TECHNICAL CORRECTIONS ACT OF 1977

(Including Carryover Basis Provisions)

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

H.R. 6715

TO CORRECT TECHNICAL AND CLERICAL MISTAKES IN THE TAX LAWS

S. 1954

TO REPEAL THE CARRYOVER BASIS PROVISIONS ADDED BY THE TAX REFORM ACT OF 1976

S. 2227

TO POSTPONE THE EFFECTIVE DATE OF THE CARRYOVER BASIS PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954

S. 2228

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO MAKE CERTAIN CHANGES IN THE ESTATE AND GIFT TAX PROVISIONS AMENDED OR ADDED BY THE TAX REFORM ACT OF 1976

OCTOBER 26, 27, 28, AND 31, 1977

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TECHNICAL CORRECTIONS ACT OF 1975
(Including Carryover Basis Provisions)

WEDNESDAY, OCTOBER 26, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senator Byrd.

Senator BYRD. The committee will come to order.

[The committee press release announcing these hearings and the bills, H.R. 6715, S. 1954, S. 2227, and S. 2228 follow:]

[Press Release]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY ANNOUNCES HEARINGS ON CARRYOVER BASIS AS PART OF THE "TECHNICAL CORRECTIONS ACT OF 1977"

Harry F. Byrd, Jr. (I.-Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Finance Committee, today announced that hearings will be held on October 27, and on October 28, 1977, on S. 1954, S. 2227, and S. 2228, and other bills which may be introduced dealing with the subject of carryover basis. The hearings will be held in Room 221 Dirksen Senate Office Building.

Hearings on October 27 will begin at 9 A.M., and will be limited to Treasury Department witnesses. Hearings for public witnesses will be held October 28 at 9 A.M. as part of the hearings on H.R. 6715, the "Technical Corrections Act of 1977." Additional hearings on a subsequent date will be scheduled if necessary.

Senator Byrd stated that the carryover basis portion of the estate tax is one of the most pressing problem areas created by the 1976 Tax Reform Act.

"Not only does carryover basis increase the complexity of the tax law, it also is a radical departure from our past estate tax law. Furthermore, the decisions about carryover basis where made at a conference between the House and Senate without thorough and adequate consideration by these bodies and their committees."

Senator Byrd said the hearings were scheduled to review carryover basis, as part of hearings dealing with a general clarification of the 1976 law.

S. 1954, sponsored by Senator Carl Curtis of Nebraska, provides for the elimination of the carryover basis provisions of the estate tax law, enacted in 1976.

S. 2227 and S. 2228 are sponsored by Senator Harry F. Byrd, Jr. of Virginia and Senator Robert Dole of Kansas. S. 2227 defers the effective date of the carryover basis provisions until January 1, 1979, S. 2228 includes several technical provisions designed to eliminate the complexities associated with carryover basis and make the law more workable.

Other Senators may introduce legislation dealing with carryover basis. In that event, those bills would also be considered in the hearings.

Public witnesses who desire to testify in the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510 by no later than the close of business on October 26, 1977.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon on the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least *75 copies* must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by October 31, 1977, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

[H.R. 6715, 95th Cong., 1st sess.]

AN ACT To correct technical and clerical mistakes in the tax laws

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 "Technical Corrections Act of 1977".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressely provided, whenever in this Act an amendment or repeal is expressed 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 1954.

(c) TABLE OF CONTENTS.—

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SEC. 2. TECHNICAL AMENDMENTS TO INCOME TAX PROVISIONS AND ADMINISTRATIVE PROVISIONS.

(a) Amendments Relating to Retention of Prior Law for Retirement Income Credit Under Section 37(e).—

(1) Clarification that spouse under age 65 must have public retirement system income.—Paragraph (2) of section 37(e) (relating to election of prior law with respect to public retirement system income) is amended by striking out "who has not attained age 65 before the close of the taxable year" and inserting in lieu thereof "who has not attained age 65 before the close of the taxable year (and whose gross income includes income described in paragraph (4)(B))".

(2) Clarification that qualifying services must have been performed by taxpayer or spouse.—Subparagraph (B) of section 37(e)(4) (defining retirement income) is amended by inserting "and who performed the services giving rise to the pension or annuity (or is the spouse of the individual who performed the services)" after "before the close of the taxable year".

(3) Disregard of community property laws.—Subsection (e) of section 37 (relating to election of prior law with respect to public retirement system income) is amended by redesignating paragraph (8) as paragraph (9) and by inserting after paragraph (7) the following new paragraph:

"(8) Community property laws not applicable.—In the case of a joint return, this subsection shall be applied without regard to community property laws."

(4) Effective dates.—

(A) The amendments made by paragraphs (1) and (2) shall apply to taxable years begnning after December 31, 1975.

(B) The amendments made by paragraph (3) shall apply to taxable years beginning after December 31, 1976.

(b) Amendments Relating to the Minimum Tax.—

(1) Special rules for minimum tax in the case of subchapter S corporations and personal holding companies.—

(A) Paragraph (1) of section 57(a) (relating to adjusted itemized deductions) is amended by striking out "An amount" and inserting in lieu thereof "In the case of an individual, an amount".

(B) The last sentence of section 57(a) (relating to items of tax preference) is amended by striking out "Paragraphs (1), (3), and" and inserting in lieu thereof "Paragraphs (3) and".

(C) Subsection (i) of section 58 (defining corporations) is amended by striking out "Except as provided in subsection (d)(2), for purposes of this part" and inserting in lieu thereof "For purposes of this part (other than section 57(a)(9))".

(2) Division of $10,000 amount among members of controlled groups.—Subsection (b) of section 58 (relating to members of controlled groups) is amended to read as follows:

"(b) Members of Conrtrolled Groups.—In the case of a controlled group of corporations (as defined in section 1563(a)), the $10,000 amount specified in section 56 shall be divided among the component members of such group in proportion to their respective regular tax deductions (within the meaning of section 56(c)) for the taxable year."

(3) COMPUTATION OF ADJUSTED ITEMIZED DEDUCTIONS IN THE CASE OF ESTATES AND TRUSTS.—Paragraph (2) of section 57(b) (relating to computation of adjusted itemized deductions in the case of estates and trusts) is amended to read as follows:

"(2) SPECIAL RULES FOR ESTATES AND TRUSTS.—

"(A) IN GENERAL.—In the case of an estate or trust, for purposes of paragraph (1) of subsection (a), the amount of the adjusted itemized deductions for any taxable year is the amount by which the sum of the deductions for the taxable year other than—

"(i) the deductions allowable in arriving at adjusted gross income,

"(ii) the deduction for personal exemption provided by section 642(b),

"(iii) the deduction for casualty losses described in section 165 (c)(3),

"(iv) the deductions allowable under section 651(a), 661(a), or 691(c), and

"(v) the deductions allowable to a trust under section 642(c) to the extent that a corresponding amount is included in the gross income of the beneficiary under section 662(a)(1) for the taxable year of the beneficiary with which or within which the taxable year of the trust ends,

exceeds 60 percent (but does not exceed 100 percent) of the adjusted gross income of the estate or trust for the taxable year.

"(B) DETERMINATION OF ADJUSTED GROSS INCOME.—For purposes of this paragraph, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—

"(i) the deductions for costs paid or incurred in connection with the administration of the estate or trust, and

"(ii) to the extent provided in subparagraph (C), the deductions under section 642(c),

shall be treated as allowable in arriving at adjusted gross income.

"(C) TREATMENT OF CERTAIN CHARITABLE CONTRIBUTIONS.—For purposes of this paragraph, the following deductions under section 642(c) (relating to deductions for amounts paid or permanently set aside for charitable purposes) shall be treated as deductions allowable in arriving at adjusted gross income:

"(i) deductions allowable to an estate,

"(ii) deductions allowable to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B),

"(iii) deductions allowable to a trust which is a pooled income fund within the meaning of section 642(c)(5), and

"(iv) deductions allowable to a trust which are attributable to transfers to the trust before January 1, 1976."

(4) SECTION 691(C) DEDUCTION NOT TAKEN INTO ACCOUNT FOR DETERMINING ADJUSTED ITEMIZED DEDUCTIONS.—Paragraph (1) of section 57(b) is amended by striking out "and" at the end of subparagraph (C), by inserting "and" at the end of subparagraph (D), and by inserting after subparagraph (D) the following new subparagraph:

"(E) the deduction allowable under section 691(c),".

(5) ALLOCATION OF ITEMS OF TAX PREFERENCE IN THE CASE OF ESTATES AND TRUSTS.—Paragraph (1) of section 58(c) (relating to estates and trusts) is amended by striking out "on the basis of the income of the estate or trust allocable to each" and inserting in lieu thereof "in accordance with regulations prescribed by the Secretary".

(6) EFFECTIVE DATE.—The amendments made by this subsection shall take effect as if included in the amendments made by section 301 of the Tax Reform Act of 1976.

(c) SICK PAY.—

(1) IN GENERAL.—Section 105(d) is amended by striking out paragraphs (4) and (6), by redesignating paragraph (5) as paragraph (4) and paragraph (7) as paragraph (6), and by inserting after paragraph (4) the following new paragraph:

"(5) SPECIAL RULES FOR MARRIED COUPLES.—

"(A) MARRIED COUPLE MUST FILE JOINT RETURN.—Except in the case of a husband and wife who live apart at all times during the taxable year, if the taxpayer is married at the close of the taxable year, the exclusion provided by this subsection shall be allowed only if the taxpayer and his spouse file a joint return for the taxable year.

"(B) APPLICATION OF PARAGRAPHS (2) AND (3).—In the case of a joint return—

"(i) paragraph (2) shall be applied separately with respect to each spouse, but

"(ii) paragraph (3) shall be applied with respect to their combined adjusted gross income.

"(C) DETERMINATION OF MARITAL STATUS.—For purposes of this subsection, marital status shall be determined under section 143(a).

"(D) JOINT RETURN DEFINED.—For purposes of this subsection, the term 'joint return' means the joint return of a husband and wife made under section 6013."

(2) CONFORMING AMENDMENT.—Subsection (c)(3) of section 505 of the Tax Reform Act of 1976 (relating to disability retirement) is amended by striking out "section 105(d)(5)" and inserting in lieu htereof "section 105(d)(4)".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall take effect as if included in section 105(d) of the Internal Revenue Code of 1954 as such section was amended by section 505(a) of the Tax Reform Act of 1976:

(d) NET OPERATING LOSSES.—

(1) AMENDMENT OF SECTION 172(b)(1)(B).—The second sentence of subparagraph (B) of section 172(b)(1) (relating to years to which net operating losses may be carried) is amended by striking out "and (F)" and inserting in lieu thereof "(F), and (G)".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to losses incurred in taxable years ending after December 31, 1975.

(e) EFFECTIVE DATE FOR FISCAL YEAR TAXPAYERS FOR CONSTRUCTION PERIOD INTEREST AND TAXES.—Paragraph (1) of section 201(c) of the Tax Reform Act of 1976 is amended to read as follows:

"(1) in the case of nonresidential real property, if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975,".

(f) CLARIFICATION OF PROVISIONS PROVIDING TAX INCENTIVES TO ENCOURAGE THE PRESERVATION OF HISTORIC STRUCTURES.—

(1) DEFINITION OF CERTIFIED HISTORIC STRUCTURES.—Subsection (d) of section 191 (relating to amortization of certain rehabilitation expenditures for certified historic structures) is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by striking out paragraph (1) and inserting in lieu thereof the following new paragraphs:

"(1) CERTIFIED HISTORIC STRUCTURE.—The term 'certified historic structure' means a building or structure which is of a character subject to the allowance for depreciation provided in section 167 and which—

"(A) is listed in the National Register, or

"(B) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

"(2) REGISTERED HISTORIC DISTRICT.—The term 'registered historic district' means—

"(A) any district listed in the National Register, and

"(B) any district—

"(i) which is designated under a statute of the appropriate State or local government, if such statute is certified by the Secretary of the Interior to the Secretary as containing criteria which will substantially achieve the purpose of preserving and rehabiliting buildings of historic significance to the district, and

"(ii) which is certified by the Secretary of the Interior to the Secretary as meeting substantially all of the requirements for the listing of districts in the National Register."

