to certain market risks.

TEMICs would not result in an appreciable tax revenue loss. According to a study undertaken recently for PSA by Coopers & Lybrand, using conservative economic assumptions, the TEMIC proposal advocated by PSA would result in a net rèvenue loss to the Treasury of $16 million over the five-year period 1995-1999. Using less conservative assumptions, the proposal would result in a net revenue loss of $28 million over the same period. Over the ten-year period 1995-2004, the TEMIC proposal is projected to result in a net revenue loss of $5 million using conservative assumptions and $18 million using less conservative assumptions.

These small projected net revenue losses do not result from the TEMIC structure itself. After all, under the proposal, TEMICs are not permitted to allocate more tax-exempt interest than they earn. Therefore, the TEMIC structure itself would not result in any more tax-exempt interest paid to investors than without TEMICs. The revenue loss would be wholly attributable to the benefit for state and local issuers from TEMICs. As a result of improved municipal market liquidity, the cost of capital financing for state and local governments would be reduced. States and localities would issue a marginally larger volume of tax-exempt bonds than they otherwise would.

TEMICs would address needless tax law constraints on the ability of municipal market participants to create customized, structured cash flows. They would improve the liquidity of the municipal securities market and would lower financing costs for state and local capital investment. TEMICs would accomplish all this at relatively little revenue cost to the federal Treasury. For these reasons, PSA strongly supports the adoption of legislation to permit TEMICs.

<u>FASITs</u>

Some of the same tax law constraints that needlessly complicate the securitization of municipal bonds also raise difficulties in securitizing other financial assets. A securitization trust structure tailored to the securitization of financial assets bearing taxable income would address specific concerns associated with asset-backed securities.

Financial institutions in particular are negatively affected by tax constraints in securitizing financial assets such as consumer loans. The tax rules governing financial asset securitization are needlessly complex. As a result, the securitization of financial assets is limited, and financial institutions are less able to sell assets to manage their balance sheets.

A bill, H.R. 1967, introduced last month by Representative Clay Shaw and cosponsored by many members of this committee, would create a FASIT structure to address these constraints. The staff of the Joint Committee on Taxation has estimated that H.R. 1967 would result in a federal revenue gain of $92 million over the ten-year period 1996-2005. PSA strongly supports this legislation.

Tax Treatment of Market Discount

The budget reconciliation bill enacted in 1993 contained a provision related to the tax treatment of market discount on municipal securities. Before 1993, market discount was taxed as a capital gain. Under current law, it is taxed as ordinary income. This new tax treatment for market discount has resulted in market inefficiency and a significant loss of liquidity for municipal bonds traded at a discount.

In January, PSA presented testimony[3] before this committee on market discount at a hearing on the capital gains provisions of H.R. 9, the Job Creation and Wage Enhancement Act of 1995. Many provisions of that bill were passed by the House in March as part of H.R. 1215, a bill which PSA supports. However, H.R. 1215 would not restore capital gains treatment for municipal market discount.

Our January testimony describes the effects of current market discount rules in considerable detail. A bill pending before this Committee, H.R. 843, introduced by Representatives Benjamin Cardin and Clay Shaw, would restore capital gains treatment for municipal market discount.[4] Earlier this year, 25 members of this committee wrote to Chairman Archer expressing support for this concept. We urge the adoption of H.R. 843.

Portfolio Interest Exemption

The committee is considering a proposal to institute a withholding tax on portfolio interest earned by foreign investors on U. S. debt instruments.[5] We oppose this proposal because it would reduce demand for U. S. securities and make it more expensive for the U. S. Treasury to finance the federal budget deficit and U. S. corporations and home mortgage lenders to raise capital for new investment.

In September 1993, PSA submitted a statement to the Select Revenue Measures Subcommittee explaining our strong opposition to a similar proposal which was pending

[3] See statement of Terry L. Atkinson, Chairman, Municipal Securities Division, Public Securities Association before the House Committee on Ways and Means, January 24, 1995.

[4] See item four under the "Capital gains" section of Ways and Means Committee release number FC-8, June 30, 1995.

[5] See item 26 under the "Foreign" section of Ways and Means Committee release number FC-8, June 30, 1995

before the 103rd Congress.[6] In brief, a substantial volume of outstanding U. S. securities is in the hands of foreign investors, and foreigners continue to purchase significant portions of new U. S. securities issues. Their investment provides substantial liquidity to the U. S. fixed income markets and results in lower financing costs for U. S. borrowers. Imposing a withholding tax on portfolio interest paid to foreigners would drastically curtail or eliminate foreign investment in U. S. debt securities. The cost would be borne by U. S. borrowers, who would face less demand for their securities, resulting in higher capital costs.

A bill to institute a withholding tax on portfolio interest paid to foreign investors, H.R. 281, was introduced earlier this year by Representative Andrew Jacobs. Because of its negative effects on capital costs for U. S. borrowers, PSA strongly opposes H.R. 281.

Bonds for the sale of the Alaska Power Administration

The privatization of federal assets is the subject of increasing congressional attention, including the sale of the federal Power Marketing Administrations (PMAs), regional authorities charged with selling and distributing power to local electric utilities. Although we take no specific position on the sale of the PMAs, in general we feel that the sale of certain federal assets can result in efficiencies for both the federal government and consumers. We also feel strongly that, to the extent which federal assets such as the Alaska Power Administration are sold to state or local entities, tax law should favor the use of tax-exempt bonds to finance the transactions.

Tax-exempt bonds provide an efficient tool for states and localities to finance capital investment. We feel that the proposal to promote the use of tax-exempt finance in the sale of the Alaska Power Administration[7] should be expanded to apply to the sale of other PMAs, if and when their sale is approved by Congress.

Expansion of arbitrage rebate exemption for certain bonds

Tax-exempt bond issuers generally are prohibited from earning arbitrage on the investment of bond proceeds. Issuers are required to restrict earnings on the investment of bond proceeds to a yield not materially higher than that on the underlying bond issue. Any arbitrage earnings generally must be rebated to the Treasury. One exception to the rebate rule applies to bonds issued for construction projects and spent-down according to a statutorily defined schedule. The committee is considering a proposal to expand the construction spend-down rebate exemption to all tax-exempt bond issues other than

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[6] See Statement of the Public Securities Association before the House Committee on Ways and Means, Select Revenue Measures Subcommittee, September 23, 1993.

[7] See item six under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

refunding issues and short-term notes, and to lengthen the spend-down schedule to three years.[8]

PSA generally believes that the statute related to yield restriction and arbitrage rebate is excessively complex and burdensome for state and local governments. We are pleased that the committee is considering simplifying the application of the spend-down rule and applying it to all bond issues. PSA supports this measure. We also urge the committee to consider other proposals related to arbitrage simplification, such as allowing rebate in lieu of yield restriction and permitting issuers to keep ten percent of their arbitrage earnings. Together, these proposals would likely not result in any federal tax revenue loss.

Bonds for certain governmental output facilities

Current law contains extraordinary restrictions on the use of tax-exempt bonds for "output" facilities; restrictions which limit the ability of local public power authorities to finance capital investment efficiently. Normally, if more than ten percent of the proceeds of a bond issue is used by a private party and more than ten percent of the debt service of an issue is secured by a private party, the issue is considered a "private-activity" bond. However, for bonds issued to finance output facilities, the test for private activity is when the lesser of ten percent or $15 million of a bond issue benefits a private party. A bill introduced by Representative Richard Neal and under consideration by the committee[9], H.R. 677, would repeal the $15 million limit and permit greater financing flexibility in the provision of public power output services. In 1993 testimony before the Select Revenue Measures Subcommittee, PSA expressed support for a similar bill then pending before the 103rd Congress.[10] PSA supports H.R. 677 and its goals of establishing equitable treatment for public power output facilities.

Nuclear decommissioning trust funds

Operators of nuclear power generating facilities are required by law to maintain and periodically contribute to decommissioning trust funds. When the useful lives of nuclear power facilities expire, the funds will be used to finance operations necessary to ensure the safe shut-down of the plants. The trust funds are subject to federal corporate income taxation, but are exempt from the alternative minimum tax. In addition, investments by the funds are generally limited to U.S. Treasury securities and state and local government securities. Consequently, in order to maximize their return, fund managers invest heavily in municipal bonds. According to John Nuveen & Co., Inc., as of several years ago, the

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[8] See item one under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

[9] See item two under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

[10] See Statement of R. Fenn Putman, Vice-Chairman, Public Securities Association before the House Committee on Ways and Means, Subcommittee on Select Revenue Measures, July 13, 1993.

assets of the nation's nuclear decommissioning trust funds totaled about $5 billion. The funds were approximately 70 percent invested in municipal securities. Nuveen estimated that trust fund assets would reach a minimum peak value of at least $60 billion. If the funds continue to invest in municipals at the estimated rate, they will eventually account for a minimum of $42 billion of municipal securities, a significant source of corporate demand.

Since enactment of the Tax Reform Act of 1986, the market for tax-exempt municipal securities has become increasingly dependent on individual investors. Corporations and other institutions hold a decreasingly small portion of outstanding municipal bonds. A market so dependent on one group of investors could become unstable if economic conditions change. The result could be higher financing costs for state and local governments. One growing source of corporate demand for municipal securities is nuclear decommissioning trust funds. The committee is considering a proposal which would likely reduce significantly or eliminate the funds' demand for municipal securities.[11] Thus, another important source of corporate demand for tax-exempt bonds would be lost.

PSA takes no position on the tax status of nuclear decommissioning trust funds. However, we are concerned that the loss of trust fund demand for municipal securities could result in higher financing costs for state and local governments. The loss of demand on the part of nuclear decommissioning trust funds for municipal securities could result in higher financing costs for states and localities. We urge you to consider the effects of any change in the tax status of nuclear trust funds on state and local governments. A set of proposals which could help to mitigate the effects of a change in the tax status of nuclear decommissioning funds on demand for municipal bonds are the provisions in H.R. 1215 to eliminate the application of the corporate alternative minimum tax to municipal bond interest.

Modification of exception to bank interest deduction disallowance for qualified 501(c)(3) bonds

Under current law, banks generally are not permitted to deduct the interest expense associated with buying or holding tax-exempt bonds. An exception exists for small issuers who sell $10 million of bonds or less per year. Banks that purchase qualified small-issue bonds are permitted to deduct 80 percent of their associated holding cost. Under current law, 501(c)(3) bonds are eligible for bank investment, subject to the $10 million per year issuance limit per issuer. Because 501(c)(3) institutions that borrow in the tax-exempt market almost always issue bonds through a state or local agency or authority — and the authority's annual issuance exceeds $10 million, even though borrowing by any one 501(c)(3) organization may not — this limitation effectively prohibits bank investment in the bonds issued by many small, tax-exempt organizations, and raises the cost of financing for many worthwhile projects. Under a proposal before the committee, the bank

[11] See item nine under the "Accounting" section of Ways and Means Committee release number FC-8, June 30, 1995.

deductibility limit for 501(c)(3) organizations would be lowered from $10 million to $5 million annually, but would be applied at the borrower, rather than the issuer, level.[12]

PSA has commented before the Select Revenue Measures Subcommittee on similar proposals twice before.[13] In general, we support the concept of less restrictive rules related to bank deductibility of interest costs associated with tax-exempt bonds. For example, we strongly support the application of the small issuer exemption at the level of the borrower rather than the issuer, as contained in the proposal before the committee. However, we are concerned about the potential effects of lowering the annual issuance limit for bank-qualified bonds for certain qualified 501(c)(3) organizations to $5 million. In most cases, this provision would result in bank-qualified status for issuers that would not otherwise qualify. However, in some cases, 501(c)(3) organizations whose bonds would otherwise be bank-qualified would not qualify under the proposal.

Expansion and indexing of the $10 million capital expenditure limitation for qualified small-issue bonds

Under current law, state and local governments may issue tax-exempt bonds on behalf of small manufacturing companies, bonds known as qualified small-issue industrial development bonds (IDBs). The face amount of such issues may not exceed $1 million. Alternatively, the face amount of the issue plus other qualified capital expenditures by the manufacturing company may not exceed $10 million in the six-year period beginning three years before and ending three years after the date of issue. A proposal before the committee would increase the capital expenditure limit from $10 million to $20 million and, presumably, index the amount annually for inflation.[14]

PSA strongly supports this proposal. The current $10 million capital expenditure limit significantly constrains the usefulness of the IDB exemption. It is actually a disincentive to capital investment and economic growth. For example, if a company issues an IDB which causes the company to reach the $10 million, six-year limit, the company may not undertake any new capital expansion for three years after the IDB issue, even if the capital investment is not financed through tax-exempt finance. Otherwise, interest on its bonds would become taxable. The proposal before the committee would provide some relief from this restriction. We are also encouraged by the proposal to index the limit annually for inflation. We have long advocated indexing this and other dollar-based limits in tax-exempt bond issuance. We strongly urge the committee to act on this proposal.

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[12] See item 12 under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

[13] See Statement of R. Fenn Putman and see Statement of Stephen Claiborn, Managing Director, Lehman Brothers, Inc. representing the Public Securities Association before the House Committee on Ways and Means, Select Revenue Measures Subcommittee, February 9, 1994.

[14] See item 13 under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

Tax-exempt financing for environmental remediation expenses

Under current law, states and localities are permitted to issue so-called "private activity" bonds for a variety of uses. However, the acquisition and clean-up of contaminated sites is generally not a permitted use for tax-exempt private activity bonds. The committee is considering a proposal to permit tax-exempt private-activity financing for such environmental remediation.[15]

PSA believes that tax-exempt bonds represent an efficient potential source of financing for the clean-up and development of sites that in their current condition may actually present hazards to communities where they exist. We feel it is appropriate for the federal government to encourage and subsidize environmental remediation, and we feel that tax-exempt financing can play an important role in that regard. Tax-exempt financing for environmental remediation represents good economic policy and good environmental policy. For these reasons, PSA supports the proposal and urges its enactment.

Qualified mortgage bonds — home improvement loans

Under current law, mortgage-revenue bonds (MRBs) may be issued to finance certain purchase-money mortgages or to finance certain qualified home improvement loans. The limit on the size of home improvement loans which may be financed through MRBs is $15,000. The committee is considering a proposal to increase the limit to $25,000.[16]

PSA supports this proposal because it would provide greater flexibility to local governments in implementing home improvement financing through MRB issuance. The limit on the size of home improvement loans has existed unchanged for many years, and inflation has eroded its value. We urge committee action on this proposal.

Qualified veterans' mortgage bonds

Under current law, certain states may issue tax-exempt bonds to finance mortgages for certain military veterans. However, because rules for veterans' mortgage bonds restrict their issuance to states where they were issued before 1984 and also restrict their volume, their use is severely limited. Several proposals before the committee would amend current limits for veterans' mortgage bonds in order to make the program more useful.[17]

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[15] See item three under the "Business tax credits" section of Ways and Means Committee release number FC-8, June 30, 1995.

[16] See item 10 under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

[17] See item 11 under the "Tax-exempt bonds" section of Ways and Means Committee release number FC-8, June 30, 1995.

PSA supports the proposals before the committee related to veterans' mortgage bonds because current-law limits make the program of only marginal value to state and local governments and to military veterans. The limits in the proposals before the committee provide considerably more flexibility for bond issuers and veterans while maintaining reasonable constraints on the use of the federal tax-exemption.

Proposed modifications to simplification provisions contained in H.R. 3419 (103rd Congress)

The committee is considering several proposed changes to H.R. 3419, tax simplification legislation which was passed by the House in May 1994. Although we have no position on any of the proposed amendments under consideration by the committee, we strongly urge the committee to take up two provisions contained in earlier versions of tax simplification legislation which were dropped from H.R. 3419 during Ways and Means Committee consideration.

The first relates to arbitrage simplification. As described above, tax-exempt bond issuers generally are required to rebate any arbitrage earnings to the Treasury. However, several exemptions to the rebate requirement exist. One is for small communities that issue $5 million or less of bonds per year. This exemption is intended to ease the regulatory burden for small communities of complying with the complicated and burdensome arbitrage rebate rules. Earlier versions of tax simplification legislation contained a proposal to increase the annual issuance limit for the small-issuer arbitrage rebate exemption from $5 million to $10 million. This proposal was excluded from H.R. 3419 during committee consideration. PSA strongly supports this proposal because it would ease the regulatory burden for small communities and would likely result in little revenue loss.

A second simplification provision relates to the definition of private use. Several tests exist in current law to determine whether a state or local government bond issue falls under the definition of "private-activity" bond. One of these is the so-called five-percent unrelated and disproportionate use rule. This test is largely superfluous, since very few if any bonds which escape consideration as private-activity bonds under other tests are "captured" by this rule. Nevertheless, the five-percent unrelated and disproportionate use rule exists, and the rule sometimes raises needless compliance burdens for state and local issuers. Again, early versions of tax simplification legislation contained a proposal to eliminate this needless test. This proposal was dropped from H.R. 3419 during committee consideration. Like the arbitrage proposal described above, this proposal would likely have a negligible effect on federal revenues.

We strongly urge the committee to restore both provisions in any further consideration of tax simplification legislation.

TESTIMONY OF JACK FEGELY
RENO PHILHARMONIC ASSOCIATION

Introduction

The high degree of philanthropy by individuals is unique to America , and is what enables our country to enjoy a higher level of social, health, artistic, and educational services in small towns as well as our cities. This unique attribute should not be penalized or discouraged through our tax code.

Congress has long sought to encourage charitable donations through the tax code. The deduction for charitable giving is one of the oldest personal deductions in the tax code, having existed almost as long as the income tax itself. The deduction for charitable donations is even more important now as the Congress considers reducing federal government funding for education , health care, social welfare and the arts. Cutbacks in these areas will put even greater financial pressure on tax-exempt organizations that provide these important services.

The three most onerous provisions of the tax code which seriously inhibit large individual contributions are: the additional 15% penalty tax on yearly pension distributions exceeding $150,000; the limitations on donations exceeding a certain percentage of AGI; and the 3% reduction in itemized deductions if AGI exceeds approximately $115,000. This paper addresses these three provisions of the tax code.

Rationale for Charitable Deductions to Tax-Exempt Organizations

Organizations exempt from federal income taxation are instrumental in the delivery of many essential social services in the form of health care, welfare services, and education. These organizations promote the general welfare and benefit society by providing in many instances, not only a safety net of services, but also support a variety of cultural and arts programs that benefit the general public.

In many instances, these organizations provide services that the government would otherwise have to provide in their absence; the government has historically provided substantial support for health, educational organizations, and the arts. If recent efforts to reduce government funding to this sector are successful, individual contributions, ***especially large contributions,*** will be crucial to ensure the continued support of these programs through the private sector.

The philanthropic sector can experiment in unique ways, partly because it is not bound by the same requirements that restrict and limit government activity. The decentralized decision-making process in the private sector is arguably more efficient and responsive to public needs than the government allocation of resources. This is why it is essential that giving to the philanthropic sector be encouraged, particularly large gifts, in light of the growing demands and pending federal budget cuts.

The focus on large gifts is particularly important for institutions of higher education and the arts. For example, nearly 35% of the contributions by taxpayers whose income exceeds $200,000 are to institutions of higher education and the arts. Among arts organizations, nearly 70% of total private contributions are received from individuals.

Under the current tax system, taxpayers consume out of ***after-tax*** income. The deduction for charitable donations effectively allows most taxpayers to donate out of ***pre-tax*** income. Academic research indicates that this tax treatment of charitable donations is an effective way to encourage giving to charity. This research indicates that the tax revenue forgone through the deduction is more than offset by additional charitable donations. A dollar of reduced taxes results in more than $1.25 of additional charitable giving.

The deduction also satisfies two tenets of the individual income tax that: (1) taxpayers be assessed on the basis of their "ability to pay," and, (2) taxpayers with equal ability to pay, pay equal amounts of tax. Gross income is generally viewed as insufficient by itself to measure a family's ability to pay. Charitable contributions are different from income spent on consumption items. ***Once contributed, the donor has neither the ability to use donated funds for his or her private benefit, nor the same ability to pay taxes.***

Current Law Impediments to Charitable Giving

Despite the success of the charitable deduction in encouraging charitable giving, there are several provisions in the tax code that penalize taxpayers that make large contributions. For example, taxpayers who make large donations out of their retirement benefits, particularly lump-sum distributions, are subject to a 15% surtax ***even if they give the entire distribution to charity.*** In addition, taxpayers who make large donations relative to their income are limited in the amount of contributions they may deduct. Individuals cannot deduct qualified contributions in excess of 50% of their adjusted gross income (AGI). Donations of appreciated property also face restrictions. Property which has appreciated may be donated and deducted at full market value, without payment of capital gains tax, but such donations are limited to 30% of AGI. Any gifts in excess of these limitations are not currently deductible, effectively putting a "cap" on the amount individuals give to charity.

Over 180,000 taxpayers claimed $2.6 billion in charitable deductions that were carried forward from prior years. These taxpayers were subject to the limitations described above, and a large majority of them will not be providing additional gifts to charities until they have "used up" the $2.6 billion.

Finally, the limitation on certain itemized deductions for high income taxpayers also reduces the amount of charitable donations they may deduct. Beginning in 1991, this provision reduces charitable deductions by 3% of the amount a taxpayer's AGI exceeds certain income thresholds ($111,800 for most taxpayers in 1994). This limitation will reduce a taxpayer's itemized deductions,

including the charitable deduction ***by as much as 80%,*** thus increasing the cost of charitable giving, and decreasing donations by individuals.

In the face of likely budget cuts and the increasing pressures on tax-exempt organizations to fill the gap, a reexamination of the rules and rationale for limiting the deductibility of certain charitable gifts, especially large gifts, is needed. Below, several approaches that would encourage charitable donations are outlined.

Options to Encourage Charitable Giving

1. Changes to 15% Surtax on Excess Pension Distributions Donated to Charity

Current Law. Any amount in excess of $150,000 distributed from a qualified benefit plan is subject to a 15% surtax. In addition, lump-sum distributions in excess of $750,000 are also subject to the 15% surtax.

Impact. Increasingly the provision is penalizing taxpayers who have followed the limits on contributions into the plans; there is no rationale for the penalty tax, especially concerning IRAs and defined contribution plans - it unfairly imposes a penalty tax for successful investing! In addition, the $150,000 limitation on the annuitized value of plan assets, given a taxpayer's life expectancy and the $750,000 limit on lump-sum distributions, are not actuarially consistent. The $750,000 limitation would need to be substantially higher to be actuarially consistent with the $150,000 limitation on the annuitized value of plan assets. For example, consider a taxpayer alive at age 70 who has a life expectancy of about 15 years. For this taxpayer, receiving $150,000 annually is actuarially equivalent to receiving a lump-sum payment of about $1,220,000 (using the federal interest rate for calculating the present value of an annuity of 8.8 percent) The surtax discourages retirees from making lump-sum distributions, which are an important source of large charitable gifts, because once the lump-sum is donated, ***any*** amount of distributions which the taxpayer takes over the next 5 years ***is not only subject to regular income taxes, but also to the additional 15% penalty tax!***

Possible Solutions: The 15% penalty tax is nothing more than a penalty tax on successful investing and should be repealed. At the very least, the current exclusions from the surtax could be modified slightly to include distributions payable to an alternative payee that is a tax-exempt organization, or any retirement distribution to the extent it is not subject to tax by reason of a charitable deduction. Such distributions do not bear any income tax liability since the taxable distribution is offset by the charitable contribution, ***but the current surtax reduces the potential gift by 15% and seriously discourages current giving.*** This change could apply such that the distribution never enters the income tax system or the distribution is reported by taxpayers for income tax

purposes, but is excluded from AGI. This method would not be "giving a tax break to the rich", since the individual would be giving the ***entire amount*** to charity.

The $150,000 and $750,000 limits were enacted in 1986, but have never been adjusted to reflect inflation or other factors Even though inflation has been relatively low over the past ten years, the purchasing power of individuals has eroded by over 30%. Most features of the tax code are adjusted annually to account for inflation, but these limits remain unchanged; they should be increased to reflect the change in the economic circumstances of taxpayers over the past decade, or, at the very least, indexed for inflation to provide future protection of retirement savings from inflation.

2. Reducing the Limitations on Charitable Deductions

Current law. Under current law, there are several limitations on charitable deductions. In some cases, the AGI of the donor determines which limitations apply. In other cases the character of the property (i.e. cash versus appreciated property) apply. And in yet other cases the characteristics of the donor (i.e., private non-operating foundation versus public charity) determine the limitations.

Impact. In theory, these limitations on deductions for charitable donation might reflect numerous policy objectives pursued by Congress. However, in practice the restrictions operate somewhat arbitrarily across taxpayers and types of giving. An overall limitation on charitable contributions runs counter to both the tax-incentive and income measurement rationales for the deductibility of charitable donations. ***If the charitable deduction is provided to encourage giving, why should the deduction be limited when a taxpayer makes a large gift? If charitable donations are deductible in order to properly measure taxable income, what changes from the perspective of income measurement when contributions are larger relative to income?***

Among wealthy donors the effect of the percentage limits can be significant. Over 180,000 taxpayers had carryovers of contributions in 1991 because they were subject to the percentage limits in previous years. Taxpayers that have little income, but who can contribute out of accumulated wealth, either in the form of cash or appreciated property, often are subject to the percentage limits. Such taxpayers also give conservatively due to uncertainty regarding their annual income, further reducing the level of charitable donations among the wealthy.

The percentage limits encourage taxpayers to time their contributions to avoid the limits. For example, consider a donor with constant AGI of $100,00 who wishes to contribute a total of $300,00 over the current and next five years. A single contribution of the entire amount would be subject to the limitation while uniform contributions of $50,000 in each year would not. Spreading deductions over several years allows some taxpayers to use the deductions to offset income at higher marginal tax rates than if the entire donation were deducted in one

year. Therefore, this sort of tax planning would not only allow the taxpayer to avoid the limit, but would result in ***lower*** tax revenue than if the percentage limit were repealed.

The intent of the Congress when imposing the percentage limits was to ensure that no taxpayer could avoid all of his or her tax through the charitable deduction. Charitable contributions are not treated as a preference item for the alternative minimum tax (AMT). However, individuals making large charitable contributions are more likely to be subject to the AMT, since regular tax liability is reduced relative to the AMT's tax preferences and adjustments. To the extent individuals are already subject to the AMT, ***they do not receive the full benefit of the charitable deduction under the regular tax, thereby reducing the incentive to give to charity.***

Possible Solutions. The percentage limits that apply to a small group of large charitable givers (less than six-tenths of 1% of all taxpayers who deduct charitable donations) should be repealed. The impact of these limits, when compared to the overall limit on itemized deductions, the AMT, or the recent changes in marginal tax rates, is modest. In addition, the limits can, in some cases, even cost the U.S. Treasury tax revenues.

3. Relaxing the Limitation on Itemized Deductions for Charitable Gifts

Current Law. For taxpayers whose AGI exceeds $111,800 in 1994, itemized deductions were reduced by 3 cents for every dollar above this threshold (i.e., 3%). For example, a taxpayer whose AGI exceeds the threshold by $10,000 must reduce itemized deductions, including charitable donations by $300. No taxpayer's itemized deductions may be reduced by more than 80%.

Impact. This provision imposes an ***additional*** tax rate on income ***and a tax penalty on charitable donations.*** The reduction in the tax benefit for donating reduces the incentive for a taxpayer to give to charity.

This provision also runs counter to one of the fundamental tenets for the income tax system--that all taxpayers pay according to their ability to pay or consume and that taxpayers with the same ability to pay, pay the same tax. Expenditures such as medical expenses, state and local taxes, and gifts and donations, generally do not reflect a taxpayer's ability to consume or pay tax.

For example, a taxpayer required to spend a large share of his or her income on medical treatment does not have the same ability to consume or pay tax as another taxpayer with the same gross income, but no medical expenses. Congress has therefore provided a deduction for these types of expenditures, including charitable donations, in the tax code. Not only does the deduction encourage giving, but taxpayers pay tax according to their ability to pay when income given to charity is deductible for tax purposes. The limitation on itemized deductions, however, applies unevenly to these types of expenditures. That is, the limitation is applied to charitable deductions, but not deductions for medical expenses.

Possible Solutions. The limitation on itemized deductions should be repealed. If Congress wants to require that higher income taxpayers pay more tax, the least complicated way to accomplish this is through the rate structure. ***Penalizing taxpayers who make charitable donations runs counter to Congress's apparent desire to encourage such donations*** through the tax code by allowing these deductions in the first place.

Even if limitations on ***all*** itemized deductions were not repealed, the deduction for ***charitable*** contributions not only encourages giving, but also allows taxpayers to be taxed according to their ability to consume and pay tax, thereby preserving a fundamental tenet of any income tax system. The limitation on itemized deductions should, therefore, not apply to ***charitable*** deductions.

Conclusion

The 15% surtax on "excess" distributions from a retirement plan ***is the most important disincentive*** to large charitable contributions. As ever increasing sums have accumulated in recent years through investments in retirement plans, the potential for these accounts to provide important charitable funding has increased dramatically. However, the 15% penalty effectively blocks large charitable contributions: for every $1 subject to the penalty tax which a taxpayer gives to charity, the taxpayer must withdraw an ***additional*** 15% just to pay taxes on the gift. As a final irony, the extra 15% is, of course subject to regular income taxes ***plus*** the 15% penalty. The 15% penalty tax seriously prohibits large contributions from retirement accounts, and should be repealed.

The primary rationale given for the deductibility of charitable donations is that expenditures by the philanthropic sector should be encouraged as a matter of social policy, in part because government expenditures would be higher absent such spending. Having some portion of the spending on education, welfare, scientific research, the arts, and other charitable activity under the direction of private interests, not the government, is desirable to ensure that a wide variety of interests are served. In light of the budget cuts currently being contemplated by the Congress, especially in the arts, tax law impediments to large gifts should be reformed or eliminated to ensure that the philanthropic sector has adequate resources to meet increasing demands.

WRITTEN STATEMENT OF

THE RETAIL TAX COMMITTEE OF COMMON INTEREST

SUBMITTED TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

IN CONNECTION WITH ITS HEARINGS ON
MISCELLANEOUS TAX REFORMS
HELD JULY 11 - 12, 1995

The Retail Tax Committee of Common Interest respectfully submits these comments in support of proposals under consideration by the Committee on Ways and Means that (1) would establish a new 10-year depreciable life for qualified commercial improvement property and (2) would allow taxpayers to estimate shrinkage for purposes of inventory accounting.

The Retail Tax Committee of Common Interest is a long-standing group of large retail businesses organized to address its members' concerns on Federal and local tax issues. The member companies operate in all 50 States, with thousands of facilities and more than 1 million employees. The membership of the Retail Tax Committee includes J.C. Penney Company, Inc.; The Limited; Melville Corporation; Sears Roebuck and Company; The Gap, Inc.; Tandy Corporation; Pier 1 Imports, Inc.; and Walmart Stores, Inc.

QUALIFIED COMMERCIAL IMPROVEMENT PROPERTY

The Retail Tax Committee of Common Interest supports the proposal to establish a new 10-year depreciation class for qualified commercial improvement property. The establishment of such a class would result in a more accurate measurement of depreciation and a more accurate statement of taxable income.

A more accurate depreciable life should be used

The current-law requirement that commercial improvements to real property be recovered over a 39-year period does not reflect accurately the expected life of the improvements. Given the competitive nature of retailing and the continuing need to present a fresh look to the public, most retailers remodel stores every five to seven years.

Current law allows only 1/39th of the cost of any real property improvements to be recovered in a year, despite the fact that at least 1/10th, and more likely 1/7 or 1/5, of the improvement's actual life will have passed. For improvements used in retail, the present-law 39-year life substantially overstates the actual time the improvements can be expected to be in service and distorts taxable income. Given that remodeling generally takes place every five to seven years, even the proposed 10-year depreciation period before the Committee may not allow full cost

recovery in many cases. Nevertheless, we believe this proposal would mark a vast improvement over the present 39-year period.

The cost of a capital asset is recovered over time for Federal income tax purposes, rather than being fully deductible in the tax period the asset is placed in service, in order to match better the cost of the asset with its contribution to revenues earned by the business. Thus, to be consistent with the rationale for depreciating capital investments, the depreciable life assigned for tax purposes must not deviate significantly from the actual period of time the asset is expected to be used in the business. While a certain amount of deviation may be acceptable to allow use of a simpler depreciation system with fewer different depreciation classes, significant deviation from the actual life of the asset will result in inaccurate measurement of income.

Reform should not be limited to leasehold improvements

The Committee on Ways and Means is considering a proposal to create a new 10-year depreciation class limited to leasehold improvements. While such a reform would be a welcome first step in addressing the inappropriate treatment of commercial improvements in a retail setting, the proposal does not respond fully to the problem. For retailers that lease the space that they occupy, a special depreciable class limited to leasehold improvements would be sufficient. Other retailers, however, own (or at least would like to preserve the option to own) their stores. If reform were limited to leasehold improvements, these latter retailers would be excluded from the more appropriate tax treatment afforded under the proposal.

It would be inappropriate to subject identical property, used in the same activity, to sharply different depreciation regimes solely because one item of property is attached to a leasehold, and the other item is attached to property that is owned. Differing treatment would create a significant tax benefit incentive to lease, rather than own, the property. The decision whether to lease or own property should be a financial decision and should not be distorted by inconsistent tax treatment of improvements to the property.

A similar issue arises in a provision that has already been adopted by the House. Section 322 of H.R. 1215 provides that a landlord may take a deduction for the remaining basis in improvements that are disposed of at the end of a lease. This addresses a valid concern of real estate developers who are the owners of such improvements by eliminating the need to depreciate several sets of improvements at the same time. However, such relief should not be limited only to lessors, but the assurance that the undepreciated portion will be available as a deduction upon abandonment should also be available to lessees, as well as those retailers who own and operate their own stores.

The 39-year life assigned to improvements that constitute real property means that only a relatively small fraction of the original cost of retail improvements is likely to be depreciated before the improvements are replaced. If the remaining basis in

abandoned improvements cannot be deducted, and must therefore continue to be depreciated, numerous sets of improvements ultimately will have to be depreciated at the same time, the one in place along with those that previously have been abandoned. Since only one set of improvements can be in place at any given time, the clarification made by section 322 of H.R. 1215 clearly is appropriate.

Similar concerns arise where the retailer is the owner of the improvements, whether it leases or owns the facility in which the improvements are located. The Retail Tax Committee urges the Committee on Ways and Means to consider expanding the scope of section 322 of H.R. 1215 as part of its consideration of tax depreciation in this area in order to address these concerns.

It should be clarified that a deduction for the remaining basis of abandoned improvements is available to a retailer in such a situation. Unless the remaining basis in such improvements is deductible on abandonment, multiple sets of improvements will have to be depreciated at the same time, despite only one set being in place. Further, retailers that lease space they built and previously occupied should be allowed to deduct improvements that are abandoned and replaced. As retailing styles and needs change, space that previously was appropriate may cease to be so. When this is the case for a retailer that owns its space, the retailer must either sell the space, or lease it to another retailer or for a different use. Assurances should be provided that any remaining basis in improvements will be recoverable upon such an event.

INVENTORY SHRINKAGE

The Retail Tax Committee of Common Interest supports the proposal to clarify the ability of taxpayers to estimate inventory shrinkage, and urges adoption of legislation that confirms this concept of present law. Further, the Retail Tax Committee recommends that specific methodologies be established for calculating these estimates in order to assure taxpayers that their calculations will be accepted on IRS examination.

Modern retailing relies on perpetual inventory systems to provide the information necessary to manage the flow and supply of goods sold to the public, as well as to prepare the retailer's Federal income tax return. Where the number of items shown on the perpetual inventory records exceeds the amount of inventory actually on hand, shrinkage has occurred. Whether the item was stolen, broken, lost, or erroneously included in the perpetual inventory, there is no question that it is not available for sale and that its cost should be subtracted from inventory.

The key to determining the amount of shrinkage is the physical inventory, the actual count of inventory items. It is clear that shrinkage established by a physical count of the inventory will be accepted for tax purposes. In earlier times, retailers were able to count their inventory within several days of year end. However, recent developments have made it more difficult to count all of the inventory in all of the stores at roughly the same

time. As a result, many retailers have gone to a system of cycle counting, i.e., the counting of inventory at different locations at different times. Where cycle counting is applied, or where for other reasons the physical inventory count is taken other than immediately before year end, the issue of how to determine the amount of shrinkage taking place between the physical inventory count and the end of the year must be addressed.

Traditionally, retailers faced with this issue have used statistical models to estimate the amount of shrinkage that is expected to have occurred between the physical inventory count and year end based on prior shrinkage experience. Recently, the IRS consistently has challenged the use of shrinkage estimates by many retail taxpayers, including a number of members of the Retail Tax Committee. The IRS Retail Industry Specialization Program (ISP) has published a position paper concluding that shrinkage deductions are allowed only when confirmed by a physical inventory count.

The U.S. Tax Court recently has rejected the IRS position and confirmed the traditional ability of taxpayers to estimate shrinkage. In Dayton Hudson Corporation and Subsidiaries v. Commissioner, 101 T.C. 462, the Tax Court denied the IRS Motion for Summary Judgment, insisting that the taxpayer's methodology for estimating its shrinkage be tested. A final decision in the case following trial of the facts has not yet been rendered. The IRS has continued its attack on the use of shrinkage estimates, arguing that estimates used by taxpayers do not clearly reflect income. Which methodologies ultimately will be acceptable is likely to be established after a long series of court cases and the unnecessary expenditure of funds by both taxpayers and the government in trying those cases.

The Retail Tax Committee urges the Committee on Ways and Means to prevent this waste of time and resources by establishing a methodology that will be deemed acceptable for estimating the amount of shrinkage losses occurring between the last physical inventory count and the end of the taxable year. The Retail Tax Committee would be pleased to work with this Committee, its staff, and the IRS to establish such a safe harbor methodology.

**STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
SUBMITTED FOR THE RECORD
JULY 27, 1995**

The Securities Industry Association (SIA) is pleased to present testimony in connection with the consideration of miscellaneous tax reform proposals by the Committee on Ways and Means.* SIA member firms are active in all phases of corporate and public finance, serving individual and institutional investors, corporations, and government entities.

The testimony is divided into two parts. Part one includes comments and recommendations related to specific proposals outlined in the Ways and Means Committee Advisory No. FC-8 dated June 30, 1995.

Part two addresses the effects of current U.S. tax law on the international competitiveness of the U.S. securities industry and presents specific proposals to reform and simplify international tax law. Part two responds to, and expands on, the list of 30 proposals included in Advisory No. FC-8 issued by the Chairman under the heading "Foreign"; reiterates and reinforces the testimony presented by Representatives Houghton and Levin during the Committee hearing on July 11, 1995 urging the Committee to act on the foreign tax reform proposals; and, details the compelling need to enact international tax reform to restore and enhance the competitiveness of U.S. firms operating in foreign markets.

We discuss a number of proposals for reform of the provisions of the International Revenue Code of 1986, as amended (the "Code"), that govern the taxation of the foreign operations and foreign source income of U.S. securities firms. The enactment of these proposals would remove a number of significant barriers that U.S. securities firms now face in their efforts to compete with foreign securities firms on a worldwide basis.

PART ONE- MISCELLANEOUS TAX REFORM

Capital Gains

Tax Treatment of Market Discount- The Revenue Reconciliation Act of 1993 changed the tax treatment of "market discount" on municipal securities. Prior to the enactment of the 1993 reconciliation measure, "market discount" was taxed as a capital gain. Under current law, it is taxed as ordinary income. The new tax treatment has had an adverse impact on secondary market liquidity for municipal securities and will surely increase the cost of borrowing for state and municipal governments. Representatives Benjamin Cardin and Clay Shaw have introduced legislation (H.R. 843) that would restore capital gains treatment for municipal market

* The Securities Industry Association is the securities industry's trade association representing the business interests of about 750 securities firms in North America, which collectively account for approximately 90% of securities industry revenue in the United States.

discount. SIA supports H.R. 843 and urges the Committee to act on this measure as soon as possible.

Rate Reduction- The Contract With America Tax Relief Act of 1995 (H.R. 1215) includes three important capital gains incentives: (1) a 50 percent capital gains deduction; (2) indexation of the "basis" of capital assets to eliminate purely inflationary gains; and, (3) a provision to treat the loss on the sale of a home as a capital loss. Enactment of H.R. 1215 would reduce the cost of capital, improve U.S. productivity, unlock investments, increase federal revenues and boost economic growth. SIA commends Chairman Archer and the other members of the Committee who supported this measure.

<u>Pass-through Entities</u>
Financial Asset Securitization Investment Trusts (FASIT)- SIA supports the enactment of legislation that would establish a new pass-through entity for the securitization of financial assets. The current tax rules governing financial asset securitization are complex and limiting. Representative Clay Shaw has introduced legislation (H.R. 1967) to create a FASIT structure that would produce a revenue gain over the ten year period following enactment, and facilitate the securitization of financial assets by financial institutions. SIA supports this bill.

<u>Pension and Employee Benefits</u>
The Committee has under consideration a number of proposals to simplify federal pension law to encourage employers to establish pension plans, increase employee participation and increase savings. SIA strongly supports enactment of pension simplification and reform. Representatives Rob Portman and Benjamin Cardin have introduced legislation (H.R. 2037) that would eliminate many of the complexities and inconsistencies in the private pension system. SIA supports the quick consideration and enactment of H.R. 2037. Enactment of this measure is long overdue and would greatly assist both employers and employees.

<u>Individual Retirement Accounts</u>
SIA fully supports the enactment of the "Savings and Investment Act of 1995," (H.R. 682). We have testified in support of expanding and modernizing IRAs as proposed in H.R. 682 on numerous occasions. Earlier this year, SIA's Chairman, John L. Steffens, Executive Vice President of Merrill Lynch and Company, testified before the Committee in support of revitalizing the IRA. SIA has also testified on this subject as part of the Savings Coalition of America.

Enactment of H.R. 682 would help increase the U.S. savings rate and provide American workers with a powerful incentive to save for retirement and other worthy goals. The IRA has proven to be an effective incentive for savings that creates "new" savings and helps and encourages individuals to prepare for their financial future. We urge the Committee to fully expand and modernize the IRA by enacting the Savings and Investment Act of 1995.

We are pleased that the Committee included in the Contract With America Tax Relief Act of 1995 a provision creating the American Dream Savings Account (ADS). SIA believes that the ADS account would encourage individuals to save, thereby boosting personal and national saving in the U.S.

<u>Mutual Fund Share Basis Reporting</u>
The Tax Simplification and Technical Corrections Act of 1993 included a provision (section 522) that would require brokers and mutual funds to report share basis to customers. The enactment of mandatory information reporting of share basis is no longer necessary as the mutual fund industry has responded to Congressional interest in legislating mandatory

basis reporting and market forces. A growing number of securities firms including, the largest retail brokerage firm in the industry, are now reporting share basis information to shareholders. Virtually all other firms in the industry are moving to develop the capability to report this information to their clients in response to the competitive pressures of the marketplace.

SIA recommends that the Committee delete the mandatory information reporting requirement in H.R. 3419. The goal of this provision is being achieved.

Foreign

Repeal Portfolio Interest Exemption- SIA strongly opposes the reinstatement of a 30 percent U.S. withholding tax on payments of interest income to foreign persons. Congress repealed this withholding tax in 1984 as part of the Deficit Reduction Act because it recognized the need for U.S. businesses to have direct, tax free access to foreign markets as a source of capital. Congress also determined at that time that the withholding tax raised costs to U.S. issuers, while causing an under-utilization of U.S. resources and personnel. After Congress repealed the tax, foreign investment in U.S. debt obligation surged.

The re imposition of a withholding tax on interest payments to foreign persons would increase the cost of borrowing for all U.S. corporations and the U.S. Treasury, generate little incremental tax revenue, and cause a disruption of international capital flows. The resulting upturn in interest rates could sharply limit or hinder economic growth in the U.S. Given the global consumption for capital and the size of our federal debt, the U.S. can ill afford a tax that would drive foreign capital to other shores. We urge the committee to reject this and any proposal to restore this or any form of punitive tax on foreign investment.

PART TWO- INTERNATIONAL TAX REFORM

As a result of the globalization of the world's financial markets, the long-term viability of the U.S. securities industry depends on the ability of U.S. securities firms to compete with foreign financial institutions in capital markets throughout the world. It is critical, therefore, that U.S. laws and regulations do not unnecessarily impede the foreign operations of U.S. securities firms by imposing restrictions that foreign firms do not face. Like overly restrictive regulations, tax laws that are unduly onerous or complex, or that reflect an outdated understanding of the securities industry, place U.S. securities firms at a competitive disadvantage relative to foreign financial institutions. Thus, we believe that Congress must review the tax rules that apply to the foreign operations of U.S. securities firms and other financial institutions, with a view to eliminating barriers to international competition.

INTRODUCTION

The world's financial markets have become highly integrated and interdependent over the past several decades, due primarily to technological innovations and the elimination of regulatory barriers (for example in the European Union). In keeping with this globalization of the capital markets, U.S. securities firms have established business operations in all of the world's major financial centers, and these foreign operations now represent a substantial portion of their worldwide revenues. This situation contrasts sharply with the historical focus of the U.S. securities industry -- competition with other U.S. financial institutions to serve U.S. customers in the U.S. capital market.

The globalization of the capital markets has also prompted foreign financial institutions to expand into markets outside their home countries, including both third-country financial centers and the U.S. capital market. As a result, U.S. securities firms now face substantial competition from foreign firms in both U.S. and foreign markets. Thus far, the U.S. securities industry has risen successfully to the challenge of international competition. The long-term viability of the U.S. securities industry will depend, however, upon the ability of U.S. securities firms to maintain and strengthen their competitive position in the global market.

The international operations of U.S. securities firms play a critical role in attracting much needed foreign capital to U.S. government securities, corporate bonds, corporate equities and direct investment in U.S. companies. As worldwide demands for capital increase, directing foreign capital to U.S. companies and the U.S. Treasury will become even more important. It is essential, therefore, that U.S. laws and regulations do not unnecessarily impede the foreign operations of U.S. securities firms by imposing restrictions that non-U.S. financial institutions do not face.

The Code provisions that presently apply to the foreign operations of U.S. securities firms reflect an outdated understanding of the U.S. securities industry. These provisions, many of which were enacted decades ago, fail to recognize that U.S. securities firms now conduct major business operations (usually in subsidiary form) in financial centers such as London, Tokyo and Frankfurt. These foreign operations are essential to the ability of U.S. securities firms to compete effectively with non-U.S. competitors. They are not, as the Code often assumes, designed to take advantage of tax planning opportunities. Indeed, the United Kingdom, Japan and Germany, as well as most other countries with developed capital markets, impose corporate income tax at rates similar to or higher than the U.S. rates. As a result, many U.S. securities firms are subject to significant foreign tax on their foreign income.

The applicable Code provisions also fail to take into account two fundamental differences between the foreign operations of U.S. securities firms and those of other non-financial U.S. businesses. First, the conduct of a foreign securities business is generally subject to significant foreign regulation. In general, a foreign securities subsidiary must obtain local regulatory approval to conduct business in a foreign jurisdiction. Each securities regulator enforces its own particular requirements, and U.S. securities firms expend considerable resources ensuring that they comply with foreign securities regulations. As is the case with U.S. securities regulation, the principal purpose of foreign regulation is to protect the customers of a foreign securities subsidiary by ensuring that the subsidiary can fulfill its obligations to customers. Thus, foreign regulatory regimes generally impose minimum capitalization requirements and may severely limit the ability of a foreign securities subsidiary to shift funds to related entities, whether through dividends or other mechanisms. One of the Code's principal concerns in the international context -- the ability of a U.S. parent corporation to arrange the capitalization and operations of its foreign subsidiaries so as to minimize U.S. tax -- is therefore much less relevant in respect of U.S. securities firms.

Second, the international provisions of the Code fail to take adequate account of the fact that a securities firm necessarily earns, as active business income, certain types of income that the Code generally views as passive

investment income, e.g., interest and dividends. As a result, the active foreign income of a U.S. securities firm is often subject to burdensome rules enacted, not with the securities industry in mind, but to limit deferral or avoidance of U.S. taxation on foreign source income from portfolio investments. These rules include, in particular, Subpart F of the Code, which requires certain U.S. shareholders of a controlled foreign corporation to include currently certain types of passive income earned by the controlled foreign corporation.* The application of these Code provisions to active securities income hinders U.S. securities firms in their efforts to compete with foreign firms. Moreover, as discussed below, to the extent that these rules preclude U.S. securities firms from lowering their foreign tax liability, they impose additional costs on the U.S. fisc in the form of higher foreign tax credits.

Although the policy concerns that led to these restrictions do not apply to the foreign operations of U.S. securities firms, the Code's anti-deferral and foreign tax credit rules do not always distinguish between interest, dividends and similar income earned by a U.S. securities firm in its active business operations and income of the same types that is earned by a non-financial taxpayer. This problem has been exacerbated with the development of new financial products and services, because the traditional sources of income for the securities industry -- commission income and gains from sales of inventory securities, which are excluded from Subpart F under current law -- represent a less significant percentage of the revenues of U.S. securities firms, while an increasing percentage is represented by other types of income that are not excluded from Subpart F.**

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* *See* Report of the House Committee on Ways and Means on the Revenue Act of 1962, H. Rep. No. 1447, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 466 ("Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income."); Report of the Senate Finance Committee on the Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 789.

** As recently as 1986, Congress assumed "that bona fide underwriters of securities would be excluded from classification as [passive foreign investment corporations] both under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to subpart F [foreign personal holding company] income by virtue of the dealer exception in sec. 954(c)) and under the income test (because a substantial amount of their income is commission income, which is not subpart F [foreign personal holding company] income)." Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at p. 1025. In 1993, Congress recognized that these assumptions were inaccurate. Explanation of Senate Finance Committee Revenue Provisions of the Omnibus Revenue Reconciliation Bill of 1993 (S.1134), at p. 144 ("The committee is informed, however, that foreign securities dealers do not always earn sufficient gross income in the form of underwriting commissions to avoid qualification as

In addition, many U.S. securities firms are denied much of the benefit of credits for foreign taxes by virtue of the allocation of domestic interest expense to their foreign subsidiaries, even where these foreign subsidiaries have incurred indebtedness of their own and the resulting interest expense has already reduced the subsidiaries' foreign source income. The foreign tax credit rules also limit the ability of U.S. securities firms to average foreign taxes paid on different types of active securities income, thereby exposing foreign earnings to double taxation on an overall basis. In contrast, many non-U.S. financial services firms have full, or relatively full, use of credits for taxes paid to foreign countries.

Some progress has been made recently in reforming these rules. In 1993, Congress enacted Code section 1296(b)(3), which excludes from passive income, for purposes of the passive foreign investment company rules, any income earned in the active conduct of a securities business by a controlled foreign corporation that is either (i) registered under the Securities Exchange Act of 1934 or (ii) an active securities dealer, broker or qualified securities affiliate, as provided in Treasury regulations. Proposed regulations recently issued under that section have comprehensively described the activities that constitute an active securities business and provide rules for distinguishing between securities firms and other taxpayers that might earn similar types of income.

These rules should form the basis for a more comprehensive reform of the anti-deferral and foreign tax credit rules, as they apply to U.S. securities firms. To this end, we discuss below certain impediments faced by U.S. securities firms under the Code's international provisions and propose solutions to these problems. These items fall into several broad categories: the treatment of active securities income earned by controlled foreign corporations under Subpart F of the Code; restrictions imposed by Subpart F of the Code on ordinary business transactions between U.S. securities firms and controlled foreign corporations; and restrictions on the ability of U.S. securities firms to utilize credits for foreign taxes paid on active foreign source income.

A. TREATMENT OF ACTIVE INCOME UNDER SUBPART F OF THE CODE

Sections 951 through 964 of the Code ("Subpart F") require a U.S. shareholder of a controlled foreign

(..continued)
[passive foreign investment corporations] under the gross income test. For example, securities dealers may earn substantial amounts of interest and dividend income from securities held as inventory for sale to customers. Securities dealers may also earn substantial amounts of interest income from transactions incidental to the business of dealing in securities, such as margin loans and reverse repurchase transactions. The committee is further informed that inventory securities held by a foreign corporate securities dealer may not represent more than 50 percent of the corporation's assets."); Report of the House Ways and Means Committee on the Revenue Reconciliation Bill of 1993, at p. 255 (same). Congress then enacted Code section 1296(b)(3), which provides an exception for certain controlled foreign corporations engaged in an active securities business from the passive foreign investment company rules.

corporation (a "CFC")* to include in income its pro rata share of certain types of income earned by the CFC in the year in which that income is earned. Exceptions are provided for CFCs that earn de minimis amounts of includible income and for income that is subject to high rates of foreign tax.

Under current law, much of the active securities income earned by CFCs that conduct a securities business (herein "securities CFCs") is taxed currently to their U.S. shareholders. This is because, as described above, the rules of Subpart F generally do not distinguish between the active business income of a securities firm and investment income of similar types (e.g., interest and dividends).** Moreover, the exceptions to Subpart F frequently are not available to a securities CFC. For example, if a securities CFC earns substantial amounts of interest and dividends on securities held in inventory, the de minimis exception is not available. In addition, although securities CFCs located in major financial centers are generally subject to foreign tax rates similar to or higher than the U.S. rates, the high tax exception frequently does not apply due to anomalies in the interaction of U.S. and foreign tax rules.

In contrast, the foreign earnings of many non-U.S. financial institutions benefit from unlimited deferral of home country taxation. Thus, the burden of current taxation, combined with restrictions on the utilization of foreign tax credits (discussed in Section C. below), seriously impedes the ability of U.S. securities firms to compete in foreign markets.

Prior to 1986, active income earned by a securities CFC generally was not taxed currently to its U.S. shareholders by virtue of a special exemption from Subpart F for income derived from the active conduct of a "banking, financing or similar business". Congress revoked this exception in 1986, however, in the belief that securities income, and other active financial services income, is "inherently manipulable" and thus easily located in tax haven jurisdictions.***

In fact, U.S. securities firms often have little or no choice as to the location of a securities CFC. Instead, location is generally governed by the type of business that the CFC conducts, the location of the relevant markets and customer base, and applicable foreign regulatory requirements. The globalization of the financial markets has not generally presented U.S. securities firms with opportunities to book income in low-tax jurisdictions. To the contrary, under the tax and securities laws of most countries, income from financial services generally must be booked in the jurisdiction where the relevant securities are

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* A controlled foreign corporation is any foreign corporation in which more than 50% of the vote or value of the outstanding shares is owned, directly or indirectly, by "U.S. shareholders" (i.e., any U.S. person that holds a 10% or greater voting interest).

** At present, gains and losses realized by a securities dealer on the sale of inventory securities or arising out of certain related hedging transactions are excluded from foreign personal holding company income under Code section 954(c). Most other types of income derived from securities and other financial products are not so excluded.

*** Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pp. 966-967.

traded or the relevant services are performed. In this respect, financial services income is not significantly different from other types of active income (such as manufacturing income) earned by U.S. multinationals for which deferral is not eliminated under Subpart F.

We discuss below several proposals for amendment of the Subpart F rules, as they apply to active income earned by securities CFCs. These proposals would go far towards removing the tax barriers that U.S. securities firms now face in their efforts to compete abroad.

1. Exclude Active Financing Income from Subpart F

One of the proposals under consideration by this Committee would exclude from the definitions of "foreign personal holding company income" and "foreign base company services income"* set forth in Code section 954, any income that is derived from sources within the country where a CFC is created or organized and that is derived in the active conduct of a "banking, financing or similar business", if the CFC is predominantly engaged in such active conduct.**

This exclusion would constitute a significant measure towards rectifying the anti-competitive treatment of active securities income under Subpart F. It is the most comprehensive proposal in this regard, and for that reason the simplest. For example, an exclusion for active financing income would obviate the need for special rules (discussed below) excluding interest, dividends and other securities income earned in connection with a securities business from foreign personal holding company income. It would also reduce the need to amend the rules governing the high-tax exception from Subpart F (also discussed below).

If this exclusion is enacted, however, it would be helpful to clarify that the term "banking, financing or similar business" includes the various activities typically conducted by securities CFCs. In this regard, we recommend that a "banking, financing or similar business" be defined to include the active conduct of a "securities business" as that term is used in Code section 1296(b)(3)(A) (relating to the exception for securities dealers from the passive foreign investment company rules). As noted above, the Treasury regulations that were recently proposed under Code section 1296(b)(3)(A) contain a comprehensive list of the "securities activities" that comprise an active securities business.

In addition, the exclusion should apply broadly to income derived from sources both within and outside the CFC's country of organization. If the exclusion were

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* Under Subpart F of the Code, a 10% U.S. shareholder of a CFC must include in income currently its pro rata share of various categories of "foreign base company income" earned by the CFC. Foreign base company income includes foreign personal holding company income, defined to include various types of investment income, such as dividends, interest and gains, and foreign base company services income, defined as income received for services performed by a CFC for a related person outside the CFC's country of organization. As noted above, de minimis and high tax exceptions may apply.

** This provision is listed as Foreign Provision #19 in the Committee Press Release and is also Section 5 of H.R. 1690, The International Tax Simplification and Reform Act of 1995, introduced on May 24, 1995 by Representatives Houghton and Levin.

limited to income earned within the CFC's country of organization, much of the active securities income earned by securities CFCs would still be treated as foreign personal holding company income or foreign base company services income. For example, under the Code, dividend and interest income is generally sourced by reference to the residence of the payor.* Thus, income from inventories of securities issued by corporations organized in a different country than the CFC (e.g., income from inventories of Eurobonds and Yankee bonds held by a CFC organized in the U.K.) is not income sourced in the CFC's country of organization.

Moreover, as a result of the internationalization of the financial markets and to enhance managerial or structural efficiency, many securities CFCs provide financial services on a regional basis and thus earn substantial amounts of active securities income outside their countries of organization.** For example, securities firms that are licensed or organized in one country within the European Union (EU) will soon be able to conduct a securities business in any other EU country without obtaining specific authorization from each country. Similarly, many U.S. securities firms have organized a CFC in one country in the Far East (for example, Hong Kong) in order to conduct business in another country or throughout the region. This often occurs, for example, where one country offers a hospitable regulatory regime. Alternatively, some countries do not permit U.S. securities firms to operate through subsidiaries organized in that country; for example, Japan requires that U.S. securities firms conduct business in Japan through a Japanese branch of either a U.S. corporation or a subsidiary organized in a third country. Any exclusion for active financing income should be broad enough to reflect these regulatory and market realities.***

2. Exclude Active Interest and Dividends from Foreign Personal Holding Company Income

If a comprehensive exclusion of active financing income from Subpart F is not enacted, Congress should, at a minimum, provide an exclusion from foreign personal holding company income for interest, dividends and other income earned on securities that are held by a securities CFC in connection with the active conduct of a securities business. Under present law, foreign personal holding company income, which must be included currently by the U.S. shareholders of a CFC, does not include gains realized on the sale of inventory property (e.g., inventory securities). Interest,

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* Code sections 861(a)(1) and (2), 862(a)(1) and (2).

** Services income is generally sourced in the location where the services are performed. Code sections 861(a)(3), 862(a)(3).

*** We note also that, in the case of foreign base company services income, restricting the exclusion to income earned within the CFC's country of organization would effectively negate the exclusion entirely. Income derived from services performed within the CFC's country of organization is not treated as foreign base company services income under current law. Thus, if the exclusion were so restricted, it would cover only income that would not be foreign base company services income in any event.

dividends and other income earned on securities held in connection with a securities business is, however, treated as foreign personal holding company income.

The treatment of interest and dividends as foreign personal holding company income is intended to eliminate incentives for U.S. taxpayers to earn investment income through foreign corporations, thereby deferring U.S. tax. In the case of a typical investor, the holding of investment securities is an activity that could otherwise be located in whichever jurisdictions were most convenient in order to minimize the tax imposed. A securities CFC, however, which typically earns substantial amounts of dividends and interest income from securities held in connection with its active business, cannot manipulate the location of this income. For a variety of reasons, a securities CFC must purchase and sell securities through regulated subsidiaries in the jurisdictions where the customers are located and the securities are most actively traded: for example, regulators may require that a customer securities business be conducted in a regulated local entity; moreover, the least costly financing, the most convenient clearing mechanism, and the greatest customer demand are generally found in a security's home jurisdiction.

There is no thus policy reason to require current inclusion of interest, dividends and other income earned on securities held in connection with an active securities business. In the absence of a more general exclusion for "active financing income", this income should be excluded from the definition of foreign personal holding company income.

3. Amend Test for Determining Whether Income Is <u>Subject to a High Rate of Foreign Tax</u>

The current inclusion rules of Subpart F of the Code are intended to prevent U.S. taxpayers from deferring U.S. tax on certain types of income by moving the income offshore. If, however, the income of a CFC is subject to foreign tax at a rate that is substantially equal to the U.S. rate, it is evident that the U.S. shareholders of the CFC have not used the CFC to avoid paying tax. Therefore, Subpart F provides that "foreign base company income" is not includible in income by a U.S. shareholder if the income is subject to a high rate of foreign tax (the "high-tax exception").

The Tax Reform Act of 1986 modified the high-tax exception to make the test broader and more mechanical than under prior law. As modified, the high-tax exception provides that, if foreign base company income is subject to an effective rate of foreign income tax that is greater than 90% of the maximum U.S. corporate income tax rate, the income is not subject to current inclusion.

Although the high-tax test appears quite simple, the test is often difficult to satisfy even when a CFC is located in a high-tax jurisdiction, such as the United Kingdom or Germany. The principal reason is that the test compares the <u>effective</u> rate (<u>i.e.</u>, the average rate of tax applied to income) of foreign income tax to the highest <u>marginal</u> rate (<u>i.e.</u>, the rate of tax applied to the last dollar of income) of U.S. corporate income tax. A second reason is that, in determining the effective rate of foreign tax, the income of a CFC must be computed under U.S. tax principles, rather than the tax laws of the foreign country. Thus, because U.S. tax law does not permit the inclusion of a foreign affiliate in a consolidated group, an effective foreign tax rate must be computed for each CFC on a corporation-by-corporation basis. If the foreign law allows "group relief" (as in the United Kingdom), or otherwise

permits a CFC to offset the losses of another corporation within its "group" against its income, the effective rate of foreign tax is reduced from a U.S. perspective.

A similar mismatch may occur where the timing of income inclusion under foreign law differs in various respects from U.S. law, e.g., where foreign law allows a CFC to value its inventory on a different basis than under U.S. tax law.* Thus, under the current rules, a U.S. shareholder of a CFC located in a "high-tax" jurisdiction is often inappropriately required to include in income currently the foreign base company income earned by a CFC, even though such income will be subject to a high rate of foreign tax in a later year. This result is inconsistent with the legislative purpose of the high-tax exception.

In order to conform the application of the high-tax exception to its purpose, the Code should exclude from foreign base company income any income of a CFC that is subject to tax in a foreign country with a maximum marginal corporate tax rate equal to 90% of the maximum marginal U.S. corporate tax rate (assuming that the CFC does not enjoy a special tax "holiday" or other special reduction in the tax rate). As a safeguard, the Internal Revenue Service could be given authority to specify that income earned in certain countries does not qualify for the high-tax exception, because those countries had enacted the highest marginal tax rate specifically to permit U.S. shareholders to avoid taxation under Subpart F.

Alternatively, a U.S. shareholder could be permitted to calculate the effective rate of foreign tax based on the taxable income of the CFC as determined under the tax laws of the foreign country (including group relief or other consolidation principles), to the extent that these laws are generally analogous to U.S. principles or result in mere differences in the timing of income. To address the "group relief" problem in particular, U.S. shareholders could be permitted to calculate the effective rate of foreign tax paid by all CFCs within a single country on an aggregate, rather than corporation-by-corporation, basis.

4. Permit Portfolio Interest Earned on Inventory Securities to Qualify for High-Tax Exception

Under current law, a foreign person is not subject to U.S. federal income tax (including withholding tax) on "portfolio" interest (i.e., U.S.-source interest paid on obligations issued after July 18, 1984 to a foreign person other than a "10% shareholder" of the issuer, a bank on an extension of credit, or a CFC "related" to the issuer).

Under Subpart F of the Code, interest income earned by a CFC is generally foreign personal holding

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* Under Treas. Reg. § 1.954-1T(d)(3)(i), the amount of foreign tax paid or accrued with respect to an item of income earned by a CFC is the amount of foreign income tax that would be deemed paid under Code section 960 (regarding the indirect foreign tax credit) with respect to that item if the item were included in the income of a U.S. shareholder under Subpart F. The amount of tax deemed paid by the CFC under Code section 960 is determined based on a "pool" of foreign taxes paid by the CFC over a period of years. Thus, the amount of foreign tax treated as paid or accrued by a CFC for purposes of the high-tax exception is determined under an averaging approach. This approach mitigates, but does not eliminate, the mismatching that arises from differences in foreign and U.S. law.

company income that must be included currently in the income of any 10% U.S. shareholder of the CFC. This rule reflects Congress' concern that the ability to achieve deferral of U.S. tax might otherwise encourage U.S. taxpayers to hold investment assets offshore and Congress' view that current taxation of investment income earned offshore would present no competitive disadvantage for U.S. multinationals.*

Where foreign personal holding company income is subject to a high rate of foreign tax, it is not required to be included currently by a U.S. shareholder because there is no tax deferral motive (the "high-tax exception", discussed above). Under current law, however, portfolio interest received by a CFC is not eligible for the high-tax exception. Thus, for example, if a securities CFC located in the United Kingdom receives interest on U.S. Treasury securities (or debt securities of a U.S. corporation) that it holds in inventory, and the CFC pays tax on the interest at the U.K. corporate rate of 35%, the interest will be includible under Subpart F, even though the high rate of U.K. tax would otherwise permit the interest income to qualify for the high-tax exception.

Although the purpose of the foregoing provision is not stated in its legislative history, it is presumably intended to prevent a U.S. taxpayer from routing interest income that is not subject to U.S. withholding tax through a CFC in order to avoid current U.S. taxation. In the case of portfolio interest securities that are held by a securities CFC in connection an active securities business, there is clearly no tax avoidance motive. Securities CFCs have substantial non-tax business reasons to hold portfolio interest obligations; for example, the market for Eurodollar obligations is centered in London, and market makers in Eurodollar securities generally carry their inventories in companies located in the United Kingdom.

Thus, the exclusion of portfolio interest from the high-tax exception is unnecessary and punitive in the case of securities held in connection with an active securities business. Moreover, this exclusion impairs the competitiveness of U.S. securities firms to the extent that third-country subsidiaries of non-U.S. firms can defer home country taxation of interest earned on U.S. securities. Accordingly, portfolio interest earned by a securities CFC on securities held in connection with the active conduct of

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* _See_ Report of the House Committee on Ways and Means on the Revenue Act of 1962, H. Rep. No. 1447, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 462 ("Nevertheless, the testimony before your committee did convince it that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income....Your committee has also concluded that U.S. tax should be imposed currently, on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business...) and 466 ("Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated."). _See also_ Report of the Senate Finance Committee on the Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 789.

a securities business should be eligible for the "high-tax" exception from Subpart F.

B. TREATMENT OF ORDINARY BUSINESS TRANSACTIONS BETWEEN SECURITIES CFCS AND U.S. PERSONS UNDER SUBPART F

Under sections 951 and 956 of the Code, a U.S. shareholder of a CFC is generally required to include in income currently its pro rata share of the CFC's increase in earnings invested in "United States property". The term "United States property" is broadly defined in Code section 956 to include an obligation of a U.S. person (other than obligations of certain unrelated U.S. corporations). Earnings of CFCs that are invested in "United States property" are taxed currently, unless an exception applies, "on the grounds that [the investment] is substantially the equivalent of a dividend" to a U.S. shareholder.*

Because the term "United States property" is broadly defined, it appears to include certain obligations that arise in ordinary course business transactions between securities CFCs and their U.S. parent corporations, or with unrelated U.S. entities that are not organized as corporations. (For simplicity, we refer to all such persons herein as "U.S. persons".) While these transactions may involve a short-term transfer of funds from a securities CFC to a U.S. person, or a short-term exchange of funds between a securities CFC and a U.S. person, they generally do not permit the U.S. person to utilize the accumulated earnings of securities CFCs on an extended basis. Thus, treating these transactions as giving rise to investments in United States property would not further the purposes of Code section 956. In addition, it would needlessly impede legitimate business transactions, force securities CFCs to transact their businesses in inefficient ways, and reduce the ability of U.S. securities firms to compete with their foreign counterparts. Moreover, the legislative history of the Revenue Act of 1962, which introduced Code section 956, indicates that Congress intended to exclude ordinary business transactions from the scope of that section.**

While we have no specific knowledge in this regard, we would anticipate that expressly exempting these ordinary course transactions from Subpart F would be revenue-neutral, given that U.S. securities firms currently seek to structure these transactions so as to avoid Subpart F inclusions. We recommend, therefore, that Code section 956 be amended to clearly exclude the following transactions from its scope.

1. Securities Repurchase and Securities Loan Transactions

In a securities repurchase transaction (a "repo"), a U.S. person (i) sells securities to a securities CFC for

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* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. 794.

** *See* H. Rep. No. 1447, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. 468-69 (describing the existing exceptions to the definition of "United States property" as covering transactions "where the property located in the United States is ordinary and necessary to the active conduct of the foreign corporation's business" and "normal commercial transactions without any intention to permit the funds to remain in the United States indefinitely"); S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. at 787, 793-94 (similar).

cash and (ii) agrees to repurchase the securities from the securities CFC, at a specified time or on demand, for the purchase price plus an additional amount that is in the nature of interest. This transaction is treated under existing case law as a short-term borrowing of cash by the U.S. person from the securities CFC under which the U.S. person posts securities as collateral.* The U.S. person has an obligation to return the amount of cash treated as loaned by the CFC. The repo transaction may also be reversed (a "reverse repo"), so that the U.S. person is treated as making a secured loan to the securities CFC. In this case, the U.S. person has a contractual obligation to return the collateral (i.e., the securities) to the CFC.

In a securities loan, a U.S. person either borrows securities from, or lends securities to, a securities CFC. The party that borrows the securities posts collateral (generally in the form of cash or marketable securities) with the lender. When the loan expires, the borrower returns the securities to the lender (plus a fee), and the lender returns the collateral (plus an additional return that is in the nature of interest on the collateral) to the borrower.** Thus, where a U.S. person borrows securities from a securities CFC, the U.S. person incurs a contractual obligation to return the loaned securities; where a U.S. person lends securities to a securities CFC, the U.S. person incurs an obligation to return collateral.

A U.S. person's contractual duty to return cash or securities to a securities CFC should not be regarded as an "obligation" that constitutes "United States property" for purposes of Code section 956, where this obligation arises in connection with a repo or securities loan transaction entered into in the ordinary course of business. First, these transactions do not give the U.S. person the use of any earnings of the CFC, on a temporary basis or otherwise, because the U.S. person generally must transfer an equal amount of either cash or marketable securities to the CFC in connection with these transactions. Furthermore, where the securities CFC and the U.S. person are acting as intermediaries between unrelated customers, the U.S. person does not have possession or use of any cash or securities received from the CFC during the term of the transaction.*

Therefore, Code section 956 should be amended to clarify that the obligation of a U.S. person to return cash

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* <u>See</u>, <u>e.g.</u>, <u>American National Bank of Austin v. United States</u>, 421 F.2d 442, 452 (5th Cir.), <u>cert</u>. <u>den</u>. 400 U.S. 819 (1970); Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 74-27, 1974-1 C.B. 24.

** When the collateral posted is cash, securities loans are almost identical to repurchase transactions. The principal difference is that where the securities loan is described in Code section 1058, the securities loan is treated for tax purposes literally in accordance with its terms as a tax-free transfer of securities in exchange for the counterparty's obligation to return substantially identical securities (rather than as a borrowing of money). When other securities, rather than cash, are posted as collateral, a securities loan does not resemble either a repurchase transaction or a cash borrowing, but is merely a temporary exchange of marketable securities.

* Collateral posted by a foreign customer with the securities CFC is re-posted by the securities CFC with the U.S. person; the U.S. person then, in turn, posts this collateral with a U.S. customer.

or securities to a securities CFC in connection with a repo or securities loan transaction that is entered into in the active conduct of a securities business will not be treated as an investment in United States property for purposes of Code section 956.

2. Margin Posted in Futures Transactions

Securities CFCs frequently enter into futures transactions on U.S. futures exchanges on behalf of their customers. The only way that a securities CFC can execute a futures transaction on a U.S. futures exchange, however, is through a U.S. futures commission merchant (an "FCM"). The CFC therefore is usually required, under the rules of a U.S. futures exchange, to post two types of "margin" with the FCM. The first, "initial margin," generally equals less than 5% of the value of the futures position. Initial margin is in the nature of a performance bond, and the amount generally does not vary over the life of the futures transaction. The FCM is obligated to return the initial margin to the CFC when the futures position is closed out.

The second type of margin, "variation margin," is an additional amount that a securities CFC must pay to an FCM as an exchange-traded futures position "moves away" from the CFC. An exchange-traded futures position is marked to market each day, and any excess variation margin is returned to the CFC when the position moves back toward the CFC.

If the obligation of a U.S. person that is an FCM to return initial or variation margin to a securities CFC is treated as an investment in United States property for purposes of Code section 956, securities CFCs would effectively be precluded from availing themselves of their own related-party FCMs, and any FCMs (whether related or unrelated) that were U.S. partnerships, trusts or other non-corporate entities. Such a result would force the U.S. financial community to transact business in inefficient ways and face burdens not borne by foreign competition, all without furthering the purposes of Code section 956.

Moreover, a securities CFC entering into a futures transaction on a U.S. futures exchange is frequently acting as an intermediary for one of its customers, in which case the CFC acts merely as an agent in collecting and remitting the margin. In effect, the FCM is receiving cash from an unrelated foreign person, rather than from the CFC. Moreover, much of the margin posted by a securities CFC cannot be retained by an FCM. Instead, the FCM is required to post much of this margin with the U.S. futures exchange. The FCM thus generally derives no real economic benefit from its brief possession of the margin.*

In view of the foregoing, Code section 956 should be amended to clarify that the obligation of a U.S. person to return margin that is posted by a securities CFC, in order to comply with the rules of a U.S. futures exchange, in connection with a transaction entered into in the active conduct of a securities business, is not treated as an investment in United States property.

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* In the case of variation margin, the duty of a U.S. person to return the margin to a securities CFC cannot constitute a debt obligation under U.S. federal tax principles, because the U.S. person has no obligation to pay a fixed sum on a certain date in the future. In this regard, we note that Treas. Reg. § 1.956-2T(d)(2) defines the term "obligation" to include "any bond, note, debenture, certificate, bill receivable, account receivable, open account, or other indebtedness".

3. Margin Posted in Over-the-Counter Derivatives and Swap Transactions

If a securities CFC enters into an over-the-counter derivatives transaction (e.g., it writes an over-the-counter option) with a U.S. person that is subject to regulatory net capital requirements (such as a U.S. broker-dealer), the U.S. person may need to collect margin from the CFC in order to avoid the regulatory net capital "haircut" that would be required if performance by the CFC were not secured. The U.S. person would thus incur a contractual obligation to return the margin to the CFC during the term of, or on termination of, the derivatives transaction. Similarly, a securities CFC that enters into a swap or other notional principal contract with a U.S. person may be required, by the terms of the contract, to post margin with the counterparty in order to secure its performance; the U.S. person would be required to return this margin during, or on termination of, the term of the contract.

Again, the status of the obligation of the U.S. person (to return margin to the CFC) in these situations is not clear, but its treatment as "United States property" for purposes of Code section 956 would be inappropriate. These obligations arise solely in order to secure performance by a securities CFC in an ordinary business transaction. Even where the U.S. person is related to the securities CFC, the posting of margin clearly is not designed to achieve the effect of a dividend. Section 956 should therefore be amended to clarify that the obligation of a U.S. person to return margin posted by a securities CFC in an over-the-counter derivatives transaction, or pursuant to the terms of a swap or other notional principal contract, is not an investment in United States property where the transaction is entered into in the active conduct of a securities business.

4. Making a Market in Debt Securities

When a U.S. person that is related to a securities CFC issues debt securities overseas, the securities CFC (if it is a securities dealer) may underwrite and make a market in those securities. In addition, a securities CFC may underwrite and/or make a market in debt securities of unrelated U.S. persons that are not corporations. At any given time, therefore, a securities CFC may have varying amounts of such securities in inventory. To the extent that these debt securities are held for sale to customers, they should not be treated as investments in United States property.

The Internal Revenue Service has recognized that debt securities of a related person purchased by a securities dealer in its market-making capacity should not be treated in the same manner as debt securities purchased by a non-dealer for purposes of Code section 108(e)(4) (under which a debtor recognizes cancellation of indebtedness income if a related party purchases its debt securities at a discount). Treas. Reg. § 1.108-2(e)(2). Likewise, debt securities held as inventory by a securities CFC should not be treated in the same manner as other debt obligations for purposes of Code section 956. Inventory securities are clearly held for ordinary business reasons. Moreover, debt securities issued by a related U.S. person that are held temporarily for sale to customers cannot be considered to serve as the equivalent of a dividend from the securities CFC to a U.S. shareholder.

5. Loans to Unrelated Partnerships

Code section 956 presently excludes from the definition of "United States property" any debt obligation of a U.S. corporation that is neither a 10-percent U.S. shareholder of the CFC nor a domestic corporation 25 percent or more of the voting stock of which is owned directly or indirectly by U.S. shareholders of the CFC. This exclusion reflects the reality that a loan by a CFC to an unrelated domestic corporation cannot be considered a repatriation of funds for the use of a U.S. shareholder.

The fact that this exclusion is limited to debt obligations of unrelated U.S. corporations has restricted the ability of securities CFCs to take full advantage of opportunities to lend to unrelated U.S. investors that are organized as partnerships or other non-corporate entities. For example, U.S. investment funds, or "hedge funds", that are organized as partnerships frequently seek to borrow in a foreign currency or to finance securities purchases in overseas markets. Securities CFCs are hampered in competing for this business, however, by the potential that any such loan may be regarded as a deemed dividend to their U.S. shareholders. As a result, securities CFCs are effectively forced to cede this business opportunity to foreign financial institutions.

To rectify this competitive disadvantage, Code section 956 should be amended to exclude obligations of unrelated partnerships and other non-corporate entities from the definition of United States property. There is no tax policy reason to treat unrelated non-corporate entities differently from unrelated corporate entities for this purpose. In both cases, a loan to an unrelated person cannot be considered a repatriation of funds to a U.S. shareholder of the CFC.

C. AMENDMENTS TO THE FOREIGN TAX CREDIT LIMITATION RULES

To prevent double taxation of foreign source income, the Code allows a U.S. taxpayer to claim a tax credit, within certain limits, for foreign taxes paid on income from sources outside the United States. In general, the foreign tax credit may not exceed the U.S. tax payable on the taxpayer's net foreign source taxable income. To compute the foreign tax credit limitation, the taxpayer must allocate deductions for expenses, such as interest expense, between gross income from U.S. sources and gross income from foreign sources. This allocation permits the taxpayer to compute taxable net foreign source income, and the U.S. tax attributable to that income.

The Code also includes special rules that prevent a taxpayer from using foreign income taxes paid on one type of income as a credit against the U.S. tax on other types of income (known as "cross crediting"). Thus, foreign source income must be allocated to different categories or "baskets" of income, and taxpayers may not use the foreign taxes imposed on income in one basket as a credit against the U.S. tax imposed on income in another basket.

1. Include High Withholding Tax Interest in the Financial Services Basket for Securities Firms and Clarify that Commodities Income Is Also Included in the Financial Services Basket

Most of the active foreign source income earned by a U.S. securities firm is included in the "financial services basket" for purposes of the foreign tax credit limitations. Thus, foreign taxes imposed on one item of securities income generally may be used as a credit against the U.S. tax imposed on another item. Certain types of income derived by a U.S. securities firm are not, however,

included in the financial services basket. As a result, a U.S. securities firm may be unable to utilize credits for foreign taxes paid on that income.

There is no policy reason to prevent "cross-crediting" with respect to the active business of a securities firm. Cross-crediting is permitted with respect to the active business income of most non-financial services businesses, by virtue of the fact that all of their business income is included within the "general" or residual limitation category. For a securities firm, the financial services basket is the equivalent of the general limitation category. Thus, the financial services basket should include all of the types of active income that may be earned by a U.S. securities firm.

a. High Withholding Tax Interest. The Code excludes "high withholding tax interest" (i.e., interest subject to foreign withholding tax at a 5% or higher rate) from the financial services basket. High withholding tax interest is subject to a separate foreign tax credit limitation so that high withholding taxes cannot be used to reduce U.S. tax on other types of foreign source income. In particular, Congress believed that the economic burden of high withholding taxes was borne not by U.S. lenders, but instead by foreign borrowers; therefore, Congress was concerned that the cross-crediting opportunities that existed under pre-1986 law provided an incentive for U.S. lenders to make otherwise uneconomical foreign loans, rather than domestic loans, in order to obtain a tax benefit. In addition, Congress was concerned that these cross-crediting opportunities might have encouraged foreign countries seeking to attract U.S. capital to increase, rather than decrease, withholding tax rates.*

A securities firm generally derives high withholding tax interest from its active business (e.g., on inventories of securities held in foreign subsidiaries for sale to foreign customers and for trading in local markets) and thus, by definition, earns such income as financial services income. A securities firm cannot choose whether or not to deal in particular debt securities on the basis of the withholding rate that applies to interest payments; in order to compete effectively in foreign markets, a U.S. securities firm must deal in the securities that its customers wish to buy and sell. Moreover, unlike a financial institution making a direct loan to a foreign borrower, a securities firm dealing in foreign-issued debt securities cannot pass the economic burden of high withholding tax rates through to the underlying issuer. Thus, high withholding rates do not have the same incentive effects for U.S. securities firms that they might otherwise have for non-securities businesses, and the policy concerns underlying the separate limitation for high withholding tax interest do not apply with respect to U.S. securities firms.