(2) AMENDMENT OF CROSS REFERENCES.—Subsection (g) of section 191 (relating to cross references) is amended to read as follows:

"(g) CROSS REFERENCES.—

"(1) For rules relating to the listing of buildings, structures, and historic districts in the National Register, see the Act entitled 'An Act to establish a program for the preservaion of additional historic properties throughout the Nation, and for other purposes', approved October 15, 1966 (16 U.S.C. 470 et seq.).

"(2) For special rules with respect to certain gain derived from the disposition of property the adjusted basis of which is determined with regard to this section, see sections 1245 and 1250."

(3) SPECIAL RULES FOR RECAPTURE OF AMORTIZATION DEDUCTION.—

(A) Paragraph (2) of section 1245(a) (relating to gain from dispositions of certain depreciable property) is amended—

(i) by striking out "190, or 191" the first place it appears and inserting in lieu thereof "or 190" and

(ii) by striking out "190, or 191" the second and third place it appears and inserting in lieu thereof "190, or (in the case of property described in paragraph (3) (C)) 191".

(B) Subparagraph (D) of section 1245(a)(3) (relating to gain from dispositions of certain depreciable property) is amended by striking out "190, or 191" and inserting in lieu thereof "or 190".

(C) Paragraph (3) of section 1250(b) (relating to depreciation adjustments) is amended by striking out "190 or 191" and inserting in lieu thereof "or 190".

(4) STRAIGHT LINE METHOD IN CERTAIN CASES.—Subsection (n) of section 167 is amended to read as follows:

"(n) STRAIGHT LINE METHOD IN CERTAIN CASES.

"(1) IN GENERAL.—In the case of any property in whole or in part constructed, reconstructed, erected, or used on a site which was, on or after June 30, 1976, occupied by a certified historic structure (or by any structure in a registered historic district) which is demolished or substantially altered after such date—

"(A) subsections (b), (j), (k), and (l) shall not apply, and

"(B) the term 'reasonable allowance' as used in subsection (a) means only an allowance computed under the straight line method.

The preceding sentence shall not apply if the last substantial alteration of the structure is a certified rehabilitation.

"(2) EXCEPTIONS.—The limitations imposed by this subsection shall not apply—

"(A) to personal property, and

"(B) in the case of demolition or substantial alteration of a structure located in a registered historic district, if—

"(i) such structure was not a certified historic structure, and

"(ii) before the beginning of the demolition or substantial alteration of such structure, the Secretary of the Interior certified to the Secretary that such structure is not of historic significance to the district.

"(3) DEFINITIONS.—For purposes of this subsection, the terms 'certified historic structure', 'registered historic district', and 'certified rehabilitation' have the respective meanings given such terms by section 191(d)."

(5) DEMOLITION OF CERTAIN HISTORIC STRUCTURES.—Subsection (b) of section 280B (relating to special rule for registered historic districts) is amended to read as follows:

"(b) SPECIAL RULE FOR REGISTERED HISTORIC DISTRICTS.—For purposes of this section, any building or other structure located in a registered historic district (as defined in section 191(d)(2)) shall be treated as a certified historic structure unless the Secretary of the Interior has certified, before the beginning of the demolition of such structure, that such structure is not of historic significance to the district."

(6) SUBSTANTIALLY REHABILITATED HISTORIC PROPERTY.—

(A) Paragraph (1) of section 167(o) (relating to substantially rehabilitated historic property) is amended by inserting "(other than property with respect to which an amortization deduction has been allowed to the taxpayer under section 191)" after "substantially rehabilitated historic property".

(B) Paragraph (2) of section 167(o) is amended by striking out "section 191(d)(3)" and inserting in lieu thereof "section 191(d)(4)".

(7) EFFECTIVE DATE.—The amendments made by this subsection shall take effect as if included in the respective provisions of the Internal Revenue Code of 1954 to which such amendments relate, as such provision were added to such Code, or amended, by section 2124 of the Tax Reform Act of 1976.

(g) FOREIGN CONVENTIONS.—

(1) DEDUCTIONS NOT DISALLOWED TO EMPLOYER WHERE EMPLOYEE INCLUDES AMOUNTS IN GROSS INCOME.—Subparagraph (D) of section 274(h)(6) (relating to application of subsection to employer as well as to traveler) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not deny a deduction to any person other than the individual attending the foreign convention with respect to any amount includible in the gross income of such individual if such person treats such amount as so includible for purposes of part III of subchapter A of chapter 61 (relating to information returns)."

(2) TECHNICAL AMENDMENTS.—The first sentence of section 274(h)(3) is amended by striking out "more than one-half" and inserting in lieu thereof "at least one-half".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to conventions beginning after December 31, 1976.

(h) CLARIFICATION OF LAST SENTENCE OF SECTION 337(c)(2).—

(1) IN GENERAL.—Subsection (c) of section 337 (relating to limitations on application of section 337) is amended by striking out the last sentence of paragraph (2) and by adding at the end of such subsection the following new paragraph:

"(3) SPECIAL RULE FOR AFFILIATED GROUP.—

"(A) IN GENERAL.—Paragraph (2) shall not apply to a sale or exchange by a corporation (hereinafter in this paragraph referred to as the 'selling corporation') if—

"(i) within the 12-month period beginning on the date of adoption of a plan of complete liquidation by selling corporation, the selling corporation and each distributee corporation is liquidated, and

"(ii) none of the complete liquidations referred to in clause (i) is a liquidation with respect to which section 333 applies.

"(B) DEFINITIONS.—For purposes of subparagraph (A)—

"(i) The term 'distributee corporation' means a corporation in the chain of includible corporations to which the selling corporation or a corporation above the selling corporation in such chain makes a distribution in complete liquidation within the 12-month period referred to in subparagraph (A)(i).

"(ii) The term 'chain of includible corporations' includes, in the case of any distribution, any corporation which (at the time of such distribution) is in a chain of includible corporations for purposes of section 1504(a) (determined without regard to the exceptions contained in section 1504(b)). Such term includes, where appropriate, the common parent corporation."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to sales or exchanges made pursuant to a plan of complete liquidation adopted after December 31, 1975.

(i) CERTAIN TRANSACTIONS INVOLVING 2 OR MORE INVESTMENT COMPANIES.—

(1) AMENDMENTS OF SECTION 368(a)(2)(F).—

(A) The first sentence of clause (iii) of section 368(a)(2)(F) is amended—

(i) by striking out "more than 50 percent" and inserting in lieu thereof "50 percent or more"; and

(ii) by striking out "more than 80 percent" and inserting in lieu thereof "80 percent or more."

(B) The first sentence of clause (vi) of section 368(a)(3)(F) is amended by striking out "is not diversified within the meaning" and inserting in lieu thereof "does not meet the requirements."

(C) The second sentence of such clause (vi) is amended to read as follows: "If such investment company acquires stock of another corporation in a reorganization describd in section 368(a)(1)(B), clause (i) shall be applied to the shareholders of such investment company as though they had exchanged with such other corporation all of their stock in such company for stock having a fair market value equal to the fair market value of their stock of such investment company immediately after the exchange."

(D) Subparagraph (F) of section 368(a)(2) is amended by adding at the end thereof the following clauses:

"(vii) For purposes of clauses (ii) and (iii), the term 'securities' includes obligations of State and local governments, commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)).

"(viii) In applying paragraph (3) of section 267(b) in respect of any transaction to which this subparagraph applies, the reference to a personal holding company in such paragraph (3) shall be treated as including a reference to an investment company and the determination of whether a corporation is an investment company shall be made as of the time immediately before the transaction instead of with respect to the taxable year referred to in such paragraph (3)."

(2) EFFECTIVE DATES.—

(A) Except as provided in subparagraph (B), the amendments made by paragraph (1) shall apply as if included in section 368(a)(2)(F) of the Internal Revenue Code of 1954 as added by section 2131(a) of the Tax Reform Act of 1976.

(B) Clause (viii) of section 368(a)(2)(F) of the Internal Revenue Code of 1954 (as added by paragraph (1)) shall apply only with respect to losses sustained after September 26, 1977.

(j) AT RISK PROVISIONS.—

(1) CLERICAL AMENDMENT TO EFFECTIVE DATE.—Subparagraph (A) of section 204(c)(3) of the Tax Reform Act of 1976 is amended by striking out "section 465(c)(1)(B)" and inserting in lieu thereof "section 465(c)(1)(C)".

(2) CLARIFICATION OF SECTION 465(d).—Subsection (d) of section 465 defining loss for purposes of the at risk provisions) is amended by striking out "(determined without regard to this section)" and inserting in lieu thereof "(determined without regard to the first sentence of subsection (a))".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall take effective on October 4, 1976.

(k) AMENDMENTS RELATING TO USE OF ACCRUAL ACCOUNTING FOR FARMING.—

(1) AUTOMATIC 10-YEAR ADJUSTMENT PERIOD FOR FARMING CORPORATIONS REQUIRED TO USE ACCRUAL ACCOUNTING.—Paragraph (3) of section 447(f) (relating to coordination with section 481) is amended—

(A) by striking out "(except as otherwise provided in such regulations)", and

(B) by inserting "(or the remaining taxable years where there is a stated future life of less than 10 taxable years)" after "10 taxable years".

(2) AUTOMATIC 10-YEAR ADJUSTMENT FOR FARMING SYNDICATES CHANGING TO ACCRUAL ACCOUNTING.—If—

(A) a farming syndicate (within the meaning of section 464(c) of the Internal Revenue Code of 1954) was in existence on December 31, 1975, and

(B) such syndicate elects an accrual method of accounting (including the capitalization of preproductive period expenses described in section 447(b) of such Code) for a taxable year beginning before January 1, 1979,

then such election shall be treated as having been made with the consent of the Secretary of the Treasury or his delegate and, under regulations prescribed by the Secretary of the Treasury or his delegate, the net amount of the adjustments required by section 481(a) of such Code to be taken into account by the taxpayer in computing taxable income shall be taken into account in each of the 10 taxable years (or the remaining taxable years where there is a stated future life of less than 10 taxable years) beginning with the year of change.

(3) EXTENDING FAMILY ATTRIBUTION TO SPOUSE IN THE FARMING SYNDICATE RULES.—

(A) Subparagraph (E) of section 464(c)(2) (defining farming syndicate) is amended by striking out "(within the meaning of section 267 (c)(4))" and inserting in lieu thereof "(or a spouse of any such member)".

(B) Paragraph (2) of section 464(c) is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (E), the term 'family' has the meaning given to such term by section 267 (c)(4)."

(4) EFFECTIVE DATE.—The amendments made by paragraphs (1) and (3) shall take effect as if included in section 447 or 464 (as the case may be) of the Internal Revenue Code of 1954 at the time of the enactment of such sections.

(l) EXTENSION OF CERTAIN PROVISIONS TO FOREIGN PERSONAL HOLDINGS COMPANIES.—

(1) SECTION 465.—Subsection (a) of section 465 (relating to deductions limited to amount at risk in case of certain activities) is amended—

(A) by striking out "In the case of a taxpayer (other than a corporation which is neither an electing small business corporation (as defined in section 1371(b)) nor a personal holding company (as defined in section 542)) engaged" and inserting in lieu thereof "In the case of an individual engaged"; and

(B) by adding at the end thereof the following new sentence: "For purposes of this section, an electing small business corporation (as defined in section 1371(b)), a personal holding company (as defined in section 542), and a foreign personal holding company (as defined in section 552) shall be treated as an individual."

(2) SECTION 189.—Subsection (a) of section 189 (relating to amortization of real property construction period interest and taxes) is amended—

(A) by striking out "an electing small business corporation (within the meaning of section 1371(b)), or personal holding company (within the meaning of section 542),"; and

(B) by adding at the end thereof the following new sentence: "For purposes of this section, an electing small business corporation (as defined in section 1371(b)), a personal holding company (as defined in section 542), and a foreign personal holding company (as defined in section 552) shall be treated as an individual."

(3) SECTION 280.—Subsection (a) of section 280 (relating to certain expenditures incurred in production of films, books, records, or similar property) is amended—

(A) by striking out "Except in the case of a corporation (other than an electing small business corporation (as defined in section 1371(b)) or a personal holding company (as defined in section 542)) and except" and inserting in lieu thereof "In the case of an individual, except"; and

(B) by adding at the end thereof the following new sentence: "For purposes of this section, an electing small business corporation (as defined in section 1371(b)), a personal holding company (as defined in section 542), and a foreign personal holding company (as defined in section 552) shall be treated as an individual."