Further, the effect of the separate limitation for high withholding tax interest is that income earned from the purchase and sale of a foreign-issued debt instrument is divided into two separate limitation categories. For example, if a U.S. securities firm buys and sells Italian government bonds, any interest income earned on those bonds will fall in the high withholding tax interest basket, while any gain or loss realized on sale of the bonds will fall in the financial services basket. As a result, foreign tax credits attributable to the interest earned on the bonds cannot be used to reduce U.S. tax imposed on foreign source

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* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pp. 864-865.

gain from sale of the bonds, even though the interest income and the gain are both components of the total profit realized by the securities firm on the purchase and sale of the bonds.

There is no tax policy reason to separate the income earned by a securities firm from a single business transaction into different baskets for foreign tax credit limitation purposes. More generally, there is no policy reason to subject the active business income of a U.S. securities firm to more than one foreign tax credit limitation. Therefore, the definition of financial services income should be amended to include high withholding tax interest derived by securities firms in the active conduct of a securities business.

b. Commodities Income. A second type of income earned by securities firms that may be excluded from the definition of financial services income is active income from a commodities business (e.g., dealing in commodity derivatives). Under existing law, neither the Code nor the regulations under Code section 904(d) mention commodities income in defining financial services income. The commodities business is closely related to the securities business conducted by U.S. securities firms, and there is no policy reason that foreign taxes paid on the income from one business should not be creditable against U.S. tax on income from the other. Therefore, the definition of financial services income should be amended to clarify that it includes income from the active conduct of a commodities business by a group of companies which earns predominantly financial services income.

2. Allocation of U.S. Interest Expense

As described above, much of the foreign source income generated by U.S. securities firms is earned in countries with tax rates that are comparable to or higher than U.S. income tax rates. The Code imposes significant limitations, however, on the ability of U.S. securities firms to credit the full amount of foreign tax paid by foreign subsidiaries against U.S. tax liability arising from an actual or deemed repatriation of foreign income. By contrast, many non-U.S. financial institutions benefit from an "exemption" system, under which their home countries do not tax income earned outside the home country; others reside in countries that do not restrict the use of foreign tax credits to the same degree as the United States. As a result, U.S. securities firms effectively bear a higher rate of taxation on foreign source income than do non-U.S. financial institutions competing in the same markets.

A principal reason for the inability of U.S. securities firms to utilize foreign tax credits is the rules of Code section 864(e) and the regulations thereunder that govern the allocation of interest expense in determining the foreign tax credit limitation. As discussed above, the Code generally limits the foreign tax credit to the U.S. tax on net foreign source income. To compute this limitation, the taxpayer must allocate deductions for interest (and other expenses) between gross income from U.S. sources and gross income from foreign sources; this allocation permits the taxpayer to compute net taxable income from foreign sources.

The existing rules governing the allocation of interest expense reflect the general principle that money is fungible. Thus, these rules treat an affiliated group of U.S. corporations as a single entity and require that the aggregate interest expense of such a group be allocated to U.S. and foreign source income based on the relative values of the U.S. and foreign assets of the group. In other words, these provisions assume that funds borrowed by any

member of a U.S. affiliated group may support the U.S. and foreign assets of the group as a whole, and that the identity of the actual borrower or the purported use of the funds is not relevant in determining the relationship between interest expense and the gross income of the group.

The interest allocation rules are problematic for all U.S. multinational corporations, because they require the allocation of interest expense to foreign source income (whether derived by a branch or a subsidiary), even where the proceeds of U.S. borrowings are invested in the United States (and not, for example, re-loaned or contributed to a foreign subsidiary). The foreign country in which the income is earned, however, does not treat any part of the interest expense incurred by a U.S. corporation as deductible in determining the foreign tax due on that income. As a result, a U.S. taxpayer's foreign tax liability will be measured by reference to a higher amount of net foreign source income than the taxpayer's U.S. tax liability on the same net foreign income. In other words, for U.S. tax purposes, net U.S. source income is effectively increased, and net foreign source income is effectively reduced. The effect of this reduction in foreign source income is to reduce the taxpayer's foreign tax credit limitation, and thus its ability to use foreign tax credits.

The effects of the interest allocation rules are exacerbated by the fact that the interest expense of a U.S. affiliated group must be allocated by reference to all of the assets held by members of the group, including the stock of foreign subsidiaries. In effect, the interest expense allocation rules treat the U.S. group as incurring debt in part to invest in the stock of foreign subsidiaries, rather than to support assets that generate U.S. source income. In this sense, the interest allocation rules effectively assume that U.S. securities firms fund their foreign operations by borrowing in the United States and making capital contributions to foreign subsidiaries, without taking into account the level of direct borrowing by those subsidiaries. In other words, a U.S. multinational corporation must apportion some of its domestic interest expense to stock in foreign subsidiaries, notwithstanding that foreign source dividends received (or deemed received) from such subsidiaries have already been reduced by the expenses of those subsidiaries, including interest expense. While this rule affects all U.S. multinational corporations, it is particularly onerous for U.S. securities firms which must maintain high amounts of leverage.

In the case of a U.S. securities firm, regulatory oversight and market realities preclude the use of debt incurred by one member of a worldwide group to support the operations of another member with the same flexibility that may be available to members of a non-financial group. Both the U.S. Securities and Exchange Commission and U.S. rating agencies discourage U.S. securities firms from establishing unregulated holding companies to borrow funds for making equity investments in regulated subsidiaries (whether U.S. or foreign). This practice, referred to as "double leverage", is considered to expose the U.S. firm to the risk that funds needed to pay down its debt will be trapped in a subsidiary, due to regulatory restrictions on distributions that would reduce the regulatory capital of the subsidiary.

A securities dealer typically finances its day-to-day operations at a much higher level of leverage than a non-financial business (e.g., a 20:1 or 30:1 debt-equity ratio, rather than a 1:1 or 2:1 ratio). Thus, the negative impact of the allocation of domestic interest expense against foreign source income is greatly exacerbated in the case of U.S. securities firms. Moreover, much of this leverage is attributable to the securities dealer's business

need to carry and finance an enormous volume of inventory. For example, it is not unusual for a U.S. government securities dealer to borrow up to 99% of the value of the government securities in which it makes a market. The cheapest and most efficient sources for inventory financing are secured borrowings in local markets, collateralized by the inventory securities that trade in the local market. In the case of a foreign subsidiary, funding in a local currency also provides a hedge against the value of local-currency securities. Nevertheless, despite the clear use of these borrowings to finance inventories of securities, the interest allocation rules treat the borrowings of U.S. broker-dealers as incurred in part to make equity investments in foreign subsidiaries, and completely disregard the fact that those foreign subsidiaries have incurred their own indebtedness to finance their own securities operations. There is thus a fundamental contradiction between the premise of funding flexibility underlying the interest expense allocation rules and the actual constraints on the funding of the members of a U.S. securities firm's worldwide group.

In summary, the interest allocation rules impose a much higher cost on U.S. securities firms than on other U.S. taxpayers, because the foreign tax credit limitation of the former is more severely reduced. These rules are also anti-competitive, in that foreign securities firms do not face similar exposure to double taxation of foreign source income. The interest allocation provisions should at the least be modified to take into account the high leverage typical of the securities industry and the non-fungibility of the interest expense incurred by a securities group. SIA recognizes that solutions to these issues that work fairly across a wide range of business organizations are not easy to develop, and we would be pleased to work with the Committee and its staff on reform of the current rules.

SIA appreciates this opportunity to present testimony to the Committee. We would be pleased to respond to questions or provide any additional information that would be helpful to the members of the Committee.

THE SOUTHLAND CORPORATION
2711 N. Haskell Avenue
Dallas, Texas 75204-2906

July 27, 1995

Statement of
The Southland Corporation
Before the
Committee on Ways and Means
United States House of Representatives

Prepared for Hearings on
Miscellaneous Tax Proposals
July 11 and 12, 1995

The Southland Corporation and its nearly five thousand 7-Eleven stores nationwide, of which three thousand are operated by local franchisees, is grateful for the opportunity to submit this statement with respect to several of the miscellaneous tax reform proposals considered by the Committee on Ways and Means in its hearings on July 11 and 12, 1995.

Southland commends the Chairman and the Members of the Committee for taking the time to consider these miscellaneous tax reforms during this busy legislative year. While the provisions we are commenting on are relatively small compared to some of the major issues before the Committee, each is particularly important to Southland and to other similarly situated taxpayers.

I. PERMIT TAXPAYERS TO ESTIMATE SHRINKAGE FOR INVENTORY ACCOUNTING

Although not discussed in the Joint Committee on Taxation's description of this proposal, we submit one of the major reasons in support of its adoption is the fact that allowing taxpayers to estimate shrinkage would be consistent with what is now permitted under generally accepted principles of accounting. In this case, as in many others, we submit that there is no reason why tax accounting should not follow generally accepted accounting principles.

Furthermore, allowing taxpayers to estimate shrinkage for inventory accounting purposes would provide a small easing of the administrative burdens of inventory accounting on companies such as ours, with no particular effect on the tax system.

2. TAX CREDIT AND TAX EXEMPT FINANCING FOR ENVIRONMENTAL REMEDIATION EXPENSES

Because of the lack of adequate financial incentives to encourage taxpayers to meet this Nation's environmental goals, we urge the Committee to adopt this proposal to create a twenty-five percent credit for costs incurred in remediating environmental hazards in areas designated by the Department of Housing and Urban Development and Agriculture. While the limited guidance issued by the Internal Revenue Service permitting taxpayers to expense certain environmental remediation costs is helpful, a great deal more is needed.

As the Committee knows, environmental cleanup is a costly and complex issue, requiring a major commitment of public and private sector resources. The proposal to create a new business credit to encourage remediation would help significantly to achieve

two important public goals.

First, to assist taxpayers to continue to make a commitment towards environmental remediation by providing an economic incentive through the tax system. Over the years, tax credits have been used to encourage a variety of important public goals such as worker training, capital investment, production of new and better fuels, and to encourage the development and production of new technologies. It seems with our Nation's dedication to restoring and protecting the environment a tax credit in this area would be appropriate.

Second, by basing the credit on the designation of specific geographical areas public goals can be established to restore areas which are in great need of environmental remediation. We believe designation to participate in the environmental remediation credit program may help areas attract new business and expand stagnant populations.

Environmental cleanup is a major National goal, and we submit that the federal government would go a long way towards meeting that goal by establishing ways within the tax system to encourage and assist taxpayers to devote resources towards environmental cleanup.

The proposed legislation would help in this regard.

III. ESTABLISH A 15-YEAR RECOVERY PERIOD FOR SMALL RETAIL MOTOR FUEL OUTLET STORES

For some time we at Southland and other members of the convenience store industry have advocated the adoption of legislation which would provide a 15-year recovery period for property used in the marketing of petroleum products, without regard to the current IRS limitations which allow 15-year recovery only where (1) 50 percent or more of the gross revenues are derived from gasoline sales and (2) 50 percent or more of floor space in the building area is dedicated to petroleum marketing.

The current formula for cost recovery in this area has been unfair in that it has led to special cost recovery treatment for facilities built by major oil companies encompassing both gasoline stations and small food stores, but has kept many convenience stores with gasoline station facilities from being eligible for 15-year recovery.

By and large Southland's convenience store and gasoline selling facilities are very similar to those created by the major oil companies and perform the same basic functions. We submit that basic fairness demands a level playing field in this area.

The proposal would set that level playing field, and permit real competition to take place without interference from the tax system.

IV. ESTABLISH 10-YEAR RECOVERY PERIOD FOR COMMERCIAL IMPROVEMENT PROPERTY AND FOR CERTAIN LEASEHOLD IMPROVEMENTS

These proposals in our estimation would restore a measure of simple common sense to the depreciation system in that they are consistent with the practical realities relating to improvements.

The current cost recovery rules requiring a 39-year recovery period for additions or improvements to commercial real estate are out of touch with new technologies in the fast paced commercial markets. Many of the additions or improvements which Southland installs in renovating its convenience stores, including electrical work, wall and floor coverings, ceilings, and lighting, clearly do not, and in many cases, cannot as a practical matter last anywhere near the 39-year recovery period required under current law.

The ten-year period contemplated by the proposed legislation is more in keeping with the projected useful life of the improvements we have been making to our stores. By enacting this legislation, convenience stores will be encouraged to make more improvements and be able to compete more effectively in the marketplace.

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The enactment of these four provisions would have a significant positive impact on our industry, and help us to compete in an increasingly diverse economy. We once again are grateful to the Committee for its attention to issues of importance to us, and hope that the Members will agree to adopt these provisions as part of tax legislation this year.

RESPECTFULLY SUBMITTED,

THE SOUTHLAND CORPORATION
Paul L. Bureau, Jr.
Vice President Corporate Tax
214-828-7162

TESTIMONY OF OLDAKER, RYAN & LEONARD
AND
SKADDEN, ARPS, SLATE, MEAGHER & FLOM

Thank you for allowing us to submit written testimony expressing the need to clarify through legislation that Subpart F income realized by a tax-exempt entity from a controlled foreign corporation ("CFC") is not appropriately classified as gross income from an unrelated trade or business for federal income tax purposes.

We represent a number of tax-exempt organizations and institutions who are interested in clarifying the tax treatment of investments in foreign corporations by tax-exempt organizations and U.S. pension funds. The ambiguity currently underlying this area of the tax law has had a stifling effect on business investment decisions by charitable and social organizations and has caused unnecessary costs and uncertainty.

Although in taxpayers' view this treatment represents existing law, conflicting guidance from the Internal Revenue Service (the "Service")combined with unsuccessful legislative proposals to modify existing law have introduced a level of uncertainty into this previously settled area of the tax law. These actions have caused investor confidence regarding these investments to be undermined, resulting in a growing reluctance to make investments in foreign entities. This clearly distorts otherwise market-driven decisions and is contrary to economic efficiency arguments often espoused by Congress and the Administration.

Our proposed clarification should not have any impact on federal revenue. It simply confirms that Subpart F income is treated in the same manner as accelerated or constructive dividends in the hands of tax-exempt investors. As such, the tax treatment of this income is no different than other dividends earned by tax-exempts.

Background: Tax-exempt entities are subject to United States tax under section 511 on their "unrelated business taxable income" ("UBTI"), which consists generally of gross income from an unrelated trade or business (including "unrelated debt-financed income") minus allowable deductions. Tax-exempt entities are subject to tax on UBTI attributable to "debt-financed property" (e.g., dividends paid on stock acquired with borrowed funds) and on gross income attributable to a "trade or business" that is both "regularly carried on" and unrelated to the organization's exempt purpose. Section 512(b) sets forth several types of income that are generally not treated as giving rise to UBTI when realized by a tax-exempt entity unless leverage is involved; these include dividends, interest, gains on dispositions of property other than inventory, real property rents, and royalties.

Section 512(b)(13) provides that each of these types of income other than dividends realized by a tax-exempt entity and attributable to payments made or to be made to that tax-exempt entity by a "controlled organization" is treated as gross income from an unrelated trade or business to the same extent as if that income had been realized directly by the tax-exempt entity. Under section 512(b)(13), a controlled organization is any corporation controlled by a tax-exempt entity, and "control" for this purpose requires direct ownership of at least 80% of the total combined voting power of the controlled organization and at least 80% of all shares of its nonvoting stock.

The rationale for the controlled organization rule is to prevent tax-exempt entities from avoiding the entity level of taxation on the business income of controlled subsidiaries by stripping income out of these subsidiaries through deductible payments to the tax-exempt entity parent. Because dividends are not deductible (and therefore can be paid only with after-tax dollars), dividends paid by the controlled subsidiary to its parent do not generate UBTI unless subsidiary stock held by the parent is debt-financed.

Treatment of Subpart F inclusions under current UBTI rules: Under Subpart F, a "United States shareholder" of a CFC is subject to United States income tax, on a flow-through basis, on its share of the "Subpart F income" of the CFC. Historically, the Service has taken the position that Subpart F income realized by a tax-exempt entity as a result of its direct or indirect ownership of an interest in a CFC constituted a constructive dividend.[1] As dividends are excluded from UBTI under section 512(b)(1), this Subpart F income is also not classified as UBTI.

In one private letter ruling on this issue (PLR 9043039 (July 30, 1990)), however, the Service departed from its established position and held that Subpart F income should be treated as UBTI to the extent that the income would constitute UBTI if received directly by the tax-exempt entity. The ruling concluded, however, that the Subpart F inclusions did not constitute UBTI because the CFC's income consisted of interest, dividends and other non-UBTI income and gains. The ruling gave no indication of why the Service elected to apply a

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[1] See, e.g., PLRs 9027051 (April 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), and 8819034 (February 10, 1988).

different rationale from that established in its previous private letter rulings.

Over three years later, the Service issued a private letter ruling consistent with the several rulings issued before PLR 9043039. In PLR 9407007 (November 12, 1993) after an analysis of facts similar to those presented in PLR 9043039, the Service concluded that Subpart F income received by a tax exempt organization from its CFC would be treated "as if it were a dividend" which was entitled to the exclusion from UBTI provided by section 512(b)(1) and 512 (b)(13). Since PLR 9407007 was issued, the Service has released no additional guidance (public or private) on this issue.

Prior Legislative Efforts: Adding to the uncertainty in the treatment of these international investments are the attempts by former Congresses to adopt a rule that would have made all Subpart F income earned by a tax exempt entity subject to UBTI, even when the entity held was not considered a "controlled organization" under section 512(b)(13).[2] Because the proposal is contrary to all of the Service's specific guidance in the area -- other than the one private revenue ruling cited above -- the Joint Committee on Taxation treated the proposal as a change to existing law and estimated that it would raise $98 million over 5 years. This proposed change met with significant opposition and was not acted upon by the Senate.

The Clarification: The clarification we are seeking would *explicitly* state that Subpart F income inclusions are no more than accelerated dividends in the hands of tax-exempt investors. As such, the tax treatment of such income is no different than other dividend income earned by tax exempts.

Consistent and appropriate tax policy supports this clarification. Subpart F income is a "deemed dividend" to the shareholder recipient from a CFC. Subpart F treats -- and taxes -- the shareholder as if that shareholder received an actual dividend from that CFC. The purpose behind the Subpart F regime is not to extract a U.S. tax on the underlying income earned by the CFC. Rather, the purpose behind the Subpart F regime is to end the deferral of tax otherwise permitted by delaying the imposition of the U.S. tax until an actual dividend is

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[2] See, e.g., Section 901 of the Tax Simplification and Technical Corrections Act of 1993, (H.R. 3419) which was passed by the House on May 17, 1994; Section 11408 of H.R. 3299, which was passed by the House in 1989. Neither bill was passed by the Senate.

paid. Because tax-exempt entities will not pay a tax on the dividend when it is actually paid, there is no tax policy reason to impose this accelerated tax on such entities.

Moreover, a contrary result, such as treating Subpart F income as UBTI, would cause great hardship to tax-exempt investors. The Subpart F rules require U.S. shareholders to include in income the portion of the underlying CFC's income that is attributable to certain categories of income. The shareholder must include these amounts in income even though they receive no dividend or actual proceeds with which to pay the tax. Thus, the treatment of Subpart F income as UBTI would force tax-exempt entities, which do not have any control over the CFCs in which they invest, to pay tax on the income that they do not receive -- even though they have no ability to make the CFCs provide the funds with which to pay the tax. Again, because the treatment of Subpart F income as UBTI would even apply to small investments, it would impose a significant cash-flow hardship on these investments, ultimately affecting negatively the resources available for charitable giving and other tax-exempt purposes.

From a policy perspective, the Tax Code should not impair the efficient flow of capital within global markets. Tax exempt entities routinely raise funds for future capital improvements and must invest the contributions they receive to augment their ability to pay for these improvements. Because investments in assets which produce UBTI severely reduce the return on investment and create increased administrative burden, tax-exempt entities avoid these investments. To the extent the treatment of investments in CFCs is in doubt, the tax-exempt community is likely to avoid these investments altogether. Such uncertainty artificially and unnecessarily reduces the investment opportunities otherwise available to these organizations and inhibits their ability to generate funding for their tax exempt purposes.

The clarification of the treatment of Subpart F income as not giving rise to UBTI would allow tax exempt entities to continue to make investments in the most efficient way possible. Without this clarification, charities, pension funds and other tax-exempt entities are forced either to avoid these investments altogether or to face the threat of a costly tax dispute.

Summary: The clarification that Subpart F income of CFCs realized by tax-exempt organizations is not treated as UBTI for federal income tax purposes is

consistent with both sound principles of tax policy and the tax treatment historically accorded this type of tax-exempt income. The ambiguities currently underlying this issue continue to negatively affect the ability of tax-exempt organizations to invest and generate funds for their tax-exempt purposes.

This clarification has broad support within the tax-exempt community. We hope the Committee will carefully consider it as tax legislation moves through Congress this year.

PACIFIC MUTUAL

July 26, 1995

ROBERT G. HASKELL
Senior Vice President
Public Affairs

Mr. Philip D. Moseley
Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

I hereby request that the attached materials be added to the official printed record for the "Miscellaneous Tax Reform" hearing held by the Committee on Ways and Means July 11, 12 and 13, 1995. If necessary, the clarification requested below could be categorized as "Possible Modifications to Simplification Provisions Contained in H.R. 3419 (103rd Congress)" as listed in the Committee Advisory.

The technical clarification described herein relates to proposed Code section 817A, as included in H.R. 3419. The intent of proposed Code section 817A has been to provide appropriate tax treatment of insurance companies issuing "modified guaranteed contracts" (MGCs). Specifically, the attached clarification would make clear that section 817A is the controlling provision as to the MGC portion of a variable contract. This clarification is considered non-controversial.

Please direct any questions about the attached submission to Peter Pastre, Director of Government Relations, Pacific Mutual at (714) 640-3221.

Sincerely,

Robert G. Haskell

Encls: (1) Brief description of clarification sought
(2) Specific language
(3) Language added to underlying proposal in H.R. 3419

cc: Paul Auster, Assistant Tax Counsel, Ways and Means Committee
Cecily Rock, Legislation Counsel, Joint Committee on Taxation
Mildeen Worrell, Minority Tax Counsel, Ways and Means Committee

Pacific Mutual Life Insurance Company
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Clarification for Variable Contracts with Modified Guaranteed Contract Option

BACKGROUND

A "Modified Guaranteed Contract," or MGC, is an annuity, life insurance or pension plan contract that credits a guaranteed rate of interest on the policy but provides for an interest rate adjustment in the event the policyholder surrenders before the end of the guarantee period. Such guarantees are not only appealing to policyowners who seek to provide for their long-term life insurance and retirement needs because they involve better interest rates, but also assist insurance companies in maintaining financial stability. Proposed Code section 817A was included in H.R. 3419, which passed the House in 1994, and in the Revenue Act of 1992 (H.R. 11), which passed the House and the Senate in 1992. The intent of proposed Code section 817A is to provide appropriate tax treatment of insurance companies issuing MGCs. It would require mark-to-market tax accounting for assets underlying MGCs where the assets are held by the insurance company in a separate account. This would result in better matching the issuing company's income with its reserve deductions.

The section 817 variable contract rules apply to a contract that may be allocated in part to variable separate accounts and in part to a fixed income option from the general account. In such case, the special capital gain and reserve rules in section 817 only apply to the portion of the contract allocable to the variable separate accounts. A variable contract with an MGC option merely offers another option analogous to the fixed income account.

PROPOSED CLARIFICATION

It is unclear how section 817A would apply to variable contracts described in section 817 that have an MGC separate account option. The attached new section 817A(f) would be added to clarify that when a variable contract offers an MGC separate account option, the section 817 rules do not apply to the MGC portion of the variable contract, as they do not apply in the case of a fixed income account. Rather, the section 817A accounting rules would apply to the portion of the contract allocated to an MGC separate account.

Proposed Amendment to Section 817A for Variable Contracts

"(f) Coordination with Section 817.--

"A variable contract which permits a policyowner to allocate amounts to an account described in subsection (d) shall be treated as a variable contract which, with respect to the portion of the contract so allocated, shall be governed by the rules of this section."

SEC. ___. TREATMENT OF MODIFIED GUARANTEED CONTRACTS.

(a) General Rule. -- Subpart E of part I of subchapter L of chapter 1 (relating to definitions and special rules) is amended by inserting after section 817 the following new section:

"SEC. 817A. SPECIAL RULES FOR MODIFIED GUARANTEED CONTRACTS.

"(a) Computation of Reserves. -- In the case of a modified guaranteed contract, clause (ii) of section 807(e)(1)(A) shall not apply.

"(b) Segregated Assets Under Modified Guaranteed Contracts Marked to Market.--

"(1) In general. -- In the case of any life insurance company, for purposes of this subtitle --

"(A) Any gain or loss with respect to a segregated asset shall be treated as ordinary income or loss, as the case may be.

"(B) If any segregated asset is held by such company as of the close of any taxable year --

"(i) such company shall recognize gain or loss as if such asset were sold for its fair market value on the last business day of such taxable year, and

"(ii) any such gain or loss shall be taken into account for such taxable year.

Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under the preceding sentence. The Secretary may provide by regulations for the application of this subparagraph at times other than the times provided in this subparagraph.

"(2) Segregated asset. -- For purposes of paragraph (1), the term 'segregated asset' means any asset held as part of a segregated account referred to in subsection (d)(1) under a modified guaranteed contract.

"(c) Special Rule in Computing Life Insurance Reserves. -- For purposes of applying section 816(b)(1)(A) to any modified

guaranteed contract, an assumed rate of interest shall include a rate of interest determined, from time to time, with reference to a market rate of interest.

"(d) Modified Guaranteed Contract Defined. -- For purposes of this section, the term 'modified guaranteed contract' means a contract not described in section 817 --

"(1) all or part of the amounts received under which are allocated to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company and is valued from time to time with reference to market values,

"(2) which --

"(A) provides for the payment of annuities,

"(B) is a life insurance contract, or

"(C) is a pension plan contract which is not a life, accident, or health, property, casualty, or liability contract,

"(3) for which reserves are valued at market for annual statement purposes, and

"(4) which provides for a net surrender value or a policyholder's fund (as defined in section 807(e)(1)).

"(e) Regulations. -- The Secretary may prescribe regulations--

"(1) to provide for the treatment of market value adjustments under sections 72, 7702, 7702A, and 807(e)(1)(B),

"(2) to determine the interest rates applicable under sections 807(c)(3), 807(d)(2)(B), and 812 with respect to a modified guaranteed contract annually, in a manner appropriate for modified guaranteed contracts and, to the extent appropriate for such a contract, to modify or waive the applicability of section 811(d),

"(3) to provide rules to limit ordinary gain or loss treatment to assets constituting reserves for modified guaranteed contracts (and not other assets) of the company,

"(4) to provide appropriate treatment of transfers of assets to and from the segregated account, and

"(5) as may be necessary or appropriate to carry out the purposes of this section.

"(f) Coordination with Section 817.-- A variable contract which permits a policyowner to allocate amounts to an account described in subsection (d) shall be treated as a variable contract which, with respect to the portion of the contract so allocated, shall be governed by the rules of this section."

(b) Clerical Amendment. -- The table of sections for subpart E of part I of subchapter L of chapter 1 is amended by inserting after the item relating to section 817 the following new item:

"Sec. 817A. Special rules for modified guaranteed contracts."

(c) Effective Date. --

(1) In general. -- The amendments made by this section shall apply to taxable years beginning after December 31, 1992.

(2) Treatment of net adjustments. -- In the case of any taxpayer required by the amendments made by this section to change its calculation of reserves to take into account market value adjustments and to mark segregated assets to market for any taxable year --

(A) such changes shall be treated as a change in method of accounting initiated by the taxpayer,

(B) such changes shall be treated as made with the consent of the Secretary, and

(C) the adjustments required by reason of section 481 of the Internal Revenue Code of 1986 shall be taken into account as ordinary income or loss by the taxpayer for the taxpayer's first taxable year beginning after December 31, 1992.

AMERICAN CEMETERY ASSOCIATION
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July 12, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Miscellaneous Revenue Proposals – Pre-need Funeral Trusts, July 11-12, 1995

Dear Mr. Moseley:

We appreciate the opportunity to comment for the record on one of the proposals contained in the Joint Committee Print: Description of Miscellaneous Tax Proposals Scheduled for Hearings before the House Committee on Ways and Means on July 11-13, 1995 (JCS-19-95). The proposal on which we will comment appears in Section II. 9. of the Joint Committee Print. It relates to the federal income tax treatment of income earned by pre-need funeral trusts.

The American Cemetery Association (ACA) consists of approximately 2,000 cemeteries and funeral homes, located in all states but one. In other words, many ACA members operate funeral homes as well as cemeteries and provide pre-need funeral arrangements to the public. We believe the tax treatment of pre-need funeral trusts is badly in need of a fresh look.

As you know, in a pre-need funeral arrangement, an individual (the "Purchaser") and a funeral home (the "Seller") enter into a contract. The Seller agrees to provide specified funeral goods and services upon the Purchaser's death, and the Purchaser agrees to make a payment or series of payments in fixed amounts. That is, the Purchaser pays in advance, and the Seller agrees to provide a specified funeral when needed at an agreed price.

Pre-need funeral contracts are governed by statute in nearly all states. Under most state laws, the Seller must deposit most or all of the Purchaser's payments (the "Corpus") into a trust. Under some state laws, income earned on the Corpus must be accumulated in the trust. In other states, some or all of the income may be distributed to the Seller, or the Seller may be entitled to a periodic administrative fee out of this income. (As far as we know, no state law contemplates income distributions to the Purchaser while the contract remains in force.) The cost of pre-need funerals is almost always less than $5,000, and so the Corpus of an individual pre-need trust is almost always relatively small. Thus, Sellers typically combine the Corpus of numerous pre-need trusts into commingled "master trust," sometimes having thousands of constituent individual trusts.

Assuming the contract is in force at the time of the Purchaser's death, the Seller provides the funeral and is paid the agreed price out of the Corpus and accumulated income of the trust. State laws vary, but, in general, the Seller ultimately is entitled to receive all of the Corpus and all the accumulated income from the trust.

In late 1987, the Internal Revenue Service ruled that, in most situations, income earned by a pre-need funeral trust is taxed to the Purchaser, as the income is earned, Rev. Rul. 87-127, 1987-2 C.B. 156. The Service applies this treatment even where the Purchaser is never entitled to receive any trust income. (Along with the Corpus, the accumulated income is taxed again to the Seller as ordinary income, when the Seller provides the funeral and receives payments from the trust.)

Under Rev. Rul. 87-127, small amounts of investment income are taxed to many thousands of pre-need Purchasers, even though these Purchasers never receive or benefit from this income. Many of these Purchasers are elderly and unsophisticated. It is our impression that most of them are low-income or moderate-income individuals, and that many are not required to file federal income tax returns.

Apart from unfairness to the Purchasers, the current system imposes a significant and unwarranted administrative burden on pre-need Sellers and trustees. Under the Rev. Rul. 87-127, pre-need trust income must be reported to the Purchasers, so that the Purchasers, in turn, can report the income on their individual returns. The Service takes the position that each pre-need funeral trust is a separate grantor trust and must file its own Form 1041, Tech. Adv. Mem. 9140006 (June 26, 1991). Obviously, such a reporting system is expensive, especially in relation to the amount of income reported. Even less elaborate reporting methods require Sellers to prepare and mail thousands of Forms K-I or 1099, each reporting a small amount of income to a Purchaser. Recently, the Service has proposed to simplify reporting by grantor trusts. Proposed Reg. §§ 1.671-4 and 301.6109-1(a)(2), 59 Fed. Reg. 37456 (July 22, 1994). Many in our industry believe, however, that even the proposed changes would leave in place an unnecessarily complex and expensive system of reporting pre-need trust income.

This situation does not benefit Purchasers, Sellers or the Federal Treasury. Little tax is collected; much paperwork is generated; and large numbers of individual taxpayers are adversely, and, in our view, unfairly affected.

Accordingly, we support the staff's interest in revisiting pre-need trust taxation. We believe major improvements in both fairness and simplification can be achieved in a revenue-neutral manner. To this end, we will be pleased to provide any information that you think would be helpful and to provide assistance in developing legislation that the industry and the Service can administer, in harmony with state law requirements and industry practice.

Very truly yours,

Stephen L. Morgan
Executive Vice President

SLM:mws

cc: Timothy C. Hanford
Professional Assistant
Tax Staff
Committee on Ways and Means
1135 Longworth House Office Building
Washington, DC 20515

This written statement is submitted for the record to the House Ways and Means Committee solely on behalf of the American Cemetery Association and its members.

by ______________________

Stephen L. Morgan
Executive Vice President
American Cemetery Association

Comments On Miscellaneous Tax Reform

by

American Society of Pension Actuaries

July 27, 1995

The American Society of Pension Actuaries (ASPA) is pleased to submit its comments on the important topic of pension simplification addressed in the Joint Committee on Taxation Staff Description (JCS-19-95) of Miscellaneous Tax Proposals that were the subject of hearings before the House Ways and Means Committee.

ASPA is an organization of approximately 3,000 members who provide actuarial, consulting and administrative services to nearly one-third of the qualified plans in the United States, primarily the "small plan" market. ASPA's members have great interest in the proposed pension simplification bills. As should be evident throughout these comments, ASPA strongly supports legislation which will reduce the regulatory and administrative burden on sponsors of qualified plans. We commend the members for their demonstrated commitment to simplifying this important part of the law and focusing the attention of Congress on the critical need to expand pension coverage.

The extreme complexity of our pension laws has been a significant factor in retarding planned savings for retirement, particularly with respect to small business. Time is now of the essence to enact legislation which will provide an opportunity for all working Americans to obtain financial security at retirement.

Action is needed now to avert the looming retirement income crisis

As a group of professionals intimately involved in the operation of plans sponsored by smaller employers, we can assure you that the problems in that sector are acute—there is a looming retirement crisis unfolding in this country and prompt and effective legislation is desperately needed.

In particular, four elements have converged to create this crisis:

1) The baby boomer population bubble is moving inexorably toward retirement age.

2) Private savings in the United States have almost disappeared.

3) Statistics reveal a startling exodus of employees from qualified plans.

4) In the absence of major changes, our Social Security system is headed for bankruptcy.

During the years 2011 through 2030, the largest ever group of Americans will reach retirement age. Without a change in policy or practice, many of this group will find themselves without the resources to be financially secure in retirement. Coverage under qualified retirement plans has dropped. Most pension practitioners will tell you that the constantly changing regulatory environment has created more complexity than most employers are willing to bear. The problem has affected small companies most severely—they have less resources to pay the compliance costs and must spread those costs over fewer employees. During the early decades of the next century, the ratio of workers to

retirees will be lower than it is today. The shrinking ratio of workers paying Social Security taxes to those drawing benefits makes it likely that future retirees will have to rely more on individual savings and private pension plans and less on Social Security. A generational economic conflict is inevitable unless immediate action is taken.

Personal savings is a vital component to economic security for individuals and economic productivity for our country. Our nation's future depends on saving today. The government, employers, and workers each play a crucial role in achieving this goal.

Pension simplification is needed

Since ERISA was enacted in 1974, a number of revenue acts have amended the retirement plan provisions of the Internal Revenue Code. Since 1980, an average of one law per year has been enacted to change the rules governing private pension plans. Unfortunately, the myriad of legislative changes in this area may have raised immediate revenue at the expense of private pension system and ultimately the retirement security of the American worker himself.

Pension simplification is a practical response to the pervasive crisis overburdening the system that is so vital to the financial security of millions of Americans. Simpler rules would enhance the viability of our nation's private pension system and significantly increase access to the private pension system by millions of workers who are not currently covered. Indeed, although almost 75 percent of workers employed in larger corporations were covered by private pension plans in 1993, less than 25 percent of those employees of smaller companies had an opportunity to participate in a private pension plan.

In most instances, the employment relationship is the best means to create savings programs that promise true delivery—real benefits for American workers. Private pension plan enhancement is good public policy. The current system is sound. Nearly 51 million civilian Americans are covered under more than 900,000 private pension plans. All totaled these private-sector plans hold $3.2 trillion in assets—assets which will stimulate the economy and be available to help American workers' enjoy their retirement years.

ASPA would like to publicly recognize and congratulate those members of Congress who have been consistent advocates of the need for pension simplification over the past several years. Senator Pryor and Representative Archer both included simplification provisions in bill introduced as early as 1991. So too did former Senator Symms and Representatives Rostenkowski and Cardin. Senator Pryor introduced simplification bills again in 1993 and once more in 1995. President Clinton has also joined the movement by proposing pension simplification legislation earlier this year.

There is an urgent need for Congress to make an investment in the private pension system if it is to provide our country's workers with economic security in their retirement years. It's very encouraging to see momentum building for genuine pension simplification, and Congress must now follow through on that momentum and pass a meaningful pension simplification bill for President Clinton's signature. Without intelligent and thoughtful legislation, the present system will continue to falter, and that would be an economic catastrophe for our aging work force.

The existing rules are discouraging the establishment of new plans, encouraging the termination of existing plans, and directing money to the administration of plans and away from plan benefits. We believe that the complexities are resulting in significant unintentional noncompliance. Simpler rules will enhance the viability of our nation's private pension plans. We strongly support the simplification themes that have resurfaced in the proposed legislation: the concepts of safe harbors for 401(k) plans, simplification of the definition of highly compensated employees, elimination of the combined plan limit under 415(e), elimination of the minimum participation rule in 401(a)(26), and repeal of the family

aggregation rules. These are positive, practical solutions that should be enacted.

The expansion of IRA funding vehicles and creation of new so-called "simplified" programs concerns ASPA.

Some proposals seek to expand access to private pension plans and savings opportunities by increasing the availability of SEPs and expanding the use of IRA funding vehicles. ASPA is greatly concerned that some of the proposals overemphasize simplification to the detriment of pension equity and protection. Although SEPs were created in response to the apparent complexity in the pension laws (hence the name "simplified employee pensions"), they are not necessarily simple—just different. SEPs are strange creatures, hybrids of IRAs which may look like qualified plans, but they lack the accountability of qualified plans and are readily subject to abuse.

While many advocate expanded IRAs as a long-term answer to our savings crisis, ASPA feels that the use of IRA funding devices like SEPs may do more harm than good. We have seen a high incidence of abuse in this area. There is no accountability or means of ensuring that the intended benefits are ever achieved. In many cases these programs result in a significant percentage of employees, concentrated in the lower wage levels, receiving no pension benefits. Moreover, the accessibility to SEP/IRA accounts (even if a two-year wait is required) will not ensure that funds will be available for their intended purpose. Unfortunately, participants often deplete SEPs to meet immediate cash needs, leaving those who can least afford it without the means of support after their working years. Intelligent plan design can enable an employer to assure that an employee's retirement savings will be there to provide the financial security the employee will so desperately need when his working years are over. In a qualified plan, participants enjoy the benefits of professional investment management and supervision and enhanced retirement security. Employment-based plans often act as forced savings. Private pension plans, unlike other forms of savings, tend to retain a significant portion of money for the intended purpose: retirement. SEPs and expanded IRAs are really no substitute for a qualified plan.

Additional measures

ASPA cannot state emphatically enough its support for pension simplification. We are committed to that cause. While the proposals reflect years of thinking, we would like to take this opportunity to suggest other pension-law changes which we believe would make it easier for small businesses to realize the benefits offered by qualified plans. These are common-sense changes that do not affect the revenue stream to the federal Treasury to any significant extent. Specifically, we would suggest the following:

1) Eliminate or simplify redundant top-heavy rules, Minimum contribution and benefit requirements should not be applied if the employer is using a safe harbor formula. The existing rules often make a plan unaffordable to small, family owned businesses.

2) Eliminate the summary annual report requirements. This report is complicated and misleading and certainly does not provide the participants any useful information about their benefit.

3) Eliminate the 150 percent full-funding limit of Internal Revenue Code section 412(c)(7). This interferes with logical funding patterns and can result in wide sweeps in the level of contribution from one year to the next.

4) Simplify distribution of QPSA notices. Beneficiary designations and notices regarding death benefit entitlements should be provided to an individual within a reasonable time of eligibility. There is little logic in providing notice only within given time frames (age 32-age 35). This increases the compliance

burden for plan sponsors and is particularly confusing to participants.

5) Use a single definition for key employee and highly compensated employee. This will ease the employer's burden in correctly identifying these individuals.

6) Permit money purchase plans to have a discretionary feature similar to a profit-sharing plan. This would avoid the requirement of maintaining two separate plans where an employer is hesitant to commit to contributing more than 10 percent of pay to a retirement plan but would like the ability to contribute additional funds if profits are available.

7) Simplify distribution rules. Currently there is a required 30-day waiting period for retirement benefits which cannot be waived if a plan provides an annuity option. In this age of direct rollovers, paperless transfers, and 800 numbers, a 30-day delay is often unnecessary, and may be a burden, particularly in hardship situations.

ASPA is pleased to have the opportunity to present its views and stands ready to assist in any way possible to improve or refine this very important initiative.

Statement By Cherokee Nation
In Support of
Section 212 of H.R. 3419, Tax Simplification
on
401(k) Plan Applicability to Tribes

July 27, 1995

It is the position of the Cherokee Nation of Oklahoma that tribal governments and their wholly owned tribal enterprises should have full ability to participate in a cash or deferred pension arrangement qualified under Section 401(k)(4)(B)(ii) of the Internal Revenue Code ("IRC"). Such plans allow build up of equity and retirement in the future by offering workers current savings from tax-deferred contributions. Millions of Americans are enrolled in retirement plans that are funded in whole or in part by elective employee salary contributions, but employees of tribal government currently are denied enrollment. The 1986 Tax Reform Act failed to state explicitly that Indian tribal governments may maintain such plans under section 401(k). As a result of this ambiguity, the argument is made that Indian tribes are tax-exempt organizations and therefore not permitted to offer tax-deferred "salary reduction" retirement plans. Some interpretations of these ambiguous provisions also have given rise to creation of tribal governments' enrollment in tax deferred annuity plans under IRC § 403(b).

The Cherokee Nation's inability to offer a 401(k) tax deferred pension plan as part of its employee compensation package has tremendously hampered the tribe's recruitment program. The impact has been particularly harmful to the tribe's efforts to recruit professional employees. The tribe is unable to stay competitive with other employers which offer such plans.

One of Cherokee Nation's most recent losses was a pediatric ophthalmologist vigorously recruited by the tribe. After many successful negotiating sessions, the tribe nearly signed up this highly qualified physician. What tipped the scales against the doctor's acceptance of the job offer was the tribe's inability to offer a 401(k) deferred compensation retirement plan. Recruiting qualified medical personnel willing to relocate to a remote tribal reservation setting is one of the greatest challenges for tribes today and for many years past. The federal government funds scholarship and other programs through the Indian Health Service to incentivize Native American physicians, nurses and other health care personnel to establish their practices or otherwise service Native American communities. These federally funded recruiting efforts are totally frustrated by one simple problem -- the apparent inability of tribes to offer 401(k) plans to their employees.

Background:

The Cherokee Nation has tried since the late 1980s to secure the right to establish a 401(k) plan for its employees. In response to the tribe's formal request, the Internal Revenue Service responded in a 1989 determination letter that the Cherokee Nation was ineligible because IRC § 401(k)(4)(B)(ii) prohibits organizations that are exempt from taxation under IRC Subtitle A from maintaining cash or deferred arrangements for their employees. The IRS letter took the position that a tribe is a tax-exempt entity for purposes of IRC § 401(k)(4)(B). Three justifications given were IRS Revenue Rulings (Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-1 C.B. 15), the fact that tribes never file bona fide income tax returns, and that tribes are relieved by treaty from filing the requisite exempt organization information report to register their tax-free status annually to the IRS. The fallacy of the IRS position, however, is that Indian tribes are not exempt from taxation under IRC Subtitle A, but actually are non-taxable by virtue of treaties, case law, and the above-referenced IRS rulings.

There is indication that the Congress intended that tribal governments should not be prevented from offering pension compensation plans that other employers enjoy. For example, Congress

passed the Indian Tribal Governmental Tax Status Act of 1982 to allow tribal governments to be treated like state and local governments for certain federal tax purposes. Specifically, IRC § 7871(a)(6)(D) allowed Indian tribes to be treated as states for the purpose of IRC § 403(b)(1)(A)(ii) so that employees of IRC § 501(c)(3) organizations and state public school systems could exclude from income (until received) contributions made by the employer to certain annuity contracts. IRC § 7871, therefore, was designed to allow tribal governments to participate in 403(b) type plans to the extent that they benefit tribal school employees. It could be argued, therefore, that the Congress did not include in IRC § 7871 a reference to IRC § 401(k) plans because tribes were not considered to be a "tax-exempt organization" prohibited by 401(k)(4)(B)(ii) from establishing tax-deferred "salary reduction" retirement plans.

Recommendation:

The Cherokee Nation strongly supports any action that would clarify that tribal governments may offer 401(k) plans, and clear up current widespread confusion over pension eligibility of tribes and their wholly owned tribal enterprises under IRC §§ 401(k) and 403(b). One approach would be a clarification that a tribe is a non-taxable rather than a "tax-exempt" organization and is eligible under IRC § 401(k)(4)(B)(ii) to establish tax-deferred salary deduction 401(k) plans to tribal employees.

Another approach would be enactment of legislation similar to what the House has twice approved that would (1) allow tax exempt organizations to establish 401(k) plans, and (2) clarify that Indian tribes and their wholly owned tribal enterprises can maintain these plans. According to the Joint Committee on Tax, the 401(k) proposal would have only a negligible impact on revenues. One of these bills (HR 11) was passed by the Congress in 1992 but vetoed by President Bush. Last year, the House passed H.R. 3419 which contained in Section 212 of IRC § 401(k)(4)(B)(ii). The House Committee on Ways and Means Report No. 103-353 appropriately explained on page 22 that the purpose of the provision was to ensure that "any organization, including an Indian tribe, previously denied eligibility on the ground that they are a tax-exempt organization (and not because they are a State or local government or agency or instrumentality thereof) is eligible to maintain a cash or deferred arrangement for its employees under the bill."

The Cherokee Nation urges prompt enactment of 401(k) simplification legislation so that tribes can establish 401(k) plans proven to be successful for countless other organizations across the country.

STATEMENT IN SUPPORT OF H.R. 1504,
THE PUBLIC PENSION EQUITY RESTORATION ACT,
ON BEHALF OF

National Conference of State Legislatures
National Association of State Treasurers
National Association of Counties
National Governors' Association
National League of Cities
United States Conference of Mayors
Municipal Treasurers Association
Government Finance Officers Association
National Conference on Public Employee Retirement Systems
American Federation of State, County & Municipal Employees
National Education Association
International Association of Fire Fighters
National Council on Teacher Retirement
National Association of Government Deferred Compensation Administrators
American Federation of Teachers
National Association of Police Organizations
Conference of Chief Justices
Service Employees International Union
National Association of State Retirement Administrators
American Association of Classified School Employees
National Public Employer Labor Relations Association
International Personnel Management Association
National School Boards Association

SUBMITTED FOR THE RECORD

HEARING ON MISCELLANEOUS REVENUE ISSUES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 11-12, 1995

On behalf of state and local governments, public unions, and millions of public employees, retirees, and beneficiaries, the 30 national organizations listed above urge the Ways and Means Committee to act promptly to preserve the tax qualified status of state and local government retirement systems by enactment of H.R. 1504, the §415 Public Pension Equity Restoration Act of 1995. Until Congress acts, public employees' retirement security will continue to be at risk because of the current application of §415 of the Internal Revenue Code to public pension plans.

§415 imposes both dollar as well as percentage-of-pay limits on retirement benefits. It is one of the "qualification" requirements imposed by the tax code that must be observed in order for a pension plan and its participants to be able to utilize the tax deferrals created by Congress to encourage retirement savings. Under §415's rigid rules, a pension of as little as $1,000 a month can nevertheless violate the limits. Furthermore, only one such violation is needed to technically disqualify an entire pension plans.

However, any reduction by a state or local government in benefits, once promised to a participant in a general retirement benefit formula, is prohibited in a broad range of jurisdictions, often as a result of state constitutional restrictions. Thus, public pension plans are presented with an untenable choice: either scale back benefits to cope with §415's limits in order to maintain federal tax qualification -- thus violating many state constitutional "anti-cutback" provisions -- or else comply with the prohibition against impairment of contract, but in so doing risk exceeding the §415 limits and losing federal tax qualified status.

Loss of federal tax qualification would mean that all pension plan participants, both active and retired, would have to take into account income in the year of disqualification all of

their accrued benefits. In addition, the pension trust could have its earnings subjected to federal taxation.

Clearly, public pension plan fiduciaries need to be able to comply with all applicable laws without subjecting state and local governments to the increased costs that would be necessary to maintain promised retirement benefits in the face of tax disqualification or penalties. Public employees also need to know that their pension benefits are safe and secure from unanticipated cutbacks. Finally, the important public policy of encouraging retirement savings needs to be fostered, not thwarted.

That is precisely what H.R. 1504, the §415 Public Pension Equity Restoration Act, is designed to do. It is the product of years of careful work, and has once again been found to have a negligible revenue impact according to the Joint Committee on Taxation in March of this year. It provides a long-term solution that will permit the necessary flexibility for future compliance without the potential for abuse, and has strong, bi-partisan support. For example, H.R. 1504 currently has 28 cosponsors, including 17 members of the Ways and Means Committee (9 Republicans and 8 Democrats). Furthermore, the full House has passed the §415 Public Pension Plan Amendments on three separate occasions, most recently as part of last year's Tax Simplification and Technical Corrections Act (H.R. 3419).

The §415 Public Pension Equity Restoration Act will preserve the ability of public employers and employees, working together, to build and save for a sound retirement future. The national organizations listed above urge you to take all steps necessary to ensure that this critically important legislation becomes law this year.

Contact: Jeannine C. Markoe, Legislative Analyst
Pension & Benefits Center
Government Finance Officers Association
1750 K Street, NW
Suite 650
Washington, DC 20006

202/429-2750

July 27, 1995

TESTIMONY OF THE NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS

Mr. Chairman and members of the Committee on Ways and Means, my name is Kurt Kaboth. I am the Secretary of the YMCA Retirement Fund and Chairman of the Pension Plan Committee of the National Assembly.

The YMCA Retirement Fund provides pension, disability and death benefits to over 47,000 employees of participating YMCAs throughout the United States. All of our employees who work over 1,000 hours a year have a fixed percentage of their pay contributed to our plan. At retirement these contributions and accumulated earnings are converted into lifelong pensions for our employees and their spouses. We are proud of our efforts to support the vital and essential community work done by YMCAs and look forward to your enactment of legislation which will make our work more effective.

I also serve as the Chairman of the Pension Plan Committee of the National Assembly of National Voluntary Health and Social Welfare Organizations, and am pleased to submit this written testimony on Miscellaneous Revenue Issues on behalf of the National Assembly. Some of the nation's largest charitable organizations join me in supporting your efforts to simplify the rules for plan sponsors to administer retirement plans as well as expand the availability of pension plans. The National Assembly represents numerous voluntary human service organizations whose missions focus on America's most precious resource: its people. The Assembly's member organizations are vital employers in the private sector who serve our citizens of all ages, colors and backgrounds throughout the 50 states. A complete list of member organizations is attached as Exhibit A.

The National Assembly's Pension Plan Committee was created in 1978 in response to the enactment of ERISA. The Committee is a voluntary association of the National Assembly's member organizations which maintain retirement programs. The Committee meets regularly to exchange ideas, monitor the pension environment and represent the retirement plans of non-profit organizations. We are pleased to be able to share some of our thoughts about pension simplification. We are encouraged by this first step toward simplification and appreciate the leadership role you have taken in this process.

From our perspective as tax-exempt employers, many of the provisions which were formerly contained in H.R. 3419 that are intended to reduce the costs to plan sponsors of administering retirement plans which were formerly are sorely needed. For example, design-based safe harbors for satisfying testing of contributions to 401(k) plans, and the elimination of the half-year age requirements for calculating plan provisions are straight-forward, common sense changes to help plan sponsors administer their various retirement plans.

One of the most important of the provisions you are now considering for tax-exempt employers is the elimination of the one-officer rule in the definition of highly compensated employee. It is critical that this simplification be enacted before the effective date of the nondiscrimination requirements for tax-exempt employers in 1996, as we discuss further below.

Simplification of complex pension rules will help our organizations in two ways. First, as plan sponsors we can offer our dedicated employees sensible, cost-effective retirement plans without needlessly burdening our administrative staffs. Second, as providers of a vast array of human services, every dollar we can save in mandated administrative or regulatory costs can be translated into a dollar for programs. Every sector of the economy will benefit from pension simplification. But the bottom line for tax-exempt organizations is that simplification will mean more money for their charitable programs and, for our employees, better opportunities to provide for their retirement income needs.

The following will discuss areas of pension simplification that we particularly support and others you may want to consider in addition to those you have previously approved:

Access to 401(k) Plans

The non-profit community is gratified that the Ways and Means Committee intends to finally provide for the availability of cash or deferred arrangements under Section 401(k) of the Internal Revenue Code to tax exempt employers.

The Tax Reform Act of 1986, unfortunately, included a provision that prevented tax-exempt employers from establishing 401(k) plans. Organizations exempt from tax under Code Section 501(c)(3) could continue to offer employees the opportunity to participate in tax deferred annuities under Code section 403(b). However, other tax exempt employers did not have access to cash or deferred arrangements.

Permitting all tax-exempt organizations to maintain qualified cash or deferred arrangements will eliminate the inequities of current law. The design based safe harbor for 401(k) plans that was included in H.R. 3419 would greatly simplify the many complex administrative steps tax-exempt plan sponsors would be required to conduct in order to offer 401(k) plans. We enthusiastically support the safe harbor.

Definition of Highly Compensated Employee

The bill will provide relief for many non-profit organizations who are faced with difficulties because of the way current nondiscrimination requirements apply to retirement plans. We support the principals of nondiscrimination and, in general, all of our plans require the participation of all eligible employees under nondiscriminatory contribution or benefit formulas. However, the testing provisions are very complicated and can hurt the very participants they are meant to protect.

Many National Assembly organizations have branches, councils or chapters throughout the United States. Some are separately incorporated and most would have to be tested separately. Most are run by modestly paid employees who may be interpreted by the IRS to be officers, despite their lack of control over organization policy. In the event an organization has an officer, under the current rules, this officer is deemed to be highly compensated, regardless of his level of compensation and the plan sponsor will have to implement costly discrimination testing at each location. The outcome of such testing could result in cutbacks of benefits for modestly paid employees who are classified by this rule as "highly compensated" employees.

We support the simplification of the definition of Highly Compensated Employee in several respects. Under a simplified definition, a highly compensated employee would be an employee who:

1) was a 5 percent owner of the employer during the current or preceding year; or

2) received compensation from the employer in excess of some threshold dollar amount (indexed).

This definition of highly compensated employee eliminates the one office rule and would continue to result in requiring employers to test their contribution and benefit structures to ensure there is no discrimination in favor of the "true" highly compensated employees; yet it would allow organizations without any highly compensated employees to avoid complicated and expensive testing.