(4) EFFECTIVE DATES.—

(A) The amendments made by paragraph (1) shall take effect as if included in the amendment made by section 204(a) of the Tax Reform Act of 1976.

(B) The amendments made by paragraph (2) shall take effect as if included in the amendment made by section 201(a) of the Tax Reform Act of 1976.

(C) The amendments made by paragraph (3) shall take effect as if included in the amendment made by section 210(a) of the Tax Reform Act of 1976.

(m) DEFINITION OF CONDOMINIUM MANAGEMENT ASSOCIATION.—

(1) IN GENERAL.—Paragraph (2) of section 528(c) (defining condominium management association) is amended by striking out "as residences" and inserting in lieu thereof "by individuals for residences".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1973.

(n) SPECIAL RULE FOR GAIN ON PROPERTY TRANSFERRED TO TRUST AT LESS THAN FAIR MARKET VALUE.—

(1) ADDITIONAL TAX TO APPLY ONLY TO RECOGNIZED GAINS.—

(A) IN GENERAL.—Subsections (a)(1), (a)(2), and (b)(1) of section 644 (relating to special rule for gain on property transferred to trust at less than fair market value) are each amended by striking out "gain realized" each place it appears and inserting in lieu thereof "gain recognized".

(B) SPECIAL RULE FOR SUBSTITUTED BASIS PROPERTY.—Subsection (d) of section 644 (relating to special rule for short sales) is amended to read as follows:

"(d) SPECIAL RULES.—

"(1) SHORT SALES.—If the trust sells the property referred to in subsection (a) in a short sale within the 2-year period referred to in such subsection, such 2-year period shall be extended to the date of the closing of such short sale.

"(2) SUBSTITUTED BASIS PROPERTY.—For purposes of this section, in the case of any property held by the trust which has a basis determined in whole or in part by reference to the basis of any other property which was transferred to the trust—

"(A) the initial transfer of such property in trust by the transferor shall be treated as having occurred on the date of the initial transfer in trust of such other property,

"(B) subsections (a)(1)(B) and (b)(2) shall be applied by taking into account the fair market value and the adjusted basis of such other property, and

"(C) the amount determined under subsection (b)(2) with respect to such other property shall be allocated (under regulations prescribed by the Secretary) among such other property and all properties held by the trust which have a basis determined in whole or in part by reference to the basis of such other property."

(2) TREATMENT OF NET OPERATING LOSSES, CAPITAL LOSSES, ETC., WHICH MAY AFFECT TRANSFEROR'S TAX IN OTHER YEARS.—Section 644(a)(2) (relating to additional tax on gain on property transferred to trust at less than fair market value) is amended by adding at the end thereof the following new sentence: "The determination of tax under clause (i) of subparagraph (A) shall be made by not taking into account any carryback, and by not taking into account any loss or deduction to the extent that such loss or deduction may be carried by the transferer to any other taxable year."

(3) TECHNICAL AMENDMENT.—Paragraph (1) of section 644(f) is amended by striking out "subsection (a)" and inserting in lieu thereof "subsection (a) (other than the 2-year requirement of paragraph (1)(A) thereof)."

(4) CONFORMING AMENDMENT TO REVISION OF SECTION 644.—Section 1402 (b)(1) of the Tax Reform Act of 1976 (relating to holding period for long-term capital gains treatment) is amended by striking out subparagraph (K) thereof.

(5) EFFECTIVE DATES.—

(A) Except as provided in subparagraph (B), the amendment made by this subsection shall apply to transfers in trust made after May 21, 1976.

(B) The amendment made by paragraph (4) shall take effect on on October 4, 1976.

(o) ALLOWANCE OF FOREIGN TAX CREDIT FOR ACCUMULATION DISTRIBUTIONS.—

(1) IN GENERAL.—Subsection (d) of section 665 is amended to read as follows:

"(d) TAXES IMPOSED ON THE TRUST.—

"(1) IN GENERAL.—For purposes of this subpart, the term 'taxes imposed on the trust' means—

"(A) the amount of the taxes which are imposed for any taxable year of the trust under this chapter (without regard to this subpart) or

"(B) subject to paragraph (2), the amount of any income, war profits, or excess profits taxes which are imposed by any foreign country or possession of the United States for any taxable year of the trust,

and which, under regulations prescribed by the Secretary, are properly allocable to the undistributed portions of distributable net income and gains in excess of losses from sales or exchanges of capital assets. The amount determined in the preceding sentence shall be reduced by any amount of taxes deemed distributed under section (b) or (c) to any beneficiary.

"(2) SPECIAL RULES FOR FOREIGN TAXES.—

"(A) ELECTIONS TO TAKE FOREIGN TAX CREDIT.—Paragraph (1)(B) shall apply with respect to any taxes only if the trust is not a foreign trust and only if—

"(i) the trust chose the benefits of subpart A of part III of subchapter N for the taxable year of the trust for which the taxes were imposed, and

"(ii) the beneficiary chooses the benefits of such subpart A for the beneficiary's taxable year in which the distribution to which such taxes were allocable is includible in gross income.

"(B) SEPARATE COMPUTATIONS OF FOREIGN TAX CREDIT LIMITATIONS.—For purposes of applying paragraph (1)(B), the amount described therein shall be the amount determined after the separate application, with respect to the trust, of the limitations of sections 904 and 907 with respect to such taxes."

(2) SPECIAL RULE FOR FOREIGN TRUSTS.—Section 667 is amended by adding at the end thereof the following new subsection:

"(d) SPECIAL RULES FOR FOREIGN TRUSTS.—In the case of amounts which are treated under section 666 as having been distributed by a foreign trust in a preceding taxable year, if the beneficiary chooses to have the benefits of subpart A of part III of subchapter N for the taxable year for which the distribution is includible in the beneficiary's income—

"(1) the income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States paid or accrued by such trust which are allocable to such amounts shall be treated as paid or accrued by the beneficiary in such taxable year.

"(2) an amount equal to the amount of the taxes treated as paid or accrued by the beneficiary by reason of paragraph (1) shall be included in the amount treated as having been distributed under subsection (b) or (c) of section 666 in a preceding taxable year.

"(3) for purposes of determining under paragraph (1) the amount treated as paid or accrued by the beneficiary, the beneficiary shall compute the limitations under sections 904 and 907 separately with respect to the beneficiary's distributions from such trust for such year, and

"(4) the items of income, deduction, and credit of the trust shall retain their character to the extent necessary to apply paragragh (3)."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to distributions made in taxable years beginning after December 31, 1975.

(p) RETENTION OF CHARACTER OF AMOUNTS DISTRIBUTED FROM ACCUMULATION TRUST TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Section 667 (relating to treatment of amounts deemed distributed by trust in preceding years) is amended by adding at the end thereof the following new subsection:

"(e) RETENTION OF CHARACTER OF AMOUNTS DISTRIBUTED FROM ACCUMULATION TRUST TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—In the case of a distribution from a trust to a nonresident alien individual or to a foreign corporation, the first sentence of subsection (a) shall be applied as if the reference to the determination of character under section 662(b) applied to all amounts instead of just to tax-exempt interest."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to distributions made in taxable years beginning after December 31, 1975.

(q) LIMITATION ON ALLOWANCE OF PARTNERSHIP LOSSES IN THE CASE OF NONRECOURSE LOANS.—

(1) IN GENERAL.—The last sentence of section 704(d) (relating to limitation on allowance of partnership losses) is amended by striking out "the principal activity" and all that follows and inserting in lieu thereof "substantially all of the activities of which relate to the holding of real property (other than mineral property) for sale or rental."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to liabilities incurred after December 31, 1976.

(r) EXEMPT INTEREST DIVIDENDS OF REGULATED INVESTMENT COMPANIES.—

(1) TREATMENT OF TAX-EXEMPT INTEREST FOR PURPOSES OF THE 90-PERCENT AND 30-PERCENT TESTS.—Subsection (b) of section 851 (relating to limitations on the definition of regulated investment company) is amended by adding at the end thereof the following new sentence: "For purposes of paragraphs (2) and (3), amounts excludable from gross income under section 103(a)(1) shall be treated as included in gross income."

(2) LOSSES ATTRIBUTABLE TO TAX-EXEMPT INTEREST WHERE STOCK IS HELD LESS THAN 31 DAYS.—Paragraph (4) of section 852(b) (relating to loss on

sale or exchange of stock held less than 31 days) is amended to read as follows:

"(4) LOSS ON SALE OR EXCHANGE OF STOCK HELD LESS THAN 31 DAYS.—

"(A) LOSS ATTRIBUTABLE TO CAPITAL GAIN DIVIDEND.—If—

"(i) under subparagraph (B) or (D) of paragraph (3) a shareholder of a regulated investment company is required, with respect to any share, to treat any amount as a long-term capital gain, and

"(ii) such share is held by the taxpayer for less than 31 days, then any loss (to the extent not disallowed under subparagraph (B)) on the sale or exchange of such share shall, to the extent of the amount described in clause (i), be treated as a long-term capital loss.

"(B) LOSS ATTRIBUTABLE TO EXEMPT-INTEREST DIVIDEND.—If—

"(i) a shareholder of a regulated investment company receives an exempt-interst dividend with respect to any share, and

"(ii) such share is held by the taxpayer for less than 31 days, then any loss on the sale or exchange of such share shall, to the extent of the amount of such exempt-interest dividend, be disallowed.

"(C) DETERMINATION OF HOLDING PERIODS.—For purposes of this paragraph, the rules of section 246(c)(3) shall apply in determining whether any share of stock has been held for less than 31 days; except that '30 days' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3)."

(3) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1975.

(s) AMENDMENTS RELATING TO REAL ESTATE INVESTMENT TRUSTS.—

(1) ANNUAL ACCOUNTING PERIOD.—Section 860 (relating to adoption of annual accounting period) is amended to read as follows:

"SEC. 860. ADOPTION OF ANNUAL ACCOUNTING PERIOD.

"For purposes of this subtitle—

"(1) a real estate investment trust shall not change to any accounting period other than the calendar year, and

"(2) a corporation, trust, or association may not elect to be a real estate investment trust for any taxable year beginning after October 4, 1976, unless its accounting period is the calendar year.

Paragraph (2) shall not apply to a corporation, trust, or association which was considered to be a real estate investment trust for any taxable year beginning on or before October 4, 1976."

(2) AMENDMENT OF SECTION 856(C)(3)(D).—

Subparagraph (D) of section 856(c)(3) is amended by inserting "(other than gain from prohibited transactions)" after "and gain".

(3) EXCISE TAX ON REIT UNDISTRIBUTED INCOME.—

(A) Paragraph (3) of section 6501(e) (relating to limitations on assessment and collection) is amended by striking out "or 43" and inserting in lieu thereof "43, or 44".

(B) Subsection (b) of section 1605 of the Tax Reform Act of 1976 (relating to technical amendments) is amended by striking out paragraph (1) thereof.

(C) Subparagraph (D) of section 1605(b)(5) of the Tax Reform Act of 1976 is amended to read as follows:

"(D) by striking out 'of chapter 43 tax for the same taxable years,' in subsection (c)(1) and inserting in lieu thereof 'of chapter 43 tax for the same taxable year, of chapter 44 tax for the same taxable year,'."

(4) CORRECTION OF CROSS REFERENCE.—Subparagraph (B) of section 859(b)(2) is amended by striking out "section 6601(c)" and inserting in lieu thereof "section 6601(b)".

(5) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on October 4, 1976.

(t) AMENDMENTS RELATING TO TREATMENT OF FOREIGN INCOME.—

(1) FOREIGN TAX CREDITS NOT DISALLOWED ON CERTAIN DISTRIBUTIONS MADE BY POSSESSIONS CORPORATIONS.—

(A) IN GENERAL.—Paragraph (1) of section 901(g) (relating to certain taxes paid with respect to distributions from possessions corporations) is amended to read as follows:

"(1) IN GENERAL.—For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation—

"(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

"(B) (i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

"(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized.

shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued."

(B) DEFINITION OF POSSESSIONS CORPORATION.—Paragraph (2) of section 901(g) (defining possessions corporation) is amended—

(i) by striking out "or during which section 931" and inserting in lieu thereof ", during which section 931", and

(ii) by inserting before the period at the end thereof the following: ", or during which section 957(c) applied to such corporation".

(C) EFFECTIVE DATES.—The amendment made by subparagraph (A) shall apply as if included in section 901(g) of the Internal Revenue Code of 1954 as added by section 1051(d)(2) of the Tax Reform Act of 1976. The amendments made by subparagraph (B) shall apply to distributions made after the date of the enactment of this Act in taxable years ending after such date.

(2) FOREIGN TAX CREDIT ADJUSTMENTS FOR CAPITAL GAINS.—

(A) IN GENERAL.—Paragraph (2) of section 904(b) (relating to treatment of capital gains for purposes of the foreign tax credit limitation) is amended by striking out "For purposes of subsection (a)—" and inserting in lieu thereof "For purposes of this section—".

(B) SOURCE RULE.—Subparagraph (C) of section 904(b)(3) is amended by striking out "For purposes of this paragraph, there" and inserting in lieu thereof "There".

(C) SOURCE RULE FOR LIQUIDATIONS OF CERTAIN FOREIGN CORPORATIONS.—Paragraph (3) of section 904(b) (relating to source rules for gain from the sale of certain personal property) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"(D) GAIN FROM LIQUIDATION OF CERTAIN FOREIGN CORPORATIONS.—Subparagraph (C) shall not apply with respect to a distribution in liquidation of a foreign corporation to which part II of subchapter C applies if such corporation derived less than 50 percent of its gross income from sources within the United States for the 3-year period ending with the close of such corporation's taxable year immediately preceding the year during which the distribution occurred."

(D) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to taxable years beginning after December 31, 1975.

(3) TREATMENT OF CERTAIN CAPITAL LOSS CARRYOVERS AND CARRYBACKS FOR PURPOSES OF THE LIMITATION ON CREDIT FOR FOREIGN TAXES.—

(A) IN GENERAL.—Clause (iii) of section 904(b)(2)(A) (relating to treatment of capital gains of corporations for purposes of the foreign tax credit limitation) is amended by striking out "any net capital loss" and inserting in lieu thereof "for purposes of determining taxable income from sources without the United States, any net capital loss (and any amount which is a short-term capital loss under section 1212(a))".

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall apply to taxable years beginning after December 31, 1975.

(4) TREATMENT OF CAPITAL LOSS CARRYOVERS FOR PURPOSES OF FOREIGN LOSS RECAPTURE.—

(A) IN GENERAL.—Subparagraph (A) of section 904(f)(2) (defining overall foreign loss) is amended by striking out "or any capital loss carrybacks and carryovers to such year under section 1212".

(B) FOREIGN OIL RELATED LOSSES.—Subparagraph (A) of section 904(f)(4) (relating to determination of foreign oil related loss where section 907 applies) is amended by striking out "or any capital loss carrybacks and carryovers to such year under section 1212".

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply—

(i) to overall foreign losses sustained in taxble years beginning after December 31, 1975, and

(ii) to foreign oil related losses sustained in taxable years ending after December 31, 1975.

(5) EFFECTIVE DATE FOR RECAPTURE OF FOREIGN OIL RELATED LOSSES.—

(A) IN GENERAL.—Paragraph (1) of section 1032(c) of the Tax Reform Act of 1976 is amended to read as follows:

"(1) IN GENERAL.—Except as provided in paragraphs (2), (3), and (5), the amendment made by subsection (a) shall apply to losses sustained in taxable years beginning after December 31, 1975. The amendment made by subsection (b)(1) shall apply to taxable years beginning after December 31, 1975. The amendment made by subsection (b)(2) shall apply to losses sustained in taxable years ending after December 31, 1975."

(B) FOREIGN OIL RELATED LOSSES.—Subsection (c) of section 1032 of the Tax Reform Act of 1976 is amended by adding at the end thereof the following new paragraph:

"(5) FOREIGN OIL RELATED LOSSES.—The amendment made by subsection (a) shall apply to foreign oil related losses sustained in taxable years ending after December 31, 1975."

(6) TRANSITIONAL RULES FOR CERTAIN MINING OPERATIONS.—The second sentence of paragraph (2) of section 1031(c) of the Tax Reform Act of 1976 is amended to read as follows: In the case of a loss sustained in a taxable year beginning before January 1, 1979, by any corporation to which this paragraph applies, if section 904(a)(1) of such Code (as in effect before the enactment of this Act) applies with respect to such taxable year, the provisions of section 904(f) of such Code shall be applied with respect to such loss under the principles of such section 904(a)(1)."

(7) TRANSITIONAL RULES FOR RECAPTURE OF CERTAIN FOREIGN LOSSES.—

(A) COMPUTATION OF DEFICIT IN EARNINGS AND PROFITS FOR PURPOSES OF THE RECAPTURE OF CERTAIN FOREIGN LOSSES.—Paragraph (4) of section 1032(c) of the Tax Reform Act of 1976 (relating to limitation based on deficit in earnings and profits for purposes of the recapture of foreign losses) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, there shall be taken into account only earnings and profits of the corporation which (A) were accumulated in taxable years of the corporation beginning after December 31, 1962, and during the period in which the stock of such corporation from which the loss arose was held by the taxpayer and (B) are attributable to such stock."

(B) RECAPTURE OF POSSESSION LOSSES DURING TRANSITIONAL PERIOD WHERE TAXPAYER IS ON A PER-COUNTRY BASIS.—

(i) Subsection (c) of section 1032 of the Tax Reform Act of 1976 (relating to effective dates for recapture of foreign losses) is amended by adding at the end thereof the following new paragraph:

"(6) RECAPTURE OF POSSESSION LOSSES DURING TRANSITIONAL PERIOD WHERE TAXPAYER IS ON A PER-COUNTRY BASIS.—

"(A) APPLICATION OF PARAGRAPH.—This paragraph shall apply if—

"(i) the taxpayer sustained a loss in a possession of the United States in a taxable year beginning after December 31, 1975, and before January 1, 1979,

"(ii) such loss is attributable to a trade or business engaged in by the taxpayer in such possession on January 1, 1976, and

"(iii) section 904(a)(1) of the Internal Revenue Code of 1954 (as in effect before the enactment of this Act) applies with respect to such taxable year.

"(B) NO RECAPTURE DURING TRANSITION PERIOD.—In any case to which this paragraph applies, for purposes of determining the liability for tax of the taxpayer for taxable years beginning before January 1, 1979, section 904(f) of the Internal Revenue Code of 1954 shall not apply with respect to the loss described in subparagraph (A)(i).

"(C) RECAPTURE OF LOSS AFTER THE TRANSITION PERIOD.—In any case to which this paragraph applies—

"(i) for purposes of determining the liability for tax of the taxpayer for taxable years beginning after December 31, 1978, section 904(f) of the Internal Revenue Code of 1954 shall be applied with respect to the loss described in subparagraph (A)(i) under the principles of section 904(a)(1) of such Code (as in effect before the enactment of this Act); but

"(ii) in the case of any taxpayer and any possession, the aggregate amount to which such section 904(f) applies by reason of clause (i) shall not exceed the sum of the net incomes of all affiliated corporations from such possession for taxable years of such affiliated corporations beginning after December 31, 1975, and before January 1, 1979.

"(D) AFFILIATED CORPORATION DEFINED.—For purposes of subparagraph (C)(ii), the term 'affiliated corporation' means a corporation which, for the taxable year for which the net income is being determined, was not a member of the same affiliated group (within the meaning of section 1504 of the Internal Revenue Code of 1954) as the taxpayer but would have been a member of such group but for the application of subsection (b) of such section 1504."

(ii) Paragraph (3) of section 1031(c) of the Tax Reform Act of 1976 is amended by striking out the last sentence.

(8) LIMITATIONS ON FOREIGN TAX CREDIT WHERE INDIVIDUAL HAS FOREIGN OIL AND GAS EXTRACTION INCOME.—

(A) REDUCTION IN FOREIGN TAX CREDIT FOR CERTAIN INDIVIDUALS HAVING FOREIGN OIL AND GAS EXTRACTION INCOME.—Subsection (a) of section 907 (relating to special rules in case of foreign oil and gas income) is amended to read as follows:

"(a) REDUCTION IN AMOUNT ALLOWED AS FOREIGN TAX UNDER SECTION 901.—In applying section 901, the amount of any oil and gas extraction taxes paid or accrued (or deemed to have been paid) during the taxable year which would (but for this subsection) be taken into account for purposes of section 901 shall be reduced by the amount (if any) by which the amount of such taxes exceeds the product of—

"(1) the amount of the foreign oil and gas extraction income for the taxable year,

"(2) multiplied by—

"(A) in the case of a corporation, the percentage which is the sum of the normal tax rate and the surtax rate for the taxable year specified in section 11, or

"(B) in the case of an individual, a fraction the numerator of which is the tax against which the credit under section 901(a) is taken and the denominator of which is the taxpayer's entire taxable income."

(B) APPLICATION OF SECTION 904 SEPARATELY TO FOREIGN OIL RELATED INCOME OF INDIVIDUALS.—Subsection (b) of section 907 (relating to application of section 904 limitation) is amended to read as follows:

"(b) APPLICATION OF SECTION 904 LIMITATION.—The provisions of section 904 shall be applied separately with respect to—

"(1) foreign oil related income, and

"(2) other taxable income."

(C) TECHNICAL AMENDMENT.—Paragraph (4) of section 904(f) (relating to recapture of overall foreign loss) is amended by striking out "In the case of a corporation to which section 907(b)(1) applies" and inserting in lieu thereof "In making the separate computation under this subsection with respect to foreign oil related income which is required by section 907(b)".

(D) EFFECTIVE DATES.—

(i) The amendments made by this paragraph shall apply, in the case of individuals, to taxable years ending after December 31, 1974, and, in the case of corporations, to taxable years ending after December 31, 1976.

(ii) In the case of any taxable year ending after December 31, 1975, with respect to foreign oil related income (within the meaning of section 907(c) of the Internal Revenue Code of 1954), the overall limitation provided by section 904(a)(2) of such Code shall apply and the per-country limitation provided by section 904(a)(1) of such Code shall not apply.

(9) EFFECTIVE DATE FOR DISALLOWANCE OF FOREIGN TAX CREDIT FOR CERTAIN PRODUCTION-SHARING CONTRACTS.—The second sentence of paragraph (3) of section 1035(c) of the Tax Reform Act of 1976 (relating to tax credit for production-sharing contracts) is amended to read as follows: "A contract described in the preceding sentence shall be taken into account under paragraph (1) only with respect to amounts (A) paid or accrued to the foreign government before January 1, 1978, and (B) attributable to income earned before such date."

(10) FOREIGN TAXES ATTRIBUTABLE TO SECTION 911 EXCLUSION.—

(A) IN GENERAL.—The last sentence of section 911(a) (relating to earned income from sources without the United States) is amended to read as follows:

"An individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions), to the extent that such deductions are properly allocable to or chargeable against amounts excluded from gross income under this subsection. For purposes of this title, the amount of the income, war profit, and excess profits taxes paid or accrued by any individual to a foreign country or possession of the United States for any taxable year shall be reduced by an amount determined by multiplying the amount of such taxes by a fraction—

"(A) the numerator of which is the tax determined under subsection (d)(1)(B), and

"(B) the denominator of which is the sum of the amount referred to in subparagraph (A), plus the limitation imposed for the taxable year by section 904(a).".

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall apply to taxable years beginning after December 31, 1976.

(11) SALE OF ASSETS BY A POSSESSIONS CORPORATION.—

(A) IN GENERAL.—Subsection (a) of section 936 (relating to Puerto Rico and possession tax credit) is amended by redesignating paragraph (2) as paragraph (3) and by amending so much of paragraph (1) as precedes subparagraph (A) thereof to read as follows:

"(1) IN GENERAL.—Except as provided in paragraph (3), if a domestic corporation elects the application of this section and if the conditions of both subparagraph (A) and subparagraph (B) of paragraph (2) are satisfied, there shall be allowed as a credit against the tax imposed by this chapter an amount equal to the portion of the tax which is attirbutable to the sum of—

"(A) the taxable income, from sources without the United States, from—

"(i) the active conduct of a trade or business within a possession of the United States, or

"(ii) the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business, and

"(B) the qualified possession source investment income.