We believe the proposed revision to the one Highly Compensated Employee rule for non-discrimination testing now contained in pension simplification introduced by Senators Pryor and Hatch and by Congressmen Portman and Cardin could be improved and still achieve the policy set by Congress to monitor "true" highly compensated employees retirement benefits provided by qualified plans. The bill as it stands would generally maintain the "highest paid officer" rule described above, subject to a limited exception that would exempt plans from ADP testing if no officer earns more than the threshold, but would continue to treat the officer as highly compensated for purposes of Code Sections 401(a)(4) and 410(b). Our suggested definition of highly compensated employee would be simpler and would better protect the benefits of more modestly paid employees. Due to the current prohibition against maintaining 401(k) plans by tax exempt employers, most of the members of the National Assembly are not concerned about the ADP tests. Our plans will become subject to 401(a)(4) beginning in 1996. We do not believe we should have to test our plans for compliance with the general nondiscrimination rules in cases where no employee earns as much as $66,000. These employees have no authority over the terms of their organization's pension plans and simply should not be treated as highly compensated.

The application of the highest paid officer rule is unfair for small and tax-exempt employers with low-wage workforces. For example, the highest paid employee of a small employer may be classified as an officer and while earning only $30,000 be highly compensated under this rule. If the same individual earned $30,000 (or even $66,000) working for a large employer with numerous highly paid employees, that individual would not be highly compensated.

Because the individual described above is considered highly compensated, the nondiscrimination rules can severely limit his or her benefits (such as section 401(k) contributions or the availability of an early retirement window). In fact, due to the way the nondiscrimination rules work, these limitations are actually more restrictive for the $30,000-a-year employee of the small employer who is deemed to be highly compensated than they are for the $150,000-a-year executive of a large employer. These limitations can, in turn, result in the small employer deciding not to establish a plan or deciding to terminate an existing plan.

In summary, we believe that a bright line definition of highly compensated employees will best serve the purposes of preventing discrimination and protecting the retirement savings of the nonhighly compensated.

Minimum Distribution Rules

We applaud the common sense approach that was contained in H.R. 3419 to correct and modify Section 401(a)(9) of the Code as amended by the Tax Reform Act of 1986. Those provisions first effective as of April 1, 1990 are very complex and have been difficult to explain to our plan participants.

The human service organizations that make up the National Assembly have many modestly paid employees. Some of our employees choose to work beyond normal retirement age. Requiring minimum distributions after age 70 1/2 forces non-highly compensated employees to receive now the pension anticipated to be needed for retirement. Most do not understand why they have to receive a part of their pension before they actually retire.

The majority of our members age 70 1/2 or more were employed by our organizations later in their lives. Many of those members were employed after completing other work careers. For others who have come to our organizations after raising families and who have not had a full working career before joining our organizations, our pensions represent the only private retirement plan coverage they will ever receive.

Combine low salaries and short service and it is hard to rationalize the forced payment of accrued pensions from our organizations under the 70 1/2 rules. A change in minimum distribution rules to permit employees to defer receipt of their pension until actual retirement will strengthen the retirement protection our plans were intended to provide and reduce administrative expenses spent to comply with this provision.

Enhance Portability

Congress should expand the goal of portability by permitting qualified plans to accept transfer or rollovers from other savings and retirement vehicles. This would permit employees both in the for-profit as well as the non-profit sectors to attract and retain qualified employees.

In the tax-exempt community, tax annuities under Section 403(b) of the Code are the most common form of retirement plan. If an employee comes to us from a for-profit employer with a 401(k) plan, under present law, he cannot transfer his 401(k) account into our 403(b) plan. Likewise, if one of our employees moves to a for-profit employer, his 403(b) distribution can only be rolled into an IRA and not into his new employer's 401(k) plan. Since both types of plans contain pre-tax contributions, these distinctions are hard to explain and seem meaningless.

Congress should eliminate the confusing rules for keeping different types of tax deferred retirement money separate and distinct. Distributions made from plans under Sections 401, 403 and 457 should be able to be transferred into other savings and retirement plans as well as into Individual Retirement Accounts. This will help portability in the private for-profit, public and tax-exempt sectors of the economy.

The Unemployment Compensation Amendments Act of 1992 that imposed new 20% withholding rules on certain taxable distributions from qualified plans and 403(b) arrangements should be an impetus to promote portability.

We support every effort on the part of our participants to continue to save for retirement. They should be encouraged to put any and all of their distributions from our plans into other retirement vehicles, and the rules should be simplified so they can do just that.

Correct Section 457 Plans

The Committee on Ways and Means should finally address the long standing discrepancy in the application of Section 457 to the tax-exempt sector. It is our hope that you will clarify that Section 457 does not apply to nonelective deferred compensation.

In 1987 the IRS informed non-profit employers through Notice 87-13 that nonelective retirement pay plans fell under Section 457. This interpretation of the Section 457 rules results in situations where individuals are taxed currently on amounts which they have not yet received, never had the right to elect to receive, and may not actually receive in the future.

Some tax-exempt organizations offer nonelective deferred compensation plans to recruit employees due to their inability to pay market rate salaries. In lieu of paying that higher salary the organization offers the employee nonelective deferred monies if he or she satisfies certain service requirements before leaving or retiring.

The current Section 457 rules however, require the organization to immediately recognize the total value of the "deferred" compensation as taxable income. The employee is then taxed on that total "deferred" compensation in the current year even though the individual has not satisfied the service requirement. Most importantly, the employee has not even received any of the "deferred" compensation.

The unfairness in the current rule highlighted in the above example deserves consideration. For-profit employers are permitted to recruit and retain employees with this very method of deferred compensation which is prohibited to the tax exempt sector. We believe employees of tax-exempt and taxable employers should be treated the same in the area of nonqualified, nonelective retirement pay plans. We hope that Congress can provide for such equity.

Thank you for this opportunity to share our thoughts about pension simplification. The National Assembly Pension Plan Committee is pleased that the members of the Ways and Means Committee are considering this legislation. As representatives of tax-exempt employers we will make ourselves available to your staff to provide additional advice. We hope that you and your colleagues in the Senate will be able to fashion an accord that will produce the best simplification legislation. Please contact me at 212-766-4150 if I may answer any questions.

EXHIBIT A

The National Assembly of National Voluntary Health
and Social Welfare Organizations

- American Association of Homes and Services for the Aging
- American Camping Association
- American Red Cross
- Association of Jewish Family & Children's Agencies
- The Association of Junior Leagues International, Inc.
- Big Brothers/Big Sisters of America
- Boy Scouts of America
- Boys and Girls Clubs of America
- Camp Fire Boys and Girls
- Catholic Charities USA
- Child Welfare League of America
- Civil Air Patrol
- The Close Up Foundation
- Coalition for Juvenile Justice
- Council of Jewish Federations
- The Council on Accreditation of Services for Families and Children
- Evangelical Lutheran Church in America Division for Church in Society)
- Family Service America, Inc.
- 4-H, Extension Service
- Girl Scouts of the USA
- Girls Incorporated
- Goodwill Industries International, Inc.
- Joint Action in Community Service
- National Association of Homes and Services for Children
- The National Center for Missing and Exploited Children
- National Coalition of Hispanic Health and Human Services Organizations
- The National Council on the Aging
- National Crime Prevention Council
- National Mental Health Association
- National Network for Youth
- National SAFE KIDS Campaign
- National School-Age Child Care Alliance
- One-to-One Partnership, Inc.
- Points of Light Foundation
- The Salvation Army
- Travelers Aid International
- United Seaman's Service
- United Way of America
- WAVE, Inc.
- Women in Community Service
- YMCA of the USA
- YWCA of the USA

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

BEFORE HOUSE WAYS AND MEANS COMMITTEE ON MISCELLANEOUS TAX REFORMS

July 27, 1995

My name is Robert A. Georgine and I am presenting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 240 pension and welfare plans, or their sponsors. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development -- legislative, administrative, and judicial -- of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

As you are aware, starting with the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, layer after layer of complex and burdensome rules have been imposed on private retirement and profit sharing plans, most often without any apparent regard for social policy objectives. As a result, an alarming number of such plans have been terminated, and many small employers have stopped offering retirement plans. Happily, this has not yet been the experience in the multiemployer arena, although plan participation is shrinking and the system is becoming increasingly fragile. On behalf of the Coordinating Committee, I applaud your continued effort to simplify some of these complex and burdensome new rules. I am hopeful the bill that this Committee produces will undo some of the harm that has been done to the private pension system by overregulation in recent years.

As I will discuss in more detail, we urge you to: provide a multiemployer plan exception to the 100% of compensation limit under Internal Revenue Code ("Code") § 415; provide for multiemployer plans the same rule of actuarial reduction of the 415 dollar limit for early retirement that is currently applied to governmental plans; exempt multiemployer plans from the requirement to vest participants who are affected by a partial termination; allow employers participating in multiemployer plans to deduct contributions that fund the full current liability of the plans; provide a multiemployer plan exception to the 150% of current liability full funding limitation; and oppose repeal of the $5,000 death benefit exclusion. I will also address briefly certain other issues.

A. Characteristics of Multiemployer Plans

To understand why multiemployer plans and their participants need the relief we are asking for, it is important for you to understand the basic characteristics of these plans.

Multiemployer plans are common in industries characterized by many small employers and highly volatile employment patterns, such as the construction trades, garment, trucking, longshore, entertainment, etc. Often participants in these plans will work for only a brief period for any one contributing employer, and work for numerous employers each year. Multiemployer plans add up these periods of service for eligibility, vesting and benefit accruals. They provide two elements for their participants and contributing employers that all observers agree are sorely needed in the pension system generally to make it feasible for small employers to provide pensions -- full portability for mobile workers and efficiencies and economies of scale in plan administration.

Multiemployer plans are funded based on contribution rates fixed in collective bargaining agreements that typically run for a period of

at least 3 years. These agreements require employers to contribute a set dollar amount per hour worked, or other measure of service or unit of production, for each employee covered by the bargaining agreement. The total contributions to the plan therefore fluctuate based on increases and decreases in covered work in the industry.

Employee representatives typically negotiate a dollar per hour labor cost with employers. The hourly dollar amount of current wages is generally this total labor cost, reduced by the amount of plan contributions. Thus, as a practical matter, employees are making benefits contributions out of their current hourly wages.

Multiemployer pension plans typically provide either flat dollar benefits or benefits equal to a dollar amount times years of service. Unlike the standard for single-employer plans, multiemployer plan benefit formulas are rarely based on a participant's compensation.

Favorable investment experience over the past decade, plus the parties' commitment to maintain steady funding for pensions, have led many plans to increase benefits substantially. These increases usually take the form of higher normal retirement benefit levels. In addition, some plans have reduced the amount of covered service needed during a year to earn a benefit credit.

B. Relief Needed

Largely because of these unique characteristics, multiemployer plans need relief from certain provisions that were never intended to have the effect they have on such plans.

1. Code § 415 Limits

a. Multiemployer Plan Exemption from Code § 415 100 Percent of Compensation Limit

The NCCMP is seeking a multiemployer plan exemption from the provision of § 415 of the Code that limits the benefits that can be paid under a pension plan to 100% of the participant's average compensation for the three consecutive calendar years in which it was the highest. The Administration Proposal would provide such an exemption.

The Code § 415 limits are designed to prevent highly compensated individuals from using pension plans as tax avoidance schemes to defer excessive pension benefits. This does not happen in the context of multiemployer plans.

However, due to the unusual structure of multiemployer plans, the work patterns of their participants and the manner in which the contribution streams that fund them are negotiated, they face a risk of running afoul of the 100% of compensation limit. Where this happens, the participants who are hurt by the limit are the lowest paid rank and file workers covered under the plan -- the exact opposite of the type of participants these rules were designed to impact.

As I mentioned, multiemployer plans typically provide the same annual retirement benefit to a participant or to all participants who have the same number of years of service. It is extremely rare for a multiemployer plan benefit formula to be based on compensation. Multiemployer plan benefit formulas are therefore very advantageous to lower paid workers. As a percentage of compensation, the more money a participant makes, the smaller is his benefit. The effect of these formulas is to provide an adequate retirement benefit even to the lowest paid workers, by, in effect, subsidizing such benefit by reducing somewhat the benefits of the higher paid workers.

Ironically, it is this very antidiscriminatory aspect of multiemployer plans that creates much of their problem under the 100% of compensation limit. The level of plan benefits is set by the trustees with one eye towards what the contribution stream funding the

plan can support and the other eye towards the reasonable retirement needs and expectations of the average plan participant. This benefit may, however, be higher than the 100% of compensation limit for the lowest paid plan participants.

Another problem is created by the work patterns of typical multiemployer plan participants. In a typical single employer plan, a plan participant is employed continuously with the same employer during his period of participation in the plan. Over time, due to inflation, that participant's compensation will increase. Because this employment is continuous, the three consecutive years in which compensation is the highest -- that is, the three years on the basis of which the 100% of compensation limit is computed -- will typically always be the last three years. Thus, in effect, single employer plan participants get the benefit of cost of living adjustments to their 100% limit while they are working, because they get the full advantage of their compensation increases due to their continuous employment. Once they leave service, their 100% limit is also directly adjusted annually under § 415(d) to reflect increases in the cost of living.

In the context of multiemployer plans, the 100% of compensation limit sometimes shrinks in value due to cost of living increases. As multiemployer plan participants grow older, they may find it more difficult to secure continuous employment. The gaps between their periods of employment may become more frequent and more prolonged. This is especially true in industries characterized by hard, physical work, especially outdoors, or work in extreme climates. Even though the hourly rate may reflect inflation, a reduced number of hours worked during some portion of any period of three consecutive years may prevent that period from being used as the base for computing the 100% limit. If an earlier group of three years is used, the worker is deprived of the automatic inflation adjustment to this limit that the typical single employer plan participant would obtain through a salary increase. In addition, because the participant has not yet retired, no direct inflation adjustment to the limit is allowed. This shrinking of the limit due to inflation is particularly pronounced in declining industries where work has become more scarce in general.

Plan trustees recognize that multiemployer pension benefits have, in effect, been paid for by the plan participants. In some declining industries, to prevent participants from losing their benefits due to inability to find continuous employment, trustees have reduced the number of hours per year necessary to earn a pension credit. For some participants this can increase the severity of the impact of the 100% of compensation limit, as their actual pay may decline -- even if hourly wage rates go up -- because they are working fewer hours. Although it looks as though they are earning additional pension benefits, these participants hit the 100% limit and lose their pension benefits anyway.

It is important to note that it is not possible to adjust plan contributions to deal with this problem. Multiemployer plan contribution rates are set through collective bargaining. The rate set for any particular collective bargaining unit is uniform, because the hourly wage package is uniform. There is no practical way to provide different contribution rates for different workers depending on the number of hours they work, even if it were possible to know or to predict the number of hours a particular worker would work during a particular year. Contributions can only be reduced across the board, and if they are, wages or other benefit plan contributions would need to be increased across the board to maintain the equilibrium and follow through on the bargained-for compensation. So the majority would be denied an adequate pension to avoid giving a generous one to the lowest-paid among them.

Ironically, the 100% of compensation limit is not a problem for highly compensated employees generally. Employers maintaining single employer plans typically provide benefits in excess of the Code § 415 limits for highly compensated employees through unfunded excess benefit plans. This is not a feasible solution in the context of multiemployer

plans. The Taft-Hartley Act requires multiemployer plan benefits to be provided through a trust.

To understand the harshness of the impact of the 100% limit on plan participants, it is important to note that, in effect, this limit is imposed retroactively. Plan participants ordinarily compute their benefits using the formulas they find in their summary plan descriptions and with reference to their years of service. They make plans for retirement based on the benefits so computed. They usually do not realize the amount of reduction in their benefit that will be made due to the 100% limit until they actually retire and make a claim for benefits.

We therefore urge you to exempt multiemployer plans from the 100% of compensation limit.

b. Need for Relief for Multiemployer Plans From Reduction in Pension <u>Benefits on Early Retirement</u>

We also ask you to provide for multiemployer plans the same § 415 dollar limit for early retirement benefits that applies to tax-exempt entity and government employees.

Code § 415(b) also imposes a dollar limit on the annual benefit that may be paid from a defined benefit plan. This dollar limit is $90,000, indexed for inflation. This amount is far higher than the typical multiemployer plan benefit and is ordinarily not a problem for multiemployer plans.

However, the dollar amount is reduced actuarially for benefits that start earlier than normal retirement age. This actuarial reduction can have a severe impact on early retirement benefits.

Many multiemployer plans provide pensions that can be taken on an unreduced basis after a certain number of years of service, e.g., 30. These are referred to, for example, as "30 and out pensions." In industries that involve hard, physical labor, it is often not feasible for participants to work past their early or mid-50s. For someone who has been working at these backbreaking jobs since high school, "early" retirement represents a well-earned chance to stop working so hard. These special service pensions are reasonably designed to address the income needs of such workers. Yet the § 415 dollar limit could restrict such workers to receiving little more than $30,000 or so a year.

To prevent this dollar limitation from becoming so low that it interferes with the ability of multiemployer plans to provide adequate retirement benefits to early retirees, we urge you to allow multiemployer plans to use the same rule that is currently available to plans maintained by government and tax exempt organizations. This rule is found in Code § 415(b)(F). It is the rule that was in place before the Tax Reform Act of 1986. Under this rule, the dollar limit will be reduced only below age 62 and will not be reduced below a dollar amount that is the actuarial equivalent of a $75,000, indexed, limitation at age 55.

2. Need for Relief for Multiemployer <u>Plans from Partial Termination Rules</u>

We also urge you to exempt multiemployer plans from the partial termination rules. We note that the Administration's pension simplification proposal would provide such an exception.

Code § 411(d)(3) requires a plan to vest nonvested participants who are affected by a partial termination of the plan to the extent that the plan is funded. A partial termination occurs when a significant percentage of a plan's participants are excluded from coverage. In at least one case, a district court has applied this test to a single employer participating in a multiemployer plan. Under this

approach, if a small employer participating in a multiemployer plan goes out of business, a partial termination may occur and the employees of that employer may have to be vested.

As I explained earlier, multiemployer plans generally exist in industries where employees transfer from employer to employer frequently. Often, employers in these industries hire workers for specific jobs. When the jobs are over, the workers are dismissed. These workers are likely to be hired by other contributing employers, possibly following a period of unemployment or to be hired back by the same employer when it gets another job. If employees had to be vested each time an employer's project ended, there would, in effect, be immediate vesting for employees in such circumstances. This would raise the overall cost of the plan, which would inhibit pension increases so that, ultimately, the pension levels might not be enough to sustain a long-term employee in retirement. Finally, it would be a windfall to participants who, after being vested because of a partial termination, may well resume participation under the plan as employees of another contributing employer.

In cases where coverage shrinks plan-wide, it would be extremely difficult to determine which employees have incurred a partial termination. What date would you pick as the beginning of the partial termination? However you draw this line, participants who left service prior to that date would be disadvantaged. At what date would the partial termination end? However you choose that date, participants who leave service after that date would be disadvantaged. What about participants who come back to service under the plan? This will be true in many cases, because these plans exist in and are designed for industries where terminated employees typically resume service with other participating employers. Why should such participants be vested when others working alongside them with the same number of years of service are not?

We also note that work covered by many of these funds is cyclical, ebbing and flowing with the highs and lows of the local economy, for instance, or the market for new homes or office space, so that what looks like planwide shrinkage may be only a temporary lull that does not foreclose affected participants from accruing further pension benefits. Because this is an expected rather than unusual feature of these job patterns, many of the plans are parties to reciprocity agreements that effectively provide portability by maintaining the workers' plan coverage while they work elsewhere in the country.

The legislative history of ERISA makes clear that the purpose of the partial termination rule was to preclude the possibility that contributions for employees that had already been deducted by the employer for income tax purposes could revert back to the employer.[1] No such possibility is present in multiemployer plans, because ERISA prohibits reversions to employers contributing to multiemployer plans.[2] Upon termination, all of the assets of a multiemployer plan must be used for the benefit of its participants and beneficiaries. Thus, the rationale for the partial termination rule does not exist in the context of multiemployer plans.

In addition, under the Bill, multiemployer plans would be required to provide five-year cliff or seven-year graded vesting. This is a relatively short period of time -- especially considering the fact that multiemployer plans add up years of service with all employers in the industry in the geographic area that contribute to the plan to determine when a participant becomes vested and that such plans often count service with plans in other geographic regions through reciprocity agreements. Five years is short enough. There is simply

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[1] H.R. Rep. No. 378, 87th Cong., 1st Sess. (1961), reprinted in 1962-3 C.B. 261, 269.

[2] ERISA § 403(c)(1), 29 U.S.C. § 1111, 29 U.S.C. § 1103(c)(1); ERISA § 404(d)(1), 29 U.S.C. § 1344(d)(1).

no justification for requiring a multiemployer plan to vest participants who, fortuitously, leave service under circumstances that constitute a partial termination.

3. The Need to Ensure Deductibility of Contributions Necessary to Fund Multiemployer Plans

To avoid undermining the currently sound funding of multiemployer plans, it is important to be to assure employers that contributions necessary to fund the plans will be tax deductible. Given the way the highly technical deduction constraints interact with the way employers contribute to multiemployer plans, this can sometimes be a problem. As I explained above, employers contribute to multiemployer plans pursuant to collective bargaining agreements that run for three or more years. If these employers cannot be assured at the bargaining table that their contributions will be deductible, it will be difficult or impossible to get them to agree to make pension contributions.

There are a couple of straightforward changes to the funding rules that would be helpful towards achieving this goal. These are: (1) to expand the Codes § 404(a)(1)(D) rule currently applicable to all other large plans to allow employers contributing to multiemployer plans to deduct contributions to fund the plan's full current liability; and (2) to exempt multiemployer plans from the 150% of current liability full funding limitation of Code § 412(7) and ERISA § 302(7).

Relieving multiemployer plans from these two deduction limits should not have any negative revenue impact. If a company sponsoring a single employer plan finds that the contribution it has planned to make for a year will not be deductible, the company simply does not make the payment. At the end of the year, that may translate into higher taxable income for the employer. In sharp contrast, however, an employer contributing to a multiemployer plan cannot stop contributing, regardless of whether or not the contribution will be deductible, without violating its labor contract. Faced with a deduction crisis, some plan boards of trustees will increase benefits to increase the deduction limit. This type of response to such a crisis could actually create a continuing need for higher employer contributions over the long term and correspondingly higher tax deductions. The senselessness of forcing plans into this situation appears particularly clearly in the context of the 150% limit, which can decrease substantially at any time due to changes in the variable rate on which it is based, thereby creating a deduction crisis that may well be temporary.

The abusive, tax-motivated overfunding that funding deduction limits are designed to address does not occur in multiemployer plans. Amounts contributed to multiemployer plans are held solely for the benefit of the covered employees, the overwhelming majority of whom are union represented rank and file workers. As the law does not allow surplus multiemployer plan assets to revert to any contributing employer, a company that contributes more than is needed for plan benefits has lost the use of that money forever. Moreover, pension contributions represent part of the negotiated compensation package. It has long been recognized that employers are generally called upon to spend the same amount on compensation in some other form, if it does not go into the pension plan. Since more dollars into the pension fund generally mean fewer dollars for wages, health care or other benefits, the union's constituency also loses if the plan is overfunded. Thus neither the union nor the employers have any incentive to maintain artificially high multiemployer contribution rates.

4. The Need to Change the Pension Plan Annual Valuation Requirement to a Tri-Annual Requirement for Multiemployer Plans

The NCCMP also supports allowing multiemployer plans to perform valuations every three years, rather than annually.

Section 7881(a)(6)(A) of the Omnibus Budget Reconciliation Act of 1989 amended Code § 412(c)(9) and ERISA § 302(c)(9) to require pension plans to have actuarial valuations performed annually, instead of every three years, as was permitted under prior law. The Joint Tax Committee's description of the change states that annual valuations are necessary because the minimum required contribution for a plan year under the minimum funding rules enacted in OBRA '87 depends on the plan's funded status for that year.

However, in recognition of the unique nature of multiemployer plans and the fact that additional contribution requirements are not needed for them because they are generally well funded, OBRA '87 provided exceptions from its minimum funding changes for multiemployer plans. The only requirement applicable to multiemployer plans for which an annual valuation would be necessary in all cases is the additional full funding limitation enacted in OBRA '87 and discussed above. Once we obtain an exemption from that limitation, there will be no reason to impose on all multiemployer plans the burden and expense of annual valuations.

5. Taxation of Burial Benefits

For over 30 years, Code § 101(b) has specifically excluded from gross income up to $5,000 in employer-paid death benefits. Many multiemployer pension plans provide modest lump-sum death benefits to surviving spouses or other beneficiaries. These short-term supplements to basic survivor annuities are aimed at helping families meet funeral expenses arising upon the employee's death. Often such benefits are described to the participants as "burial benefits."

The NCCMP opposes any proposal to eliminate this modest $5,000 death benefit exclusion. This would make it more expensive for plans to provide these benefits by forcing them to buy insurance instead of self-funding the benefit. It might lead a number of plans to discontinue burial benefits. Elimination of this benefit would not serve any policy objective, nor would it in any way simplify our pension rules. Rather, this is another short-sighted attempt to find additional revenue to make the simplification bill, as a whole, revenue neutral.

6. Benefits of Post-Age 70 Retirees

The NCCMP also seeks three changes to the provisions of H.R. 3419 that would modify the minimum distribution rules of Code § 401(a)(9).

a. Definition of Mandatory Distributees

Under current law, distributions to a qualified plan participant must begin by April 1 of the calendar year following the calendar year in which that participant reaches age 70½, regardless of whether the participant has retired. Under H.R. 3419, distributions would be required to begin by April 1 of the calendar year following the later of the year in which the participant attains age 70½ or the year in which he retires. The old rule would continue to apply to five percent owners.

In the case of multiemployer plans, we urge you not to require any minimum distributions, except in the case of five percent owners. The administrative burdens and complexities imposed on such plans by the minimum distribution rule cannot be justified by any pension or tax policy.

As I mentioned before, multiemployer plans arose in industries where workers tend to move frequently from one employer to another.

Because multiemployer plan benefits are typically based on accumulated service with numerous employers, multiemployer plans typically do not make distributions to participants who terminate service prior to retirement age. Virtually all multiemployer plans make application for a pension, not separation from service, the event

that triggers a plan distribution. These plans therefore often have a relatively large number of vested employees with whom they have had little or no contact in recent years and for whom identifying data may be incomplete or out of date. It may be extremely difficult for a plan to find these participants when they reach age 70½.

It may also be difficult to determine if a participant has "retired" or is still looking for work. In addition, some multiemployer plans do not have sufficient data to know when a particular participant reaches age 70½.

b. Actuarial Increase in Benefits

H.R. 3419 would provide that, in the case of an employee (other than a five percent owner) who retires in a calendar year after attaining age 70½ the employee's accrued benefit must be actuarially increased to reflect the value of benefits that the employee would have received if he had retired at age 70½ and begun receiving benefits at that time. It appears that this provision could have the effect of preventing plans from suspending benefits for employees who work after attaining age 70½.

Multiemployer plans are supported by fixed, negotiated contributions and, therefore, have limited resources. Typically, these plans are able to provide only very modest benefits to relatively low-income people. The percentage of multiemployer plan participants who work beyond age 70½ may not be great. However, a requirement to provide benefits to these participants while they are still working and receiving a paycheck would diminish somewhat the plan's ability to provide adequate benefits to retired participants who have no other source of income.

We suggest that you clarify that neither this section of H.R. 3419, nor any provision of Code § 401(a)(9), will prevent a plan from suspending benefits upon reemployment of a retiree, in accordance with Code § 411(a)(3)(B), ERISA § 203(a)(3)(B) and regulations thereunder.