"(2) CONDITIONS WHICH MUST BE SATISFIED.—The conditions referred to in paragraph (1) are:".

(B) INCOME FROM SALE OF CARRYOVER BASIS PROPERTY NOT TAKEN INTO ACCOUNT.—

(i) Subsection (d) of section 936 (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(3) CARRYOVER BASIS PROPERTY.—

"(A) IN GENERAL.—Income from the sale or exchange of any asset the basis of which is determined in whole or in part by reference to its basis in the hands of another person shall not be treated as income described in subparagraph (A) or (B) of subsection (a)(1).

"(B) EXCEPTION FOR POSSESSIONS CORPORATIONS, ETC.—For purposes of subparagraph (A), the holding of any asset by another person shall not be taken into account if throughout the period for which such asset was held by such person section 931, this section, or section 957(c) applied to such person.".

(ii) The heading of such subsection (d) is amended to read as as follows:

"(d) DEFINITIONS AND SPECIAL RULES.—".

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply as if included in section 936 of the Internal Revenue Code of 1954 at the time of its addition by section 1051(b) of the Tax Reform Act of 1976.

(12) GAIN ON DISPOSITION OF STOCK IN A DISC.—

(A) DELAY IN EFFECTIVE DATE.—Paragraph (4) of section 1101(g) of the Tax Reform Act of 1976 (relating to effective date for amendment relating to gain or disposition of DISC stock) is amended by striking out "December 31, 1975" and inserting in lieu thereof "December 31, 1976".

(B) TECHNICAL AMENDMENT.—Paragraph (1) of section 995(c) (relating to gain on disposition of stock in a DISC) is amended by adding at the end thereof the following new sentence:

"Subparagraph (C) shall not apply if the person receiving the stock in the disposition has a holding period for the stock which includes the period

'Subparagraph (C) shall not apply if the person receiving the stocf in the disposition has a holding period for the stock which includes the period for which the stock was held by the shareholder disposing of such stock."

(C) EFFECTIVE DATE.—The amendment made by subparagraph (B) shall aply to dispositions made after December 31, 1976, in taxable years ending after such date.

(13) LIMITATION ON PARTNER'S TAX WHERE PARTNER RECEIVES AMOUNT TREATED AS SALE OF SECTION 1248 STOCK.—

(A) IN GENERAL.—Section 751 (relating to unrealized receivables and inventory items) is amended by adding at the end thereof the following new subsection:

"(e) LIMITATION ON TAX ATTRIBUTABLE TO DEEMED SALES OF SECTION 1248 STOCK.—For purposes of applying this section and sections 731, 736, and 741 to any amount resulting from the reference to section 1248 (a) ~~in the second~~ sentence of subsection (c), in the case of an individual, the tax attributable to such amount shall be limited in the manner provided by subsection (b) of section 1248 (relating to gain from certain sales or exchanges of stock in certain foreign corporations)."

(B) CROSS REFERENCE.—Section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest is amended by adding at the end thereof the following new subsection:

"(c) CROSS REFERENCE.—

"For limitation on the tax attributable to certain gain connected with section 1248 stock, see section 751(e)."

(C) EFFECTIVE DATE.—The amendmends made by this paragraph shall apply to transfers beginning after October 9, 1975, and to sales, exchanges, and distributions taking place after such date.

(14) EXCISE TAX ON TRANSFERS OF PROPERTY TO FOREIGN PERSONS TO AVOID FEDERAL INCOME TAX.—

(A) TRANSFERS INVOLVING ESTATES.—Section 1491 (relating to tax on transfers to avoid income tax) is amended by striking out "trust" each place it appears therein and inserting in lieu thereof "estate or trust."

(B) CLARIFICATION OF PARAGRAPH (3) OF SECTION 1492.—Paragraph (3) of section 1492 (relating to nontaxable transfers) is amended to read as follows:

"(3) To a transfer described in section 367; or."

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to transfers after October 2, 1975.

(15) ELECTION TO TREAT NONRESIDENT ALIEN INDIVIDUAL AS RESIDENT OF THE UNITED STATES.—

(A) PROVISIONS AFFECTED BY ELECTION.—Paragraph (1) of section 6013 (g) (relating to election to treat nonresident alien individual as resident of the United States) is amended to read as follows:

"(1) IN GENERAL.—A nonresident alien individual with respect to whom this subsection is in effect for the taxable year shall be treated as a resident of the United States—

"(A) for purposes of chapters 1 and 5 for all of such taxable year, and

"(B) for purposes of chapter 24 (relating to wage withholding) for payments of wages made during such taxable year."

(B) CONFORMING AMENDMENT.—Paragraph (5) of section 6013(g) (relating to termination of election by Secretary is amended by striking out "chapter 1" and inserting in lieu thereof "chapters 1 and 5."

(C) CERTAIN AMOUNTS WITHHELD UNDER CHAPTER 3 TREATED AS OVERPAYMENTS OF TAX.—Subsection (b) of section 6401 (relating to excessive credits) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, any credit allowed under paragraph (1) of section 32 (relating to withholding of tax on nonresident aliens and on foreign corporations) to a nonresident alien individual for a taxable year with respect to which an election under section 6013(g) is in effect shall be treated as an amount allowable as a credit under section 31."

(D) EFFECTIVE DATES.—The amendments made by this paragraph—

(i) to the extent that they relate to chapter 1 or 5 of the Internal Revenue Code of 1954, shall apply to taxable years ending on or after December 31, 1975, and

(ii) to the extent that they relate to wage withholding under chapter 24 of such Code, shall apply to remuneration paid on or after the first day of the first month which begins more than 90 days after the date of the enactment of this Act.

(16) ELECTION TO TREAT NONRESIDENT ALIEN INDIVIDUAL AS RESIDENT OF THE UNITED STATES.—

(A) IN GENERAL.—Paragraph (2) of section 6013(g) (relating to election to treat nonresident alien individual as resident of the United States) is amended by striking out "who, at the time an election was made under this subsection," and inserting in lieu thereof "who, at the close of the taxable year for which an election under this subsection was made,".

(B) EFFECTIVE DATE.—The amendment made by subparagraph (A) shall apply to taxable years beginning after December 31, 1976.

(u) HOLDING PERIOD OF COMMODITY FUTURES CONTRACTS.—

(1) IN GENERAL.—The last sentence of section 1222 (relating to other terms relating to capital gains and losses) is amended by inserting "agricultural" before "commodity" the first place it appears therein.

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to sales or exchanges after December 31, 1977.

(v) AMENDMENT OF SECTION 1239(a).—

(1) IN GENERAL.—Subsection (a) of section 1239 (relating to gain from sale of depreciable property between certain related taxpayers) is amended by striking out "subject to the allowance for depreciation provided in section 167" and inserting in lieu thereof "of a character which is subject to the allowance for depreciation provided in section 167."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply as if included in the amendment made to section 1239 of the Internal Revenue Code of 1954 by section 2129(a) of the Tax Reform Act of 1976.

(w) RECAPTURE OF DEPRECIATION ON PLAYER CONTRACTS.—

(1) IN GENERAL.—Subparagraph (C) of section 1245(a)(4) (defining previously unrecaptured depreciation with respect to contracts transferred) is amended to read as follows:

"(C) PREVIOUSLY UNRECAPTURED DEPRECIATION WITH RESPECT TO CONTRACTS TRANSFERRED.—For purposes of subparagraph (A)(ii), the term 'previously unrecaptured depreciation' means the amount of any deduction allowed or allowable to the taxpayer transferor for the depreciation of any contracts involved in such transfer."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to transfers of player contracts in connection with any sale or exchange of a franchise after December 31, 1975.

(x) TREATMENT OF PENSIONS AND ANNUITIES FOR 50-PERCENT MAXIMUM RATE ON PERSONAL SERVICE INCOME.—

(1) IN GENERAL.—Subparagraph (A) of section 1348(b)(1) (defining personal service income) is amended by striking out "pension or annuity" and inserting in lieu thereof "pension or annuity which arises from an employer-employee relationship or from tax deductible contributions to a retirement plan."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1976.

(y) CHANGES IN THE SUBCHAPTER S PROVISIONS.—

(1) GRANTOR TRUST MAY BE TREATED AS PERMITTED SHAREHOLDER AFTER DECEDENT'S DEATH; GRANTOR OR GRANTOR TRUST MUST BE INDIVIDUAL.—Paragraph (1) of subsection (f) of section 1371 is amended to read as follows:

"(1)(A) A trust all of which is treated as owned by the grantor (who is an individual who is a citizen or resident of the United States) under subpart E of part I of subchapter J of this chapter.

"(B) A trust which was described in subparagraph (A) immediately before the death of the grantor and which continues in existence after such death, but only for the 60-day period beginning on the day of the grantor's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the grantor, the preceding sentence shall be applied by substituting '2-year period' for '60-day period'."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1976.

(z) WITHDRAWALS FROM INDIVIDUAL RETIREMENT ACCOUNTS, ETC.—

(1) IN GENERAL.—The last sentence of section 4973(b) (relating to excess contributions to individual retirement accounts, etc.) is amended by striking out "solely because of employer contributions to a plan or contract described in section 219(b)(2)" and inserting in lieu thereof "solely because of ineligibility under section 219(b)(2) or section 220(b)(3)."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply as if included in section 1501 of the Tax Reform Act of 1976 at the time of the enactment of such Act.

(aa) AMENDMENTS RELATING TO DISCLOSURE OF TAX RETURNS.—

(1) DISCLOSURE OF MAILING ADDRESS TO NATIONAL INSTITUTE FOR OCCUPATIONAL SAFETY AND HEALTH AND FOR PURPOSES OF COLLECTING CERTAIN STUDENT LOANS.—

(A) Subsection (m) of section 6103 (relating to disclosure of taxpayer identity information) is amended to read as follows:

"(m) DISCLOSURE OF TAXPAYER IDENTITY INFORMATION.—

"(1) TAX REFUNDS.—The Secretary may disclose taxpayer identity information to the press and other media for purposes of notifying persons entitled to tax refunds when the Secretary, after reasonable effort and lapse of time, has been unable to locate such persons.

"(2) FEDERAL CLAIMS.—Upon written request, the Secretary may disclose the mailing address of a taxpayer to officers and employees of an agency personally and directly engaged in, and solely for their use in, preparation for any administrative or judicial proceeding (or investigation which may result in such a proceeding) pertaining to the collection or compromise of a Federal claim against such taxpayer in accordance with the provisions of section 3 of the Federal Claims Collection Act of 1966.

"(3) NATIONAL INSTITUTE FOR OCCUPATIONAL SAFETY AND HEALTH.—Upon written request, the Secretary may disclose the mailing address of taxpayers to officers and employees of the National Institute for Occupational Safety and Health solely for the purpose of locating individuals who are, or may have been, exposed to occupational hazards in order to determine the status of their health or to inform them of the possible need for medical care and treatment.

"(4) INDIVIDUALS WHO HAVE DEFAULTED ON STUDENT LOANS.—

"(A) IN GENERAL.—Upon written request by the Commissioner of Education, the Secretary may disclose the mailing address of any taxpayer who has defaulted on a loan made from the student loan fund established under part E of title IV of the Higher Education Act of 1965 for use only for purposes of locating such taxpayer for purposes of collecting such loan.

"(B) DISCLOSURE TO INSTITUTIONS.—Any mailing address disclosed under subparagraph (A) may be disclosed by the Commissioner of Education to any educational institution with which he has an agreement under part E of title IV of the Higher Education Act of 1965 only for use by officers, employees or agents of such institution whose duties relate to the collection of student loans for purposes of locating individuals who have defaulted on student loans made by such institution pursuant to such agreement for purposes of collecting such loans."

(B) Paragraph (3) of section 6103(a) is amended by inserting ", subsection (m)(4)(B)," after "subsection (e)(1)(D(iii)".

(C) Paragraph (2) of section 7213(a) (relating to penalties for unauthorized disclosure of information) is amended—

(i) striking out "or any local" and inserting in lieu thereof ", any local";

(ii) by inserting ", or any educational institution" after "enforcement agency"; and

(iii) by striking out "section 6103(d) or (l)(6)" and inserting in lieu thereof "subsection (d), (l)(6), or (m)(4)(B) of section 6103".

(2) DISCLOSURE OF TAX RETURN INFORMATION REGARDING SPECIAL FUEL EXCISE TAXES.—Subsection (d) of section 6103 (relating to disclosure to State tax officials) is amended by inserting "31," after "24,".

(3) RETURN INFORMATION OTHER THAN TAXPAYER RETURN INFORMATION.—Paragraph (2) of section 6103(i) (relating to return information other than taxpayer return information) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the name and address of the taxpayer shall not be treated as taxpayer return information."

(4) DISCLOSURE OF RETURN INFORMATION CONCERNING POSSIBLE CRIMINAL ACTIVITIES.—Paragraph (3) of section 6103(i) (relating to disclosure of return information concerning possible criminal activities) is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the name and address of the taxpayer shall not be treated as taxpayer return information if there is return information (other than taxpayer return information) which may constitute evidence of a violation of Federal criminal laws."

(5) CRIMINAL PENALTY FOR UNAUTHORIZED DISCLOSURE OF INFORMATION.—Section 7213(a) (relating to unauthorized disclosure of information) is amended—

(A) by striking out "to disclose" in paragraphs (1), (2), and (5) and inserting in lieu thereof "willfully to disclose",

(B) by striking out "to thereafter print or publish" in paragraph (3) and inserting in lieu thereof "thereafter willfully to print or publish", and

(C) by striking out "to offer" in paragraph (4) and inserting in lieu thereof "willfully to offer".

(6) NO CIVIL LIABILITY FOR GOOD FAITH BUT ERRONEOUS INTERPRETATION OF DISCLOSURE REQUIREMENTS.—Section 7217 (relating to civil damages for unauthorized disclosure of return and return information) is amended—

(A) by redesignating subsections (b) and (c) as subsections (c) and (d), respectively;

(B) by inserting after subsection (a) the following new subsection:

"(b) NO LIABILITY FOR GOOD FAITH BUT ERRONEOUS INTERPRETATION.—No liability shall arise under this section with respect to any disclosure which results from a good faith, but erroneous, interpretation of section 6103."; and

(C) by striking out "An action" in subsection (d) (as so redesignated) and inserting in lieu thereof "PERIOD FOR BRINGING ACTION.—An action".

(7) EFFECTIVE DATES.—

(A) Except as provided in subparagraph (B), the amendments made by this subsection shall take effect January 1, 1977.

(B) The amendments made by paragraph (6) shall apply with respect to disclosures made after the date of the enactment of this Act.

(bb) AMENDMENTS RELATING TO INCOME TAX RETURN PREPARERS.—

(1) NEGOTIATION OF CHECKS BY BANK.—Subsection (f) of section 6695 (relating to negotiation of check) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply with respect to the deposit by a bank (within the meaning of section 581) of the full amount of the check in the taxpayer's account in such bank for the benefit of the taxpayer."

(2) DEFINITION.—Clause (iii) of section 7701(a)(36)(B) (relating to exceptions from the definition of income tax return preparer) is amended to read as follows:

"(iii) prepares as a fiduciary a return or claim for refund for any person, or".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to documents prepared after December 31, 1976.

(cc) CLARIFICATION OF DECLARATORY JUDGMENT PROVISIONS WITH RESPECT TO REVOCATIONS OF OR OTHER CHANGES IN THE QUALIFICATIONS OF CERTAIN ORGANIZATIONS.—

(1) QUALIFICATION OF CERTAIN RETIREMENT PLANS.—Subsection (a) of section 7476 (relating to declaratory judgments relating to qualification of certain retirement plans) is amended by adding at the end thereof the following new sentence: "For purposes of this section, a determination with respect to a continuing qualification includes any revocation of or other change in a qualification."

(2) CLASSIFICATION OF ORGANIZATIONS UNDER SECTION 501(C)(3), ETC.—Subsection (a) of section 7428 (relating to declaratory judgments relating to status and classification of organizations under section 501(c)(3), etc.) is amended by adding at the end thereof the following new sentence: "For purposes of this section, a determination with respect to a continuing qualification or continuing classification includes any revocation of or other change in a qualification or classification."

(3) EFFECTIVE DATE.—The amendments made by paragraphs (1) and (2) shall take effect as if included in section 7476 or 7428 of the Internal Revenue Code of 1954 (as the case may be) at the respective times such sections were added to such Code.

SEC. 3. TECHNICAL, CLERICAL, AND CONFORMING AMENDMENTS TO ESTATE AND GIFT TAX PROVISIONS.

(a) AMENDMENTS RELATING TO TREATMENT OF SECTION 306 STOCK.—

(1) APPLICATION OF "FRESH START" TO SECTION 306 STOCK.—Subsection (a) of section 306 (relating to dispositions of certain stock) is amended by adding at the end thereof the following new paragraph:

"(3) ORDINARY INCOME FROM SALE OR REDEMPTION OF SECTION 306 STOCK WHICH IS CARRYOVER BASIS PROPERTY ADJUSTED FOR 1976 VALUE.—

"(A) IN GENERAL.—If any section 306 stock was distributed before January 1, 1977, and if the adjusted basis of such stock in the hands of the person disposing of it is determined under section 1023 (relating to carryover basis), then the amount treated as ordinary income under paragraph (1)(A) of this subsection (or the amount treated as a dividend under section 301(c)(1)) shall not exceed the excess of the amount realized over the sum of—

"(i) the adjusted basis of such stock on December 31, 1976, and

"(ii) any increase in basis under section 1023(h).

"(B) REDEMPTION MUST BE DESCRIBED IN SECTION 302(b).—Subparagraph (A) shall apply to a redemption only if such redemption is described in paragraph (1), (2), or (4) of section 302(b)."

(2) CLARIFICATION THAT SECTION 303 OVERRIDES SECTION 306.—Subsection (b) of section 306 (relating to exceptions) is amended by adding at the end thereof the following new paragraph:

"(5) SECTION 303 REDEMPTIONS.—To the extent that section 303 applies to a distribution in redemption of section 306 stock.".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to the estates of decedents dying after December 31, 1976.

(b) COORDINATION OF DEDUCTION FOR ESTATE TAXES ATTRIBUTABLE TO INCOME IN RESPECT OF A DECEDENT WITH THE CAPITAL GAIN DEDUCTION, ETC.—

(1) IN GENERAL.—Subsection (c) of section 691 (relating to deduction for estate taxes in the case of income in respect of decedents) is amended by adding at the end thereof the following new paragraph:

"(4) COORDINATION WITH CAPITAL GAIN DEDUCTION, ETC.—For purposes of sections 1201, 1202, and 1211, and for purposes of section 57(a)(9), the amount of any gain taken into account with respect to any item described in subsection (a)(1) shall be reduced (but not below zero) by the amount of the deduction allowable under paragraph (1) of this subsection with respect to such item."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply with respect to decedents dying after the date of the enactment of this Act.

(c) AMENDMENTS RELATING TO CARRYOVER BASIS.—

(1) MINIMUM CARRYOVER BASIS FOR TANGIBLE PERSONAL PROPERTY.—

(A) IN GENERAL.—Subsection (h) of section 1023 (relating to adjustment to basis for December 31, 1976, fair market value) is amended by adding at the end thereof the following new paragraph:

"(3) MINIMUM BASIS FOR TANGIBLE PERSONAL PROPERTY.—

"(A) IN GENERAL.—If the holding period for any carryover basis property which is tangible personal property includes December 31, 1976, then, for purposes of determining gain and applying this section, the adjusted basis of such property immediately before the death of the death of the decedent shall be treated as being not less than the amount determined under subparagraph (B).

"(B) AMOUNT.—The amount determined under this subparagraph for and property is—

"(i) the value of such property (as determined with respect to the estate of the decedent without regard in section 2032); divided by

"(ii) 1.0066 to the nth power where n equals the number of full calendar months which have elapsed between December 31, 1976, and the date of the decedent's death."

(B) CONFORMING AMENDMENT.—Paragraph (3) of section 1023(g) (relating to decendent's basis unknown) is amended by striking out "to the person acquiring such property from the decedent" and inserting in lieu thereof "and cannot be reasonably ascertained".

(2) TREATMENT OF INDEBTEDNESS.—

(A) IN GENERAL.—Paragraph (1) of section 1023(g) (defining fair market value) is amended by inserting "(without regard to whether there is a mortgage on, or indebtedness in respect of, the property)" after "chapter 11".

(B) TECHNICAL AMENDMENT.—Subsection (g) of section 1023 (relating to other special rules and definitions) is amended by striking out paragraph (4).

(3) ONLY ONE FRESH START WITH RESPECT TO CARRYOVER BASIS PROPERTY HELD ON DECEMBER 31, 1976.—Subsection (h) of section 1023 (relating to adjustment to basis for December 31, 1976, fair market value) is amended by adding at the end thereof the following new paragraph:

"(4) ONLY ONE FRESH START.—There shall be no increase in basis under this subsection by reason of the death of any decedent if the adjusted basis of the property in the hands of such decedent reflects the adjusted basis of property which was carryover basis property with respect to a prior decedent."

(4) AUTOMATIC LONG-TERM STATUS FOR GAINS AND LOSSES ON CARRYOVER BASIS PROPERTY.—Subparagraph (A) of section 1223(11) is amended by inserting "or 1023" after "section 1014".

(5) CLARIFICATION THAT ADJUSTED BASIS IS INCREASED FOR STATE ESTATE TAXES.—

(A) Subsection (c) of section 1023 (relating to increase in basis for Federal and State estate taxes attributable to appreciation) is amended to read as follows:

"(c) INCREASE IN BASIS FOR FEDERAL AND STATE ESTATE TAXES ATTRIBUTABLE TO APPRECIATION.—

"(1) FEDERAL ESTATE TAXES.—The basis of appreciated carryover basis property (determined after any adjustment under subsection (h)) which is subject to the tax imposed by section 2001 or 2101 in the hands of the person acquiring it from the decedent shall be increased by an amount which bears the same ratio to the Federal estate taxes as—

"(A) the net appreciation in value of such property, bears to

"(B) the fair market value of all property which is subject to the tax imposed by section 2001 or 2101.

"(2) STATE ESTATE TAXES.—The basis of appreciated carryover basis property (determined after any adjustment under subsection (h)) which is subject to State estate taxes in the hands of the person acquiring it from decedent shall be increased by an amount which bears the same ratio to the State estate taxes as—

"(A) the net appreciation in value of such property, bears to

"(B) the fair market value of all property which is subject to the State estate taxes."

(B) The second sentence of paragraph (2) of section 1023(f) (defining net appreciation) is amended by striking out "For purposes of subsection (d)," and inserting in lieu thereof "For purposes of paragraph (2) of subsection (c), such adjusted basis shall be increased by the amount of any adjustment under paragraph (1) of subsection (c), for purposes of subsection (d),".

(C) Paragraph (3) of section 1023(f) (defining Federal and State estate taxes) is amended to read as follows:

"(3) FEDERAL AND STATE ESTATE TAXES.—For purposes of subsection (c)—

"(A) FEDERAL ESTATE TAXES.—The term 'Federal estate taxes' means the tax imposed by section 2001 or 2101, reduced by the credits against such tax.

"B) STATE ESTATE TAXES.—The term 'State estate taxes' means any estate, inheritance, legacy, or succession taxes, for which the estate is liable, actually paid by the estate to any State or the District of Columbia."

(6) CLARIFICATION OF INCREASE IN BASIS FOR CERTAIN STATE SUCCESSION TAXES.—Paragraph (2) of section 1023(e) (relating to further increase in basis for certain State succession tax paid by transferee of property) is amended by striking out "for which the estate is not liable".

(7) CLARIFICATION OF APPLICATION OF FRESH START.—Paragraphs (1) and (2)(A) of section 1023(h) (relating to adjustment to basis for December 31, 1976, fair market value) are each amended by striking out "for purposes of determining gain" and inserting in lieu thereof "for purposes of determining gain and applying this section".

(8) TECHNICAL AMENDMENT WITH RESPECT TO CERTAIN TERM INTERESTS.—Paragraph (1) of section 1001(e) (relating to certain term interests) is amended by striking out "section 1014 or 1015" and inserting in lieu thereof "section 1014, 1015, or 1023".