In addition, we urge you to allow plans that do not suspend these benefits to compute the required actuarial increase at the time that plan distributions begin, with reference to the entire period starting with the year in which the participant reached age 70½ and concluding with the date distributions commence. This would be far more manageable from an administrative perspective than having to compute the increase on a year-by-year basis.

c. 70½ Rule Should Not Be Changed to 70 Rule

We also urge you not to change any rule that previously applied at age 70½ to make it apply at age 70. This would burden plans by forcing them to completely rework their administration and computer systems, which have already been set up to attempt to identify and make payments to participants at age 70½. It would complicate rather than simplify.

7. Design-Based ADP and ACP Testing

H.R. 3419 would provide a design-based safe harbor so that a plan could satisfy the actual deferral percentage test if, in addition to satisfying certain notice requirements, a minimum percentage of employer contributions is provided to each nonhighly compensated employee. As currently proposed, this percentage would be a percentage of compensation.

The same goal could be achieved under multiemployer plans by allowing them to satisfy the safe harbor if the required plan contributions per hour of service (or day, or shift, etc.) is at least 3% of the hourly wage rate (or the daily or shift rate, etc.) for each covered employee. Thus, for example, if a participant is working under a bargaining agreement calling for $20/hour regular time pay, the safe

harbor would be met if the required contribution rate is at least \$0.60/hour. If the pay rate is higher for overtime, the plan contribution rate would be correspondingly higher -- or contributions could be limited to regular-time hours. This would make the safe harbor workable for multiemployer plans, and would open the door to § 401(k) as an important retirement savings opportunity for this segment of the workforce.

We also suggest that the safe harbor be applied on an employer-by-employer or bargaining unit by bargaining unit basis. Thus, if the plan contribution rate under one bargaining agreement would not meet the safe harbor, the safe harbor could still apply to allow § 401(k) deferrals with respect to work under other agreements.

This clarification could probably be achieved through a statement in the Committee Report that Congress intends the safe harbor to apply to multiemployer plans as described above.

8. Effective Date for Five-Year Cliff or Seven-Year Graded <u>Vesting for Multiemployer Plans</u>

As noted above, H.R. 3419 would repeal the current law provision allowing multiemployer plans to provide ten-year cliff vesting. It is important that the employee representatives have an opportunity to try to negotiate higher contribution rates to pay increased costs associated with the new rules. Thus, the provision should be effective, at the earliest, as of the beginning of the first plan year that begins after the expiration of the longest-running collective bargaining agreement that was in effect or ratified on or before the date that the bill is enacted. Such an extended effective date was provided in H.R. 3419 last year and would be provided in S. 1006.

9. <u>Miscellaneous</u>

I would also like to take this opportunity to express the NCCMP's support for provisions of the Bill that would: allow tax-exempt organizations generally to maintain cash or deferred arrangements; eliminate the Code § 415(e) combined limits; simplify the definition of highly compensated employees; and extend the favorable tax treatment of group legal services plans.

I appreciate this opportunity to present this testimony on behalf of the National Coordinating Committee for Multiemployer Plans.

Thank you.

* * *

If you have any questions, or if we can be of further help, please call Vivian Lee Hobbs of our professional staff at (202) 942-5190.

NATIONAL COUNCIL ON TEACHER RETIREMENT

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Public Pension Plans Need Resolution of Conflict with Section 415

Statement
by
the National Council on Teacher Retirement
Submitted to
the Committee on Ways and Means, U.S. House of Representatives
In Connection with Hearings
July 11, 12, and 13, 1995

Chairman Archer and Members of the Ways and Means Committee, the National Council on Teacher Retirement (NCTR) appreciates the opportunity to submit testimony on the need to resolve public pension plans' problems with Section 415 of the Internal Revenue Code. Without this resolution, such plans may be disqualified, endangering the tax deferred status of state and local government employees' future pension benefits. The NCTR is an association of 68 state, local, territorial, and university pension systems serving nearly 9 million active and retired public employees.

To resolve this problem, legislation known as the "Public Pension Equity Restoration Act" has been introduced during the past few Congresses. This year the bill is numbered H.R. 1504 and supported by the following Ways and Means Committee Members:

Rep. Robert Matsui	Rep. Phil Crane
Rep. Nancy Johnson	Rep. Andy Jacobs
Rep. Sander Levin	Rep. Rob Portman
Rep. Jon Christensen	Rep. Phil English
Rep. Pete Stark	Rep. Barbara Kennelly
Rep. Sam Johnson	Rep. Gerald Kleczka
Rep. Jim McDermott	Rep. Richard Zimmer

Rep. Sam Gibbons

The legislation has also enjoyed broad support in past Congresses. During the 103d Congress, 28 members of the Ways and Means Committee cosponsored it. In 1994, the House passed H.R. 3419, the "Tax Simplification and Technical Corrections Act of 1994," which included the language of the "Public Pension Equity Restoration Act." It was also part of H.R. 4210 and H.R. 11, which passed both the House and Senate during the 102nd Congress. On the Senate side, Sen. David Pryor and Sen. Orrin Hatch introduced on June 30 the "Pension Simplification Act of 1995" (S.1006), which includes text similar to the "Public Pension Equity Restoration Act."

Federal and State Pension Laws Conflict

"Public pension plans" is a short-hand way of referring to the pension plans sponsored for teachers, police officers, fire fighters, and other state and local government employees. "Section 415" is a provision of the Internal Revenue Code that limits the size of an individual's pension benefit.

Without relief, public pension plan administrators face a dilemma. If they comply with Section 415, they may be forced to cut back the pension of a retirement system member. Many states have constitutional and other protections, known as "anti-cutback rules," that prevent pensions from being reduced. If such a cut back occurs, the retirement system member may sue the administrator. On the other hand, if the administrator ignores Section 415 and follows state law, IRS may disqualify the plan. Under disqualification, vested members of the pension plan could be forced to claim as current, taxable income, the entire value of their accrued pension benefit.

Accordingly, we ask the Committee to include the "Public Pension Equity Restoration Act" in whatever further legislation it undertakes this year.

Key Points about the "Public Pension Equity Restoration Act"

- A bipartisan group of Members of Congress supports the Act.
- The Joint Committee on Taxation has scored the Act as revenue negligible.
- Both Houses of Congress have passed previous versions of the Act.
- A national coalition of state and local governments and employee groups has endorsed the Act.

How the "Public Pension Equity Restoration Act" Will Resolve the Problems

The Act provides a four-part solution.

Part One. The definition of "compensation" for the purposes of Section 415 testing of public pension plans will be expanded to include employer pension contributions made through the employer pick-up option (414(h)), as well as employee contributions to salary deferral plans such as those offered under Sections 457, 403(b) (tax-sheltered annuities), 401(k), and 125 (flexible spending accounts, also known as cafeteria plans).

These amounts are often included as annual compensation in the public pension plan's computation of an individual's pension benefit, but are required to be excluded when the Section 415 percentage-of-pay is determined. The result can often be an average annual compensation amount for testing purposes that is substantially less than the pension plan's average, which in turn produces a benefit that exceeds the 415 limit.

Part Two. Public-sector employees tend to be longer-tenured and lower-paid than their private-sector counterparts. For example, it is not unusual to find school employees and others with 40 years of service. Because public pension plan benefit formulas often reward this kind of service, the consequence can be a pension benefit that, while not large in absolute dollar terms, can exceed 100 per cent of the individual's high three-year average compensation. This can still occur even if the definition of compensation is changed as proposed in the bill. Therefore, the bill provides that the percentage-of-pay component of the Section 415 limit test will not apply to public pension plans. However, the Section 415 dollar limits will remain.

Part Three ERISA provides private-sector employers with the ability to maintain "excess-benefit" arrangements, to be used solely for the purpose of providing benefits for certain employees in excess of the limits on contributions and benefits imposed by Section 415 on qualified pension plans. These excess plans are "unqualified," and thus, amounts in them count as currently taxable income to the employee. In the private sector, excess plans give an employer the right to pay a benefit to an employee that exceeds the 415 limits without subjecting its pension plan to disqualification.

Public pension plans have no similar "safety valve" to avoid disqualification. This remedy would therefore extend the same concept to public-sector employers while recognizing the unique differences between public and private-sector plans. Specifically, the bills would permit a governmental employer to establish an excess-benefit arrangement. However, its use would be limited solely to providing benefits in excess of the 415 caps for the limited number of employees whose benefits happen to exceed the 415 limits simply by operation of the regular benefit formula of the plan.

In effect, the excess-benefit arrangement would serve as an "overflow" device. It permits the pension plan to pay benefits guaranteed to the retiree -- thereby avoiding the problem of violating state anti-cutback rules -- without, in so doing, subjecting the plan to IRS disqualification.

The bill makes clear that this excess arrangement is expressly not a new form of salary deferral that a public employee can elect to utilize. While the bill provides that the public pension plan will maintain its tax-exempt status with regard to the investment earnings of any funded excess-benefit arrangement, it also specifically provides that, as with the private-sector employee, such funding will not be deferred, and will therefore have to be taxable on a current basis to those employees who will receive a part of their benefit from an excess plan.

Part Four. Survivor and disability benefit payments can often exceed the Section 415 limits. In the case of disability benefits, these payments typically are made to an employee who is disabled long before normal retirement age, and are therefore subjected to limits that are actuarially reduced from age 62 to the age of the recipient at the time of injury. In the case of the private sector, such benefits are usually not paid out of the pension plan because they are more commonly provided through a disability insurance policy. Such disability benefits are therefore not subject to the 415 limits.

In the public sector, however, the tendency is toward self-insurance, with the disability benefit paid out of the pension plan. As such, it is subject to Section 415, even though the actual amount may be far less than that paid out in the private sector. The Public Pension Equity Restoration Act would therefore exempt public pension plan survivor and disability benefits from the Section 415 limits.

Conclusion

The "Public Pension Equity Restoration Act" will harmonize the operation of state pension law with the federal pension law embodied by Section 415. The NCTR urges you to include this critical legislation in whatever further tax bill the Committee considers this year. Please contact Cynthia L. Moore, NCTR's Washington Counsel, at 703-243-3494, for further questions. Thank you very much.

WRITTEN STATEMENT OF THE
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036

For the Printed Record of the Hearings held
July 11 and 12, 1995
by the
Committee on Ways and Means
of the
U.S. House of Representatives

Introduction.

This testimony is submitted on behalf of the National Rural Electric Cooperative Association ("NRECA"). We at NRECA believe that there is a critical need for simplification of the laws affecting qualified retirement plans. Accordingly, we applaud the leadership shown by Chairman Archer in holding this hearing. We are also very appreciative of the leadership roles being played by Mr. Portman and Mr. Cardin (H.R. 2037) in introducing legislation that would significantly reduce the complexity of the retirement plan rules.

Our testimony today is in support of the Portman/Cardin bill. We believe that this bill best achieves simplicity in a manner consistent with sound retirement plan policy.

NRECA

NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems serve over 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Various programs administered by NRECA provide pension and welfare benefits to over 125,000 rural electric employees, dependents, directors, and consumer-members in those localities.

NRECA has for many years been deeply interested in retirement and health care policy. In this regard, NRECA has sponsored studies of both areas, such as "Retirement Coverage in Smaller Firms: Evidence and Policy Implications," "Retirement Coverage in Smaller Firms: Toward a Solution," "Health Care Needs, Resources, and Access in Rural America," and "The NRECA Survey of Health Coverage in Smaller Firms." NRECA has made these studies available to Members of Congress and their staffs, as well as to officials within the Administration.

NRECA remains committed to the study of retirement and health care policy and to finding solutions to the vexing problems in these challenging areas.

The need for simplification of the retirement plan rules.

We believe that it is essential that the rules affecting qualified retirement plans be simplified. Before discussing why this need exists, it is important to clarify what we mean by simplification. Stated briefly, we view simplification as the elimination or modification of rules that impose administrative burdens on employers or employees that are not justified by tax policy or retirement policy. The rules in need of simplification have arisen not as the result of any one Act of Congress, but rather through the cumulative effect of years of layering one set of requirements on another. Under this view, the end result of simplification is not simply shorter statutes and regulations, nor does the end result include any fundamental change in tax policy or retirement policy. The end result is a very significant reduction in the time and money devoted to administering retirement plans.

We believe that this type of simplification will stimulate the establishment and enhancement of qualified retirement plans by lowering the major hurdle to such growth, which is the ever growing cost of plans. At the same time, this type of simplification will not undermine the important tax policy and retirement policy objectives of current law.

The need for this type of simplification exists with respect to both large and small employers, but is particularly acute with respect to the latter. Retirement plan coverage among employees of small employers is dismally low; NRECA's 1987 survey of employers in rural areas with 60 or fewer full-time employees revealed that less than 19 percent of the employers surveyed maintained a retirement plan. The survey also found that the primary reason for the lack of coverage was the cost of retirement plans. A simplification bill that would reduce this cost would have a major effect in raising the number of employees of small employers who can retire with dignity and security.

NRECA support for the Portman/Cardin bill.

The Portman/Cardin bill, if enacted, would achieve precisely the type of simplification that is described above and that we at NRECA believe is so desperately needed. The bill modifies burdensome rules that contribute little to tax policy or retirement policy.

This bill would not only stimulate the growth of the private retirement plan system, but would also play an important role in restoring the confidence of the business community in the tax system. Over the years, frequent changes in the tax law, as well as the creation of layers of burdensome requirements, have undermined businesses' respect for the tax system. This bill would not alone restore businesses' confidence and respect but it would certainly be an important step in the right direction and could serve as a signal to the business community that the lawmakers hear their concerns and want to address them.

Very simply, we at NRECA could not be more supportive of this bill.

Specific issues.

We would like to comment more specifically on certain provisions of the Portman/Cardin bill. However, we do not by any means intend to imply that we do not support the provisions of the Portman/Cardin bill not discussed or that we view such provisions as unimportant.

Our specific comments focus on the following areas: the definition of highly compensated employee, voluntary employees' beneficiary associations ("VEBAs"), section 401(k) plans, the definition of compensation, and simplified employee pensions ("SEPs").

Definition of highly compensated employee.

In our view, one of the most important parts of the Portman/Cardin bill is its modification of the definition of a "highly compensated employee."

Present law. The term "highly compensated employee" is used for purposes of applying various nondiscrimination rules applicable to employee benefit plans. In general, under present law, the term is defined to include any employee who during the current or preceding year falls in any of the following four categories:

(1) a 5-percent owner of the employer;

(2) received compensation from the employer in excess

of $75,000 (indexed to $100,000 in 1995);

(3) received compensation from the employer in excess of $50,000 (indexed to $66,000 in 1995) and was in the top 20% of the employer's employees by compensation; or

(4) was an officer and received compensation from the employer in excess of $45,000 (indexed to $60,000 in 1995).

In addition, if in a year no officer of an employer receives compensation over $45,000 (indexed), the employer's highest paid officer is treated as a highly compensated employee (the "1-officer rule").

Also, under present law, certain family members working for the same employer are aggregated and treated as a single employee, which can serve to limit the retirement plan benefits of such family members.

Problems under present law. The present-law definition of highly compensated employee has three significant shortcomings. First, it is overly complicated. The summary set forth above does not even include a series of additional exceptions and special provisions. Moreover, the complexity is exacerbated by the fact that the definition generally requires examination of both the current and preceding year. Second, the definition is overly broad. Under the present-law rule, for example, an officer earning $40,000 from a small tax-exempt employer and a 5-percent owner earning $40,000 from a struggling small business can both be highly compensated employees and thus be subject to onerous restrictions under the nondiscrimination rules. This is clearly inappropriate. Third, the family aggregation rules are not only complex, but also burden employers, particularly small family-owned businesses, with restrictive rules unjustified by policy concerns.

Portman/Cardin bill. The Portman/Cardin bill addresses all of the problems with the present-law definition. Under the bill, the definition is simpler, including only an employee who:

(1) was a 5-percent owner at any time during the current or preceding year;

(2) received compensation for the preceding year in excess of $80,000 (indexed); or

(3) was the employer's highest paid officer for the preceding year.

In addition, the bill would repeal the family aggregation rules.

Finally, and most importantly, the bill addresses the excessive reach of the present-law definition. Under the bill, generally, neither a 5-percent owner nor the highest paid officer is treated as a highly compensated employee unless such individual also earns over $80,000 (indexed). This change would correct a significant bias in present law against small employers.

As noted above, an officer earning, for example, $40,000 from a small tax-exempt employer or a 5-percent owner earning 40,000 from a struggling small business can be highly compensated under current law. Meanwhile, at all large employers, employees earning $66,000 or less are nonhighly compensated employees. In fact, under present law, employees earning much higher amounts (up to $100,000) at certain large employers qualify as nonhighly compensated employees.

The Portman/Cardin bill eliminates this unfairness by establishing one dollar threshold -- $80,000 (indexed) -- that applies to all employers, large or small. The bill also provides safeguards against abuse. If an employer has no employees earning over $80,000 (indexed), and by virtue of that fact were entirely exempt from all applicable nondiscrimination rules, there may be potential for abuse at least with respect to certain types of employers. The bill addresses this issue by requiring employers without any employees earning over $80,000 (indexed) to satisfy the nondiscrimination rules on an availability basis, treating the highest paid officer and all 5-percent owners as highly compensated employees for this purpose.

One could argue that this anti-abuse provision in the Portman/Cardin bill is inadequate because it permits an employer without any employees earning over $80,000 (indexed) to maintain a broadly available section 401(k) plan under which the employer's highest paid officer and 5-percent owners may contribute up to the $9,240 limit (or the section 415 limit, if lower) without any nondiscrimination concerns. This is arguably similar to a $9,240 IRA and thus could be referred to as the "$9,240 IRA problem." For two main reasons, we disagree that this is a problem. First, employees earning up to $66,000 (or even $100,000) at large employers across the country effectively have a $9,240 IRA under present law. A $40,000 per year officer of a small tax-exempt employer, for example, should not be treated more harshly. In fact, if that officer is treated as a highly compensated employee, under the ADP (and ACP) nondiscrimination tests, he or she is treated even worse than truly highly paid executives at large companies. At large employers, invariably many highly compensated employees contribute little or nothing, enabling the other highly compensated employees to contribute much more than the maximum permitted high-paid average; the $40,000 officer at the small tax-exempt employer is the only highly compensated employee and thus is limited to the maximum permitted high-paid average.

Our second response to the "$9,240 IRA problem" is that middle-income Americans saving $9,240 is not a problem at all, but actually a goal to strive to achieve. There is an alarming need in this country to stimulate savings and retirement savings in particular. If a middle-income American can afford to save $9,240 for retirement, such savings should be encouraged.

The Portman/Cardin bill also contains a provision to prevent owners of very profitable businesses from manipulating their technical compensation below $80,000 (indexed) to take advantage of the definition of highly compensated employee.

In short, the definition of highly compensated employee under the Portman/Cardin bill would correct serious flaws in present law and lift significant burdens from small employers, without any sacrifice in policy.

<u>VEBAs</u>.

<u>In general</u>. The Portman/Cardin bill not only provides extensive simplification of the retirement plan rules but also provide a major advance in terms of health policy by clarifying the law with respect to VEBAs.

In general, VEBAs are trusts through which employers provide welfare benefits, such as health insurance, to their employees. The most important advantage of a VEBA is not found in the tax laws but rather in the fact that VEBAs provide small employers with a means of pooling their buying power and thereby reducing their health insurance costs. The reduction of the cost of health insurance is crucial to expanding the health insurance coverage of employees of small employers.

VEBAs also have certain tax advantages. These tax

advantages were significantly curtailed by the Deficit Reduction Act of 1984 ("DEFRA"). The provisions of the bill relating to VEBAs would not modify any rule imposed by DEFRA. On the contrary, the bill would enable small employers to maintain a VEBA, subject to the DEFRA restrictions.

In general, the current IRS position is that in order for different employers to maintain a common VEBA, the employers must either be (1) affiliated, or (2) in the same line of business and in the same geographic locale (such as within a single state). It is unclear under present law whether employers that are not subject to common ownership or common control may be considered "affiliated."

A narrow interpretation of affiliation, limiting it to the common ownership or control situations, would be inconsistent with sound health policy because such an interpretation would significantly reduce the ability of closely related small employers to band together to reduce their health costs. This result would also be inequitable because large employers, by virtue of their size, have access to such reduced costs.

Accordingly, NRECA wholeheartedly supports the provision of the Portman/Cardin bill that clarifies that certain types of employers are considered affiliated if they perform services that are the same or directly related to each other. The bill provision applies to "section 501(c)(12) organizations," which includes a range of different types of employers (e.g., rural electric cooperatives, telephone cooperatives, mutual ditch or irrigation companies, and benevolent life insurance companies of a purely local character). NRECA believes that this provision would serve important health policy objectives.

Multiple employer trusts. We would like to emphasize that a VEBA maintained by such affiliated employers does not in any way resemble the abusive type of multiple employer trust that has caused concern among Congress, the Department of Labor, and state regulators. That concern relates to trusts that are marketed to unrelated small employers by third party entrepreneurs whose practices result in large gains for themselves and large losses for the small employers. A VEBA of the sort described in the Portman/Cardin bill is almost invariably maintained by the affiliated employers themselves through a wholly controlled association that provides a broad array of ongoing services to the member employers. There is no third-party entrepreneur involved and thus no opportunity for the type of abusive practices causing the concerns.

In addition, we believe that Federal and state laws provide sufficient tools for regulators to prevent the abusive trusts. The current problem lies not in the laws, but in the enforcement of those laws. It would hardly seem appropriate for this problem, under which small employers are being victimized, to prevent legislation enabling small employers to use VEBAs to reduce their health care costs. The better answer would be for the laws to be enforced and to allow small employers the benefits of VEBAs.

Possible tax concerns. In the past, three possible concerns have been raised with respect to a similar VEBA provision: (1) the provision would essentially enable VEBAs to operate as insurance companies without being subject to the Federal tax rules applicable to insurance companies, (2) VEBAs were not intended to benefit large groups of employees, and (3) the provision would cause a loss of Federal tax revenues. We address each of these three arguments below.

The basic distinction between an insurance company and a VEBA is that an insurance company provides insurance coverage to policyholders who typically have no relationship to each other. A VEBA, on the other hand, must provide coverage to employees who

share an "employment-related common bond." In general, the IRS position is that employees share such a bond if their employers meet the tests described previously, i.e., that the employers are either (1) affiliated, or (2) in the same line of business and in the same geographic locale. Accordingly, for example, under the IRS position, 100 employers with 100,000 employees in the same state could maintain a common VEBA even though the employers and employees have no relationship to each other other than being in the same line of business. If such employees share an employment-related common bond, there can be little doubt that employees of a national group of employers share an employment-related common bond in the circumstances described in the Portman/Cardin bill, i.e., where their employers are not only in the same line of business but also provide the same service or directly-related services.

The second concern is that VEBAs were not intended to benefit large groups of employees. There is no basis in the regulations for this position. In outlining what groups of employees may participate in a common VEBA, the Treasury regulations contain no rules with respect to the size of the group. For example, under the Treasury regulations, a national conglomerate with 200,000 employees can clearly maintain a single VEBA for all of its employees. It is difficult to understand why there could be an objection to a VEBA covering, for example, 50,000 employees of small employers on the grounds that such a VEBA is too big while current regulations permit large employers' VEBAs to cover far greater numbers of employees

The third concern is that the VEBA provision would cause a loss of Federal tax revenues. Our response to that objection is very simple: we at NRECA are prepared to work with Members of Congress and their staffs to develop proposals to pay for this important health care provision.

Clarification. Implicit in the concerns described above with respect to the VEBA provision is the view that the provision would represent a major change in the law. We do not agree. There is no authority with precedential value articulating a definition of "affiliation" inconsistent with the VEBA provision. We believe that the VEBA provision in the Portman/Cardin bill is simply a clarification, albeit a very important one, of the meaning of "affiliation" under present law.

Moreover, in the only court case to address the issue, the IRS position that employers in the same line of business must be in the same geographic locale was held to be invalid and thus not part of present law. In the absence of any court case upholding the IRS position, we submit that the geographic locale rule is not applicable. Without the geographic locale rule, the VEBA provisions in the Portman/Cardin bill, by definition, do not permit any VEBA not permitted under present law.

Three-state proposal Finally, we would like to mention one VEBA proposal that has been discussed in the past and has subsequently been proposed as a regulation by Treasury. The proposal would be to limit VEBAs to a three-contiguous-state area, or a larger area if the Secretary determined that the employer-group in the three-state area was too small to make self-insurance economical. Very briefly, we view this proposal as significantly more restrictive than present law, because, as noted, the geographic locale rule has been held invalid and thus not part of present law. Moreover, if this proposal were adopted in lieu of the provisions in the Portman/Cardin bill, it would have a very adverse effect on health care policy as it would significantly limit small employers' ability to band together to obtain health insurance at a lower cost.

Section 401(k).

Section 401(k) nondiscrimination rules. Section 401(k) plans are probably the fastest growing type of retirement plan because of the flexibility they provide to each participant to plan for his or her own retirement needs. However, if any item has slowed the growth of section 401(k) plans, particularly among smaller employers, it is the application of complex nondiscrimination rules that require calculations based on the contributions made by each employee eligible to participate.

NRECA supports the policy objectives of the nondiscrimination rules. NRECA believes that the law should prevent qualified retirement plans from operating primarily for the benefit of highly compensated employees. However, we believe that the policy objectives can be achieved without the administrative burdens of present law.

As the level of matching or nonelective contributions is increased in a section 401(k) plan, it becomes increasingly likely that the plan will satisfy the nondiscrimination rules. Accordingly, when the matching or nonelective contributions reach a certain level, it seems unnecessary to require the employer to apply the burdensome nondiscrimination rules based on the actual contribution made by each eligible employee. In such circumstances, the nondiscrimination rules should be deemed satisfied without regard to the actual amount contributed by each eligible employee.

This is precisely what the Portman/Cardin bill does. In general, the Portman/Cardin bill provides a safe harbor under which the nondiscrimination rules are deemed satisfied if the employer makes a matching contribution of a dollar for every dollar contributed by a nonhighly compensated employee, up to three percent of the employee's compensation, and a matching contribution of 50¢ for every dollar contributed by the employee between three and five percent of the employee's compensation. The bill also provides an alternative safe harbor under which the nondiscrimination rules are generally deemed satisfied if the employer makes a nonelective contribution on behalf of each eligible nonhighly compensated employee of at least three percent of the employee's compensation.

We believe that this safe harbor would significantly ease the burdens of maintaining a section 401(k) plan without sacrificing the policy concerns underlying the nondiscrimination rules.

Section 401(m) nondiscrimination rules -- The Portman/Cardin bill provides that, with respect to employer matching contributions, the section 401(m) nondiscrimination rules are deemed satisfied under a safe harbor provision similar to the one described above with respect to the section 401(k) nondiscrimination rules. We support this provision.

Section 401(k) plans for rural cooperatives. The Portman/Cardin bill contains a provision correcting two "glitches" in the manner in which the section 401(k) rules apply to rural cooperatives. The corrections would simply allow rural cooperatives to maintain section 401(k) plans on the same basis as other employers. We support this provision.

Use of prior year data -- Under the Portman/Cardin bill, the section 401(k) and 401(m) nondiscrimination rules (other than the safe harbor provisions) would generally be applied based on the preceding year's data with respect to the employer's nonhighly compensated employees. We believe that this proposal would contribute substantially to the administrability of plans subject to the section 401(k) and 401(m) nondiscrimination rules.

Definition of compensation.