(9) EFFECTIVE DATE.—The amendments made by this subsection shall apply in respect of decedents dying after December 31, 1976.

(d) AMENDMENTS RELATING TO VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY.—

(1) CLARIFICATION THAT SPECIAL VALUATION APPLIES ONLY TO INTERESTS PASSING TO QUALIFIED HEIRS.—Paragraph (1) of section 2032A(b) (defining qualified real property) is amended by striking out "real property located in the United States" and inserting in lieu thereof "real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and".

(2) PROPERTY RECEIVED IN SATISFACTION OF PECUNIARY BEQUEST.—Subsection (e) of section 2032A (relating to definitions and special rules for farm valuation property) is amended by adding at the end thereof the following new paragraph:

"(9) PROPERTY ACQUIRED FROM DECEDENT.—Property shall be considered to have been acquired from or to have passed from the decedent if—

"(A) such property is so considered under section 1044(b) (relating to basis of property acquired from a decedent),

"(B) such property is acquired by any person from the estate in satisfaction of the right of such person to a pecuniary bequest, or

"(C) such property is acquired by any person from a trust in satisfaction of a right (which such person has by reason of the death of the decedent) to receive from the trust a specific dollar amount which is the equivalent of a pecuniary bequest."

(3) USE OF FARM VALUATION PROPERTY TO SATISFY PECUNIARY BEQUEST.—Subsection (a) of section 1040 (relating to use of certain appreciated carryover basis property to satisfy pecuniary bequest) is amended by inserting "(determined without regard to section 2032A)" after "chapter 11".

(4) TREATMENT OF CERTAIN COMMUNITY PROPERTY.—Subsection (e) of section 2032A is amended by adding at the end thereof the following new paragraph:

"(10) COMMUNITY PROPERTY.—If the decedent and his surviving spouse at any time held qualified real property as community property, the interest of the surviving spouse in such property shall be taken into account under this section to the extent necessary to provide a result under this section with respect to such property which is consistent with the result which would have obtained under this section if such property had not been community property."

(5) SUBSTITUTION OF BOND FOR PERSONAL LIABILITY OF QUALIFIED HEIR FOR THE RECAPTURE TAX WITH RESPECT TO FARM VALUATION PROPERTY.—

(A) IN GENERAL.—Paragraph (6) of section 2032A(c) is amended to read as follows:

"(6) LIABILITY FOR TAX; FURNISHING OF BOND.—The qualified heir shall be personally liable for the additional tax imposed by this subsection with respect to his interest unless the heir has furnished bond which meets the requirements of subsection (e) (11)."

(B) BOND REQUIREMENTS.—Subsection (e) of section 2032A is amended by adding at the end thereof the following new paragraph:

"(11) BOND IN LIEU OF PERSONAL LIABILITY.—If the qualified heir makes written application to the Secretary for determination of the maximum amount of the additional tax which may be imposed by subsection (c) with respect to the qualified heir's interest, the Secretary (as soon as possible, and in any event within 1 year after the making of such application) shall notify the heir of such maximum amount. The qualified heir, on furnishing a bond in such amount and for such period as may be required, shall be discharged from personal liability for any additional tax imposed by subsection (c) and shall be entitled to a receipt or writing showing such discharge."

(6) EFFECTIVE DATE.—The amendments made by this subsection shall apply to the estates of decedents dying after December 31, 1976.

(e) AMOUNT OF SECURITY REQUIRED FOR EXTENDED PAYMENT PROVISIONS FOR CLOSELY HELD BUSINESSES.—

(1) IN GENERAL.—

(A) Paragraph (2) of section 6324A(e) (defining aggregate interest amount) is amended to read as follows:

"(2) REQUIRED INTEREST AMOUNT.—The term 'required interest amount' means the aggregate amount of interest which will be payable over the first 4 years of the deferral period with respect to the deferred amount (determined as of the date prescribed by section 6151(a) for the payment of the tax imposed by chapter 11)."

(B) Subparagraph (B) of section 6324A(b) (2) (relating to maximum value of required property) is amended by striking out "aggregate interest amount" and inserting in lieu thereof "required interest amount".

(C) Paragraph (5) of section 6324A(d) (relating to special rules) is amended by striking out "aggregate interest amount" and inserting in lieu thereof "required interest amount".

(D) Paragraph (4) of section 6324A(e) (relating to application of definitions in case of deficiencies) is amended by striking out "aggregate interest amount" and inserting in lieu thereof "required interest amount".

(2) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying after December 31, 1976.

(f) CLARIFICATION OF THE $3,000 ANNUAL EXCLUSION FROM THE RULE INCLUDING IN GROSS ESTATE TRANSFERS WITHIN 3 YEARS OF DEATH.—

(1) AMENDMENT OF SECTION 2035(b).—Subsection (b) of section 2035 (relating to adjustments for gifts made within 3 years of decedent's death) is amended to read as follows:

"(b) EXCEPTIONS.—Subsection (a) shall not apply—

"(1) to any bona fide sale for an adequate and full consideration in money or money's worth, and

"(2) to any gift to a donee made during a calendar year if the decedent was not required by section 6019 to file any gift tax return for such year with respect to gifts to such donee.

Paragraph (2) shall not apply to any transfer with respect to a life insurance policy."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to the estates of decedents dying after December 31, 1976, except that it shall not apply to transfers made before January 1, 1977.

(g) AMENDMENTS RELATING TO ESTATE TAX MARITAL DEDUCTION.—

(1) DEDUCTION NOT REDUCED FOR GIFT TO SPOUSE WHICH IS INCLUDED IN DONOR'S ESTATE BY REASON OF SECTION 2035.—Subparagraph (B) of section 2056(c) (1) (relating to adjustment to estate tax marital deduction for certain gifts to spouse) is amended by adding at the end thereof the following new sentence:

"For purposes of this subparagraph, a gift which is includible in the gross estate of the donor by reason of section 2035 shall not be taken into account."

(2) REDUCTION FOR GIFT TAX MARITAL DEDUCTION IN EXCESS OF 50 PERCENT OF THE VALUE OF GIFTS TO A SPOUSE.—Clause (ii) of section 2056(c) (1) (B) (relating to adjustment to estate tax marital deduction for certain gifts to spouse) is amended by inserting "required to be included in a gift tax return" after "with respect to any gift".

(3) EFFECTIVE DATE.—The amendment made by this subsection shall apply to the estate of decedents dying after December 31, 1976.

(h) COORDINATION OF SECTIONS 2513 AND 2035.—

(1) IN GENERAL.—Section 2001 (relating to imposition and rate of estate tax) is amended by adding at the end thereof the following new subsection:

"(e) COORDINATION OF SECTIONS 2513 and 2035.—If—

"(1) the decedent's spouse was the donor of any gift one-half of which was considered under section 2513 as made by the decedent, and

"(2) the amount of such gift is includible in the gross estate of the decedent's spouse by reason of section 2035,

such gift shall not be included in the adjusted taxable gifts of the decedent for purposes of subsection (b)(1)(B), and the aggregate amount determined under subsection (b)(2) shall be reduced by the amount (if any) determined under subsection (d) which was treated as a tax payable by the decedent's spouse with respect to such gift."

(2) CONFORMING AMENDMENT.—Subparagraph (C) of section 2602(a)(1) (relating to amount of tax on generation-skipping transfers) is amended by striking out "section 2001(b))" and inserting in lieu thereof "section 2001 (b), as modified by section 2001(e))".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply with respect to the estates of decedents dying after December 31, 1976, except that such amendments shall not apply to transfers made before January 1, 1977.

(i) INCLUSION IN GROSS ESTATE OF STOCK TRANSFERRED BY THE DECEDENT WHERE THE DECEDENT RETAINS OR ACQUIRES VOTING RIGHTS.—

(1) IN GENERAL.—Section 2036 (relating to transfers with retained life estate) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) VOTING RIGHTS.—

"(1) IN GENERAL.—For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

"(2) CONTROLLED CORPORATION.—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone of in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

"(3) COORDINATION WITH SECTION 2035.—For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent."

(2) CONFORMING AMENDMENT.—Subsection (a) of section 2036 is amended by striking out the last sentence thereof.

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to transfer made after June 22, 1976.

(j) AMENDMENTS RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS, ETC., FOR SPOUSE.—

(1) APPLICATION OF ESTATE TAX EXCLUSION TO INDIVIDUAL RETIREMENT ACCOUNTS, ETC., FOR SPOUSE.—Subsection (e) of section 2039 (relating to exclusion of individual retirement accounts, etc.) is amended by striking out "section 219" each place it appears and inserting in lieu thereof "section 219 or 220".

(2) TRANSFERS TO INDIVIDUAL RETIREMENT ACCOUNTS, ETC., FOR SPOUSE TREATED AS TRANSFERS OF PRESENT INTERESTS.—Section 2503 (relating to taxable gifts) is amended by adding at the end thereof the following new subsection:

"(d) INDIVIDUAL RETIREMENT ACCOUNTS, ETC., FOR SPOUSE.—For purposes of subsection (b), any payment made by an individual for the benefit of his spouse—

"(1) to an individual retirement account described in section 408(a),

"(2) to an individual retirement annuity described in section 408(b), or

"(3) for a retirement bond described in section 409,

shall not be considered a gift of a future interest in property to the extent that such payment is allowable as a deduction under section 220."

(3) EFFECTIVE DATES.—

(A) The amendment made by paragraph (1) shall apply to the estates of decedents dying after December 31, 1976.

(B) The amendment made by paragraph (2) shall apply to transfers made after December 31, 1976.

(k) PROVISIONS RELATING TO TREATMENT OF JOINT INTERESTS.—

(1) REMOVAL OF REQUIREMENT OF ACTUARIAL COMPUTATIONS FOR JOINT INTERESTS IN PERSONAL PROPERTY.—

(A) IN GENERAL.—Subchapter (B) of chapter 12 (relating to transfers for purposes of the gift tax) is amended by inserting after section 2515 the following new section:

"SEC. 2515A. TENANCIES BY THE ENTIRETY IN PERSONAL PROPERTY.

"(a) CERTAIN ACTUARIAL COMPUTATIONS NOT REQUIRED.—In the case of—

"(1) the creation (either by one spouse alone or by both spouses) of a joint interest of a husband and wife in personal property with right of survivorship, or

"(2) additions to the value thereof in the form of improvements, reductions in the indebtedness thereof, or otherwise,

the retained interest of each spouse shall be treated as one-half of the value of their joint interest.

"(b) EXCEPTION.—Subsection (a) shall not apply with respect to any joint interest in property if the fair market value of the interest or of the property (determined as if each spouse had a right to sever) cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses."

(B) CHANGE IN SECTION 2515 HEADING.—The heading for section 2515 is amended to read as follows:

"SEC. 2515. TENANCIES BY THE ENTIRETY IN REAL PROPERTY."

(C) CLERICAL AMENDMENTS.—The table of sections for subchapter B of chapter 12 is amended by striking out the item relating to section 2515 and inserting in lieu thereof the following:

"Sec. 2515. Tenancies by the entirety in real property.
"Sec. 2515A. Tenancies by the entirety in personal property."

(D) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to joint interests created after December 31, 1976.

(2) EXTENSION OF FRACTIONAL INTEREST RULE TO CERTAIN JOINT INTERESTS IN REAL OR PERSONAL PROPERTY CREATED BEFORE 1977.—Section 2040 (relating to joint interests) is amended by adding at the end thereof the following new subsections:

"(c) JOINT INTERESTS OF HUSBAND AND WIFE CREATED BEFORE 1977.—Under regulations prescribed by the Secretary—

"(1) IN GENERAL.—In the case of any joint interest created before January 1, 1977, which (if created after December 31, 1976) would have constituted a qualified joint interest under subsection (b)(2) (determined without regard to clause (ii) of subsection (b)(2)(B)), the donor may make an election under this subsection to have paragraph (1) of subsection (b) apply with respect to such joint interest.

"(2) TIME FOR MAKING ELECTION.—An election under this subsection with respect to any property shall be made for the calendar quarter in 1977, 1978, or 1979 selected by the donor in a gift tax return filed within the time prescribed by law for filing a gift tax return for such quarter. Such an election may be made irrespective of whether or not the amount involved exceeds the exclusion provided by section 2503(b); but no election may be made under this subsection after the death of the donor.