Section 415 sets forth limits on participants with respect to allocations under a defined contribution plan and with respect to benefits under a defined benefit plan. Both limits are based in part on a participant's taxable compensation. Thus, for example, if a participant elects to reduce his or her salary to contribute to a section 401(k) plan or to obtain health insurance under a cafeteria plan, the participant's section 415 limit is generally reduced by virtue of the reduction in his or her taxable compensation.

There is no policy justification for this result. There is no reason that a participant's election to buy health insurance or to save for retirement should reduce his or her section 415 limit. Moreover, anecdotal evidence suggests that this rule is a constant source of inadvertent violations by retirement plans striving to comply with lengthy regulations.

The Portman/Cardin bill would address this problem by including all pre-tax salary reduction contributions in the definition of compensation for purposes of section 415. This provision simply and effectively solves a problem under present law and we support the provision

SEPs.

SEPs were designed to be simple to establish and maintain. It was intended that SEPs would thus be an attractive option for employers, primarily small employers, that had failed to adopt a retirement plan due to the complex requirements. However, the attractiveness of SEPs to small employers has been undermined by the application of rules that are more restrictive than those applicable to other qualified retirement plans.

A 1989 report sponsored by NRECA entitled "Retirement Coverage in Smaller Firms: Toward a Solution" recommended that SEPs be "revised to increase their flexibility and encourage greater use while retaining their administrative advantages." This is precisely what the Portman/Cardin bill does. For example, the bill significantly enlarges the group of small employers that may permit pre-tax employee contributions to SEPs by raising the maximum permissible number of employees from 25 to 100. The bill also provides that the nondiscrimination rules applicable to such pre-tax employee contributions and to matching contributions are deemed satisfied under the same safe harbor provisions that the bill would apply to the section 401(k) and 401(m) nondiscrimination rules (as described above, regarding minimum levels of matching contributions or nonelective contributions).

NRECA believes that the Portman/Cardin bill's SEP provisions, combined with the other retirement plan proposals discussed previously, could usher in a new era of broader retirement plan coverage among small employers.

July 19, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Archer:

I am writing to express my views regarding the state of competition in the credit card industry. I write in my capacity as Treasurer of Arlington County, Virginia, a past President of the Treasurers' Association of Virginia, and the founder of the Northern Virginia Tax and Revenue Group. I believe that my views, which are shared by the rest of Virginia's treasurers, are representative of our municipal, county and state counterparts across the nation.

I have learned the hard way that VISA and MasterCard, the two bank card associations in the United States, wield extraordinary and inappropriate financial power. As a government treasurer, I have had to deal with these associations regarding the terms on which my county's taxpayers can utilize their VISA and MasterCard credit cards to pay taxes and other mandatory payments which they owe. That experience has been extremely difficult - so difficult, in fact, that it has resulted in Visa/MasterCard terminating credit card services for tax collection purposes in Arlington at the end of March 1994 because I did not bend to their will.

Arlington is not an isolated exception. Visa/MasterCard have ordered their merchant banks to terminate the use of their credit cards for the payment of taxes in every jurisdiction in Virginia. Nationally, Visa/MasterCard have discontinued the credit card services of, at least, 500 and, perhaps, as many as 800 state and local government agencies. Interestingly, in all cases, the services of both credit cards have been terminated simultaneously. Should a local bank defy Visa/MasterCard, they are liable for monthly fines (as much as $100,000 has been threatened) or loss of their ability to vend bank card services.

The specific dispute between Visa/MasterCard and governments arises from our refusal to absorb the fee imposed for using a credit card. This fee, which averages about 2.85 percent nationally, would increase operating costs dramatically if absorbed by government. For example, were all of Arlington's revenue to be received through Visa/MasterCard, credit card fees would cost us more than an additional $8 million annually; over twice the current budget of the Treasurer's office! Clearly, it is the card holder, who voluntarily elects to use a credit card for the payment of government taxes and fees, who should pay the costs arising from its usage. Let me add that in our ten year history of using credit cards, I have yet to talk with a single taxpayer who disagreed with this position (as evidenced by the nearly 9,000 credit card charges we processed last year, under this arrangement).

In my opinion, the power of these two associations, which totally control the credit card industry and between which there is, in my experience, virtually no difference, is extremely disturbing given their suppressive activities. (If their closely coordinated actions and policies do not reflect a monopoly situation, they certainly reflect a powerful oligopoly). By contrast, the attitudes and policies of other independent card issuers, in particular Discover Card, are dramatically more positive and constructive.

For some time, it had puzzled me why there had been no start-ups of new independent credit cards, similar to Discover Card, in the last several years; particularly by the major companies that have entered the market, such as General Motors and AT&T. Recently, I became aware that there is a policy on the part of the bank card associations to severely penalize any existing or prospective VISA or MasterCard member who offers an independent card - a policy under which any such company loses the ability to issue VISA and MasterCard cards. Now it is clear to me why it is that no such cards have been initiated since Discover Card and why Visa/MasterCard dominate the market. Acting together, they have effectively stifled credit card development, employing the same heavy-handed tactics they have employed in stifling governmental usage.

I believe that, maximizing the benefits of a free and competitive market place through the development of new credit cards, such as Discover Card (which has worked with government to create new approaches to serving our citizens), is the only way to check the power of the bank card associations. In my view, policies which effectively prevent the introduction of such cards are inimical to badly needed competition in this industry. I would urge you to look into this problem and seek legislative or other approaches to addressing it.

Sincerely,

F O'Leary

Francis X. O'Leary
Treasurer Arlington County

TESTIMONY OF MASTERCARD INTERNATIONAL INC.

MasterCard International Incorporated ("MasterCard")[1] appreciates the opportunity to submit to the Ways and Means Committee ("Committee") of the United States House of Representatives, our views concerning the effort underway in the Committee to modify Section 112 of H.R. 3419 which would permit payment of taxes to the Internal Revenue Service ("IRS") by credit card. More specifically, this statement reflects our views regarding the proposal ("Proposal") noted in the June 30, 1995 Advisory from the Committee (No. FC-8) to significantly alter Section 112 by "clarifying that the fees that may be imposed for using a credit card to pay Federal taxes could not be borne by the Federal government." The Proposal would represent an extreme change in Section 112 creating the unique and inequitable circumstance in which the only way a credit card company could accommodate IRS acceptance of credit cards is to provide its services to the IRS for free. For the reasons discussed below, we urge the Committee to reject this Proposal. MasterCard requests that this statement be made part of the record of the Committee's July 11 and July 12, 1995 hearing on miscellaneous tax reforms.

In order to fully appreciate the significant adverse consequences the Proposal would have on the IRS acceptance of credit cards, it is important to understand the MasterCard system and how the IRS would participate in that system. MasterCard is an organization comprised of financial institutions that perform the various functions necessary to operate the credit card system. The primary function of member financial institutions is to issue credit cards to individuals for their use in purchasing goods and services from merchants and other organizations who are licensed by the system to accept the cards. This is commonly referred to as the "card issuing" function.

MasterCard members also authorize merchants and other organizations such as government entities through merchant agreements to accept credit cards. Members that perform this function are commonly referred to as "acquiring members."

There are sophisticated electronic systems which interconnect the various parties in a MasterCard credit card transaction. For example, there are systems which enable the authorization process in which a merchant who has been presented a credit card can transmit an on-line message to the credit card issuer to obtain the card issuer's authorization for the transaction. Once the credit card has been accepted by the merchant, the record for that transaction is transmitted by the acquiring member who contracted with that entity to accept MasterCard credit cards, through the MasterCard system to the member that issued the card to the cardholder. Through the MasterCard system, funds are cleared from the issuing member to the acquiring member to cover the transaction, and the acquiring member transfers or credits funds to the merchant. In addition, the card issuing member debits the cardholder's account for the amount of the transaction

[1] MasterCard is a membership organization comprised of financial institutions that are licensed to use the MasterCard service marks in connection with payment systems, including credit cards.

and, at the end of the billing cycle, sends the cardholder a periodic statement which reflects the transaction as well as other transactions made on the account by the cardholder during the billing cycle. In a typical credit card transaction, the issuing member and acquiring member are two separate financial institutions.

Needless to say, there are substantial costs involved in operating the various components of the MasterCard system and these costs must be borne by participants in the system. Cardholders bear their share of the costs by compensating card issuers through the payment of interest charges and fees established by their particular card issuer. Merchants and other organizations that accept credit card payments compensate acquiring members for their services by paying a fee or through other means such as compensating balance arrangements. The terms of the compensation and other merchant contract provisions are established through negotiations between the acquiring member and the merchant.

It is our understanding that the IRS seeks to accept credit cards in order to obtain a variety of benefits resulting from the use of the credit card systems. In particular, the ability to accept credit card and similar types of electronic payments is essential to the IRS effort to modernize through the use of electronic filing and other similar programs. Paper-based payment products such as checks cannot be electronically transmitted with an electronically filed tax return. Therefore, the maximum economic efficiencies of electronic filing simply are not attainable without the ability to, at the same time, accept payments transmitted electronically, such as credit card payments.

We also understand that the IRS seeks other benefits that would accrue from acceptance of credit cards. For example, because credit card payments can be cleared electronically, they require less time to process than checks and other paper payment instruments and reduce the amount of time it takes to deposit taxes collected into Treasury accounts. Also, IRS acceptance of credit cards, by enabling taxpayers to access available credit on their credit card accounts to pay their taxes, would increase the likelihood of compliance by taxpayers who otherwise would be unable to make timely payment because they do not have sufficient cash available to do so.

In order to accept MasterCard credit card payments, it would be necessary for the IRS to enter into an agreement with one or more acquiring members of MasterCard. For more than three years, MasterCard and other industry representatives have worked with Committee Staff, Staff of the Senate Finance Committee, Staff of the Joint Committee on Taxation, and the IRS to develop workable legislation which would enable the IRS to enter into such an agreement in an appropriate way. The results of those efforts were embodied in Section 112 of H.R. 3419 which provides a framework in which it would be possible for the IRS to enter into the arrangements necessary for credit card acceptance. Among other things, Section 112 would authorize the IRS to pay the fees necessary to economically justify credit card acceptance. As we understand the

Proposal, however, the Committee is now considering prohibiting the IRS from paying for participation in the credit card systems. MasterCard strongly urges the Committee to reject any proposal that would prevent the IRS from paying for credit card services. It would be inappropriate to treat the credit card industry differently than any other payment service provider is treated when dealing with the IRS. The IRS should pay for credit card services just as the IRS today compensates banks and other providers for the services needed by the IRS to process payments by check. It also would be inappropriate for Congress to encourage the IRS to modernize its systems but mandate that the IRS can only realize the benefits of the modernization program if it obtains a subsidy from the credit card industry in the form of free services. The Proposal is akin to authorizing the IRS to obtain mainframe computers from IBM, personal computers from Apple Computer, and software from Microsoft, to update the IRS data processing capabilities, but prohibiting the IRS from paying for any of these products. Obviously, it is impossible for the IRS to achieve its modernization objectives if it is prohibited from paying for the products and services necessary to modernize. In order to achieve its objectives, the IRS must be able to pay a fair price for the products and services it acquires, just as any private sector company would be required to do so.

In short, in order for the IRS to accept credit cards, it must have the flexibility to negotiate an agreement with an acquiring member and, of course, pay for those credit card services. Accordingly, in the event the Committee decides to consider legislation authorizing the IRS to accept credit cards, we urge the Committee to reject the Proposal and adopt Section 112 of H.R. 3419 as currently drafted.

Once again, we would like to thank the Committee for the opportunity to comment on the Proposal. MasterCard is committed to working with the Committee and its staff to achieve workable legislation authorizing the IRS to accept credit cards and similar products.

TESTIMONY OF VISA U.S.A. INC.

This statement sets forth the views of VISA U.S.A. Inc. ("VISA")[1] on the proposal being considered by the Ways and Means Committee ("Committee") of the United States House of Representatives. That proposal would authorize the Internal Revenue Service ("IRS") to accept credit card payments but would prohibit the IRS from paying any fees for participating in those systems. As discussed more fully below, we believe that the IRS, just like any other organization seeking to obtain services from private sector providers, should pay a fair price for those services and we urge the Committee to reject any proposal that would prohibit the IRS from doing so. We request that this statement be made part of the record of the Committee's hearings on miscellaneous tax reforms which took place on July 11 and July 12, 1995.

VISA strongly supports IRS efforts to modernize the revenue collection process. We believe that accepting credit cards should be an important part of that effort, for it could greatly enhance the efficiency of the IRS collection function. However, if the IRS is to enjoy the benefits of credit card acceptance, it must have the flexibility to pay for the services.

Enormous capital investment has been made to create the credit card systems and there are ongoing costs of operation which must be borne by those who participate in the systems. For example, more than $10 billion has been invested in establishing the VISA card system and the more than 19,000 member financial institutions that participate in that system incur costs to provide ongoing services to consumers, businesses and other entities utilizing the system.

A key function of the VISA member financial institutions is to issue credit cards to consumers and businesses who use them to pay for goods and services. Many members of VISA also perform the important role of establishing arrangements with merchants and other entities to enable them to accept VISA cards. Members who enter into these arrangements are known as "acquirers." In the event that the IRS wishes to accept VISA cards, it would be necessary for the IRS to enter into an agreement with at least one acquirer. The acquirer would provide the services needed to accept VISA cards, including establishing the telecommunications links and systems needed to transmit credit card payments electronically and would generally serve as the interface between the IRS and the VISA system to authorize, clear and settle transactions.

The arrangement with an acquirer also is the channel through which the IRS would obtain the other significant concrete, quantifiable economic benefits that flow from the ability to accept credit cards. For example, a key element of the IRS efforts to generate efficiencies by modernizing the revenue collection process is the effort underway to facilitate electronic filing of tax returns. That process will be efficient only if tax payments also can be transmitted electronically with the filing itself. Therefore, it is essential to the success of the electronic filing programs that the IRS have access to forms of payment

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[1] VISA is a membership organization comprised of financial institutions that are licensed to use the VISA service marks in connection with payment systems, including credit cards.

which can be transmitted electronically and are widely used by U.S. taxpayers. There is no question that credit cards would satisfy the needs of the IRS in a manner, and to an extent, which simply is not possible today with other payment mechanisms.

In addition, regardless of whether a tax return is filed electronically or on paper, the ability to accept credit card payments produces significant efficiencies when compared to payments by check. For example, because the information needed to clear a credit card payment may be transmitted electronically, funds would be transferred to IRS accounts much more quickly than is possible for check payments. Moreover, it is anticipated that authorizing the IRS to accept credit cards will increase taxpayer compliance by enabling taxpayers, who do not have cash to pay their taxes, to make timely payments to the IRS by using credit available on their credit card accounts.

In exchange for these services and benefits, the IRS would be expected to compensate the acquirer that arranges for the IRS to accept VISA cards or any other payment card. Indeed, in order for the arrangement between the acquirer and the IRS to be economically feasible and sustainable, the acquirer must be compensated for its services. The amount and manner of compensation would be negotiated directly between the acquirer and the IRS (or another Federal entity designated by Congress for this purpose). In many arrangements, compensation is paid as a "merchant discount" on each transaction. Again, the amount of that discount is negotiated by the acquiring member and the merchant. Compensating balance arrangements provide another means of compensating the acquirer, which can be used in lieu of or in combination with a merchant discount. More than 2,000 governmental agencies around the country already accept credit cards and compensate their acquirers in order to do so. These include Federal operations such as the U.S. Government Printing Office and U.S. Commissaries as well as large municipalities like the cities of Boston, Massachusetts and Irvine, California.

In any event, if the IRS is to enjoy the benefits of credit card acceptance, it must retain the authority to negotiate and pay a fee for the necessary credit card services. However, the proposal under consideration by the Committee would statutorily prohibit the IRS from paying any compensation for credit card services and, thus, would thwart the IRS efforts to obtain the benefits of credit card acceptance.

VISA strongly opposes such an approach and urges the Committee to reject the proposal. It would be fundamentally unfair to adopt a proposal which treats the credit card industry differently than any other private sector company is treated when dealing with the United States Government. In this regard, the IRS currently utilizes the services of many banks in processing tax payments received by check and compensates those banks for those services. Entities that provide credit card services to the IRS should be treated in precisely the same way -- the IRS should fairly compensate them for the services they provide to the IRS.

Moreover, it would be entirely inappropriate to authorize the IRS to accept credit cards but statutorily mandate that the only way the IRS can

achieve the benefits of credit card acceptance is to obtain a subsidy from the credit card industry in the form of services provided at no charge. Such a subsidy would be the equivalent of a new tax on the credit card industry which inevitably would be passed on to American consumers.

The IRS and other Federal governmental entities regularly procure and pay for goods and services from the private sector. If the IRS accepts credit cards, the credit card industry would be providing services to the IRS in much the same way that office equipment companies sell equipment and services to the IRS. There is no expectation that an office equipment company would "donate" its products or services to the IRS.

Once again, we urge the Committee to reject the proposal and to ensure that the IRS, if authorized to accept credit cards, retains the authority to enter into agreements and pay appropriate fees for obtaining credit card services.

VISA appreciates the opportunity to submit our views to the Committee on this important matter. We stand ready to continue to work with the Committee and its staff as it considers legislation authorizing the IRS to accept credit card payments

Written Testimony Submitted to the
Committee on Ways and Means in connection with
its Hearings on Miscellaneous Tax Reforms
by Bruce H. Vincent, Senior Vice President,
Swift Energy Company and Chairman,
Legislative and Regulatory Affairs Committee
of the Investment Program Association

My name is Bruce H. Vincent. I am submitting this statement in my capacity as Chairman of the Investment Program Association's Legislative and Regulatory Affairs Committee. The IPA has devoted considerable time, energy and resources to an effort to encourage the IRS, the Treasury Department, and the congressional tax writing committees to seriously consider simplifying the tax reporting and compliance system for individual limited partners who hold interests in large, widely-held partnerships.

We are delighted that the IRS, the Treasury and the Congress have recognized the mutual interest we all have in creating a simpler system under which large partnerships and limited partners can more successfully attempt to comply with the Federal income tax laws. We strongly support the simplified reporting rules for large partnerships contained in H.R. 3419. However, we believe the extension of a provision of existing law to limited partners in large non-publicly traded partnerships is absolutely essential to the success of our joint efforts to simplify and improve the ability of limited partner investors to comply with the Federal income tax laws.

H.R. 3419 provided that large partnerships (generally a partnership with at least 250 partners or an electing partnership with more than 100 partners) would be required to determine taxable income by applying all limitations and other provisions affecting the computation of taxable income at the partnership rather than the partner level. In addition, all elections affecting the computation of taxable income or any credit generally would be required to made by the partnership.

Each partner would be required to separately take into account their respective distributive share of the following items, determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income from other activities (e.g.,portfolio income or loss); (3) net capital gain or loss; (4) tax-exempt interest; (5) net alternative minimum tax adjustments; and (6) tax credits.

H.R. 3419 codified these changes to permit large partnerships to compute partnership income, loss, minimum tax liability, capital gains and losses and tax credits at the partnership level and to flow through these items to individual limited partners in far simpler fashion. These proposed changes make it possible to significantly alter and simplify the form on which this information is transmitted to limited partners. These provisions had already been approved by the Congress as part of H.R. 11 in 1992.

We urge that this general approach be adopted, along with the additional important provision I will describe below.

To truly achieve a simplified reporting system for millions of limited partners with small investments in widely-held partnerships, the IPA believes that one additional item must be added to the large partnership simplification proposals contained in H.R.3419. The IPA proposes that existing and newly formed widely-held, non-publicly traded partnerships be permitted to elect to be subject to existing Section 469(k) of the Internal Revenue Code of 1986, as amended.

Section 469(k) requires items of passive or portfolio income or loss, net passive or portfolio gain or loss, net alternative minimum tax adjustments, tax credits, etc. to be separately accounted for by publicly traded partnerships. Limited partners with interests in publicly-traded partnerships may not offset reported losses against their share of similar income or gain from other partnerships. Limited partners may only take such losses into account, should they exceed income from the partnership, in computing taxable income in the year in which they dispose of their entire interest in the partnership.

To simplify the compliance burden for limited partners holding interests in large, non-publicly traded partnerships, it is proposed that existing and newly formed such partnerships be permitted to elect to be subject to Section 469(k) and thus be permitted to maintain the record of currently non-deductible passive and portfolio losses for each limited partner and to report the deduction for passive or portfolio losses properly allocable to limited partners at such time as the electing partnership has passive or portfolio income against which to offset such losses or at the time a partner disposes of his entire partnership interest.

By adding this proposed change to the partnership simplification provisions, the Congress will help limited partners by reducing unnecessary complexity and at the same time achieve a small revenue increase for the Treasury. This change would spare the vast majority of individual limited partners from a totally unnecessary bookkeeping burden and the added cost of annually retaining a tax professional to determine if they may have, at best, a small, insignificant deductible loss.

Limited partners want a simpler tax regime. They are willing to forego the possibility of a small tax deduction obtained only after the expenditure of tax preparer fees barely less than the value of the deduction. The IPA strongly urges your favorable action on this proposed change.

**WRITTEN STATEMENT OF CHARLES H. LEONARD
SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER,
TEXAS EASTERN PRODUCTS PIPELINE COMPANY,
GENERAL PARTNER OF TEPPCO PARTNERS, L.P.
FOR THE RECORD OF THE HEARINGS ON MISCELLANEOUS TAX REFORMS
BEFORE THE COMMITTEE ON WAYS AND MEANS**

Mr. Chairman and members of the Committee, I appreciate the opportunity to submit this statement to the Committee in connection with the hearings on miscellaneous tax reforms. My name is Charles H. Leonard, and I am senior vice president and chief financial officer of Texas Eastern Products Pipeline Company, the sole general partner of TEPPCO Partners, L.P. ("TEPPCO"). TEPPCO owns and operates an approximately 4,300 mile pipeline system which extends from Southeast Texas through the Midwestern United States to the Northeastern United States. As a publicly traded limited partnership, TEPPCO has over 20,000 limited partners that reside throughout the United States.

TEPPCO believes that federal tax laws affecting publicly traded partnerships ("PTPs") are complex and deter investors from owning interests in TEPPCO and other PTPs. TEPPCO supports the simplification provisions for large partnerships that are described in the announcement for this hearing, including the simplified flow through provision and the simplified audit procedures. In addition, TEPPCO believes that treatment of PTP investments under the unrelated business income tax ("UBIT") rules and regulated investment company ("RIC") rules is inconsistent with the purposes of these rules and should be amended.

Large Partnership Simplification

TEPPCO strongly supports the large partnership simplification provisions because they would make it easier for TEPPCO's unitholders to file their individual income tax returns. Many of the items required to be reported separately serve no useful purpose and add to the costs associated with tax compliance for both TEPPCO and its unitholders. Many of TEPPCO's unitholders have received erroneous notices in the past that the amounts reported on their individual returns did not match with the amounts reported by TEPPCO to IRS. The mismatch was caused by the failure of the IRS computer program to combine all of the appropriate items before the match was attempted. We believe that this sort of problem would be eliminated or greatly reduced by the enactment of the large partnership simplification provisions that reduce the number of possible items that need to be separately reported. Tax return preparation costs should also be significantly reduced if many items are combined for reporting purposes.

The announcement for this hearing indicated that consideration is being given to deleting the simplified audit procedures provision for large partnerships. TEPPCO does not support such deletion. The current audit procedures are unworkable for partnerships with thousands of partners. The settlement process is made more costly for both partnerships and the IRS because of the rights of limited partners to participate. Because of the time period that normally elapses between the end of the tax year and the conclusion of the audit, many limited partners no longer own their units and are difficult and costly to track down. In many cases, the costs involved in collecting the added tax can be less than the tax itself. This audit process is further complicated by the inability of the Tax Matters Partner to bind all limited partners in the treatment of partnership items. The simplified procedures included in H.R. 3419 are far superior to the current procedures because they would allow the IRS and the partnership to resolve all issues at the partnership level, and flow through any resulting adjustment to the current year partners, thereby eliminating the need for thousands of amended individual income tax returns.

The large partnership simplification provisions were developed in a collaborative effort with Treasury, IRS, the staff of Congressional tax writing committees, and representatives of the partnership community. They should be enacted without further delay.

Unrelated Business Income Tax

Under present law, a tax-exempt organization that invests in a PTP is treated as engaged in the PTPs trade or business and is taxed on its share of PTP income unless it falls within one

of the exceptions for passive income, or is below a $1,000 threshold. The practical effect of this rule is to deny PTPs access to a significant source of capital and to deny tax-exempt organizations (including IRAs) the benefits of investing in PTPs. The rule is intended to prevent tax-exempt organizations from using their tax exempt status to unfairly compete with taxable businesses through the use of partnerships. Application of this rule to limited partners in PTPs goes far beyond what is necessary to accomplish the purpose of the unrelated business income tax ("UBIT"). The UBIT rules recognized the legitimate needs of tax-exempt organizations to make passive investments and accordingly has always exempted interest, dividends, rents and royalties from their application. At the time these exemptions were created, PTPs did not exist. However, investments in PTPs by limited partners are equally as passive. Limited partners do not participate in any way in managing or operating the trade or business of the PTP.

Although the existing UBIT rules have kept pension funds and other large tax-exempt investors from owning PTP units, many individual investors have purchased PTP units through their IRAs, often unaware of the negative UBIT consequences. The $1,000 deduction is very little help to the small tax-exempt investor in PTPs because to take advantage of the deduction requires careful monitoring of the income allocated from the PTP, and all other investments that are subject to UBIT, to insure that such income in the aggregate does not exceed $1,000.

TEPPCO supports the proposal of the Coalition of Publicly Traded Partnerships to amend the large partnership simplification provisions to include a *de minimis* rule which exempts from UBIT investments representing less that a 5% interest in a partnership's capital. This proposal was submitted to the Committee by Dr. Letitia Chambers, president of the Coalition, in her testimony at the hearing on July 12, 1995. Such a rule would allow investment in PTPs by a tax exempt organization while insuring that it could not acquire enough ownership so as to use the PTP to unfairly compete with taxable businesses. TEPPCO believes that the proposal would have little or no effect on the federal budget deficit because it would merely shift the capital of tax exempt entities from one untaxed investment to another.

Mutual Funds

Mutual fund investors are also denied access to PTPs through rules that govern the qualification of mutual funds as regulated investment companies ("RIC"). Mutual.funds must receive 90% of their gross income from such sources as dividends, interest, or gains on sale of securities. Income received from a PTP does not qualify. Rather than risk the loss of its pass-through status as a RIC, mutual funds generally avoid investments in PTPs. Otherwise, they would need to carefully monitor all sources of income to insure that the income received from PTPs and all other non-qualified sources does not exceed 10 percent of total gross income.

Like many PTPs, TEPPCO units trade on the New York Stock Exchange. PTP units are just as appropriate for mutual funds as the other securities that generate qualifying income. As more and more individuals choose to invest through mutual funds, TEPPCO loses more access to potential sources of capital that would otherwise be very interested in owning our units.

TEPPCO supports the Coalition of Publicly Traded Partnership's proposal to amend Code section 851(b) to treat income from PTPs as qualifying income as submitted by Dr. Chambers in her testimony before the Committee on July 12, 1995.

Conclusion

TEPPCO strongly supports large partnership simplification and thanks the Ways and Means Committee for including it as part of the hearings on miscellaneous tax reforms. TEPPCO believes that the large partnership provisions included in H.R. 3419 should be adopted in their entirety, and that UBIT and RIC rules that deter investment in PTPs be reformed as proposed by the Coalition of Publicly Traded Partnerships.

On behalf of TEPPCO and its unitholders, I thank the Committee for the opportunity to participate and for its thoughtful consideration of our views.

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