"(3) TAX EFFECTS OF ELECTION.—In the case of any property with respect to which an election has been made under this subsection, for purposes of this title—

"(A) the donor shall be treated as having made a gift at the close of the calendar quarter selected under paragraph (2), and

"(B) the amount of the gift shall be determined under paragraph (4).

"(4) AMOUNT OF GIFT.—For purposes of paragraph (3)(B), the amount of any gift is one-half of the amount—

"(A) which bears the same ratio to the excess of (i) the fair market value of the property on the date of the deemed making of the gift under paragraph (3)(A), over (ii) the fair market value of such property on the date of the creation of the joint interest, as

"(B) the excess of (i) the consideration furnished by the donor at the time of the creation of the joint interest, over (ii) the consideration furnished at such time by the donor's spouse, bears to the total consideration furnished by both spouses at such time.

"(5) SPECIAL RULE FOR PARAGRAPH (4)(A).—For purposes of paragraph (4)(A)—

"(A) in the case of real property, if the creation was not treated as a gift at the time of the creation, or

"(B) in the case of personal property, if the gift was required to be included on a gift tax return but was not so included, and the period of limitations on assessment under section 6501 has expired with respect to the tax (if any) on such gift,

then the fair market value of the property on the date of the creation of the joint interest shall be treated as zero.

"(6) SUBSTANTIAL IMPROVEMENTS.—For purposes of this subsection, a substantial improvement of any property shall be treated as the creation of a separate joint interest.

"(d) TREATMENT OF CERTAIN POST-1976 TERMINATIONS.—

"(1) IN GENERAL.—If—

(A) before January 1, 1977, a husband and wife had a joint interest in property with right of survivorship,

"(B) after December 31, 1976, such joint interest was terminated, and

"(C) after December 31, 1976, a joint interest of such husband and wife in such property (or in property the basis of which in whole or in part reflects the basis of such property) was created,

then paragraph (1) of subsection (b) shall apply to the joint interest described in subparagraph (C) only if an election is made under subsection (c).

"(2) SPECIAL ROLES.—For purposes of applying subsection (c) to property described in paragraph (1) of this subsection—

"(A) if the creation described in paragraph (1)(C) occurs after December 31, 1979, the election may be made only with respect to the calendar quarter in which such creation occurs, and

"(B) the creation of the joint interest described in paragraphs (4) and (5) of subsection (c) is the creation of the joint interest described in paragraph (1)(A) of this subsection."

(1) AMENDMENTS RELATING TO ORPHANS' EXCLUSION.—

(1) ORPHANS' EXCLUSION WHERE THERE IS A TRUST FOR MINOR CHILDREN.—Section 2057 (relating to bequests, etc., to certain minor children) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) QUALIFIED MINORS' TRUST.—

"(1) IN GENERAL.—For purposes of subsection (a), the interest of a minor child in a qualified minors' trust shall be treated as an interest in property which passes or has passed from the decedent to such child.

"(2) QUALIFIED MINORS' TRUST.—For purposes of paragraph (1), the term 'qualified minors' trust' means a trust—

"(A) except as provided in subparagraph (D), all of the beneficiaries of which are minor children of the decedent,

"(B) the corpus of which is property which passes or has passed from the decedent to such trust,

"(C) except as provided in paragraph (3), all distributions from which to the beneficiaries of the trust before the termination of their interests will be pro rata,

"(D) on the death of any beneficiary of which before the termination of the trust, the beneficiary's pro rata share of the corpus and accumulated income remains in the trust for the benefit of the minor children of the decedent who survive the beneficiary or vests in any person, and

"(E) on the termination of which, each beneficiary will receive a pro rata share of the corpus and accumulated income.

"(3) CERTAIN DISPROPORTIONATE DISTRIBUTIONS PERMITTED.—A trust shall not be treated as failing to meet the requirements of paragraph (2)(C) solely by reason of the fact that the governing instrument of the trust permits the making of disproportionate distributions which are limited by an ascertainable standard relating to the health, education, support, or maintenance of the beneficiaries.

"(4) TRUSTEE MAY ACCUMULATE INCOME.—A trust which otherwise qualifies as a qualified minors' trust shall not be disqualified solely by reason of the fact that the trustee has power to accumulate income.

"(5) COORDINATION WITH SUBSECTION (c).—In applying subsection (c) to a qualified minors' trust, those provisions of section 2056(b) which are inconsistent with paragraph (3) or (4) of this subsection shall not apply.

"(6) DEATH OF BENEFICIARY BEFORE YOUNGEST CHILD REACHES AGE 23.—Nothing in this subsection shall be treated as disqualifying an interest of a minor child in a trust solely because such interest will pass to another person if the child dies before the youngest child of the decedent attains age 23."

(2) AGE 23 FOR TERMINABLE INTEREST RULE IN THE CASE OF ORPHANS' EXCLUSION.—The second sentence of subsection (c) of section 2057 (relating to limitation in the case of life estate or other terminable interest) is amended by striking out "21" and inserting in lieu thereof "23".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to the estates of decedents dying after December 31, 1976.

(m) DISCLAIMER BY SURVIVING SPOUSE WHERE INTEREST PASSES TO SUCH SPOUSE.—

(1) IN GENERAL.—Paragraph (4) of section 2518(b) (defining qualified disclaimer) is amended to read as follows:

"(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—

"(A) to the spouse of the decedent, or

"(B) to a person other than the person making the disclaimer."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to transfers creating an interest in the person disclaiming made after December 31, 1976.

(n) AMENDMENTS RELATING TO TAX ON GENERATION-SKIPPING TRANSFERS.—

(1) CERTAIN POWERS OF INDEPENDENT TRUSTEES NOT RELATED AS POWERS.—Subsection (e) of section 2613 (relating to definitions for purposes of the tax on generation-skipping transfers) is amended to read as follows:

"(e) CERTAIN POWERS NOT TAKEN INTO ACCOUNT.—

"(1) LIMITED POWER TO APPOINT AMONG LINEAL DESCENDANTS OF THE GRANTOR.—For purposes of this chapter, an individual shall be treated as not having any power in a trust if such individual does not have any present or future power in the trust other than a power to dispose of the corpus of the trust or the income therefrom to a beneficiary or a class of beneficiaries who are lineal descendants of the grantor assigned to a generation younger than the generation assignment of such individual.

"(2) POWERS OF INDEPENDENT TRUSTEES.—

"(A) IN GENERAL.—For purposes of this chapter, an individual shall be treated as not having any power in a trust if such individual—

"(i) is a trustee who has no interest in the trust,

"(ii) is not a related or subordinate trustee, and

"(iii) does not have any present of future power in the trust other than a power to dispose of the corpus of the trust o rthe income therefrom to a beneficiary or a class of beneficiaries designated in the trust instrument.

"(B) RELATED OR SUBORDINATE TRUSTEE DEFINED.—For purposes of subparagraph (A), the term 'related or subordinate trustee' means any trustee who is—

"(i) the spouse of the grantor or of any beneficiary,

"(ii) the father, mother, lineal descendant, brother, or sister of the grantor or of any beneficiary,

"(iii) an employee of a corporation in which the stockholdings of the grantor, the trust, and the beneficiaries of the trust are significant from the viewpoint of voting control, or

"(iv) an employee of a corporation in which the grantor or any beneficiary of the trust is an executive."

(2) CLARIFICATION OF SECTION 2613(b)(2)(B).—Subparagraph (B) of section 2613(b)(2) defining taxable termination for purposes of the tax on generation-skipping transfer) is amended—

(A) by striking out "an interest and a power" and inserting in lieu thereof "a present interest and a present power", and

(B) by striking out "interest or power" and inserting in lieu thereof "present interest or present power".

(3) ALTERNATE VALUATION IN CERTAIN CASES WHERE THERE IS A TAXABLE TERMINATION AT DEATH OF OLDER GENERATION BENEFICIARY.—

(A) IN GENERAL. Subparagraph (A) of section 2602(d)(1) (relating to alternate valuation) is amended by inserting "(or at the same time as the death of a beneficiary of the trust assigned to a higher generation than such deemed transferor)" after "such deemed transferor".

(B) SPECIAL RULES.—Subparagraph (A) of section 2602(d)(2) (relating to special rules for alternate valuation) is amended by inserting "(or beneficiary)" after "the deemed transferor".

(4) EFFECTIVE DATE.—The amendments made by this subsection shall take effect as if included in chapter 13 of the Internal Revenue Code of 1954 as added by section 2006 of the Tax Reform Act of 1976.

(o) ADJUSTMENT IN INCOME TAX ON ACCUMULATION DISTRIBUTIONS FOR PORTION OF ESTATE AND GENERATION-SKIPPING TRANSFER TAXES.—

(1) IN GENERAL.—Subsection (b) of section 667 (relating to tax on accumulation distribution) is amended by adding at the end thereof the following new paragraph:

"(6) ADJUSTMENT IN PARTIAL TAX FOR ESTATE AND GENERATION-SKIPPING TRANSFER TAXES ATTRIBUTABLE TO PARTIAL TAX.—

"(A) IN GENERAL.—The partial tax shall be reduced by an amount which is equal to the pre-death portion of the partial tax multiplied by a fraction—

"(i) the numerator of which is that portion of the tax imposed by chapter 11 or 13, as the case may be, which is attributable (on a proportionate basis) to amounts included in the accumulation distribution, and

"(ii) the denominator of which is the amount of the accumulation distribution which is subject to the tax imposed by chapter 11 or 13, as the case may be.

"(B) PARTIAL TAX DETERMINED WITHOUT REGARD TO THIS PARAGRAPH.—For purposes of this paragraph, the term 'partial tax' means the partial tax imposed by subsection (a)(2) determined under this subsection without regard to this paragraph.

"(C) PRE-DEATH PORTION.—For purposes of this paragraph, the pre-death portion of the partial tax shall be an amount which bears the same ratio to the partial tax as the portion of the accumulation distribution which is attributable to the period before the date of the death of the decedent or the date of the generation-skipping transfer bears to the total accumulation distribution."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply—

(A) in the case of the tax imposed by chapter 11 of the Internal Revenue Code of 1954, to the estates of decedents dying after December 31, 1976, and

(B) in the case of the tax imposed by chapter 13, to any generation-skipping transfer (within the meaning of section 2611(a) of such Code) made after April 30, 1976.

(p) RELIEF OF EXECUTOR FROM PERSONAL LIABILITY IN THE CASE OF RELIANCE ON GIFT TAX RETURNS.—

(1) IN GENERAL.—Section 2204 (relating to discharge of fiduciary from personal liability) is amended by adding at the end thereof the following new subsection:

"(d) GOOD FAITH RELIANCE ON GIFT TAX RETURNS.—If the executor in good faith relies on gift tax returns furnished under section 6103(e)(3) for determining the decendent's adjusted taxable gifts, the executor shall be discharged from personal liability with respect to any deficiency of the tax imposed by this chapter which is attributable to adjusted taxable gifts which—

"(1) are made more than 3 years before the date of the decedent's death, and

"(2) are not shown on such returns.".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply with respect to the estates of decedents dying after December 31, 1976.

(q) AMENDMENT OF GOVERNING INSTRUMENTS TO MEET REQUIREMENTS FOR GIFTS OF SPLIT INTEREST TO CHARITY.

(1) CHARITABLE LEAD TRUSTS IN THE CASE OF ESTATE TAX.—The first sentence of paragraph (3) of section 2055(e) is amended to read as follows: "In the case of a will executed before December 31, 1977, or a trust created before such date, if a deduction is not allowable at the time of the decedent's death because of the failure of an interest in property which passes from the decedent to a person, or for a use, described in subsection (a) to meet the requirements of subparagraph (A) or (B) of paragraph (2) of this subsection, and if the governing instrument is amended or conformed on or before December 31, 1977, or, if later, on or before the 30th day after the date on which judicial proceedings begun on or before December 31, 1977 (which are required to amend or conform the governing instrument), become final, so that interest is in a trust which meets the requirements of such subparagraph (A) or (B) (as the case may be), a deduction shall nevertheless be allowed."

(2) CHARITABLE LEAD TRUSTS AND CHARITABLE REMAINDER TRUSTS IN THE CASE OF INCOME AND GIFT TAXES.—Under regulations prescribed by the Secretary of the Treasury or his delegate, in the case of trusts created before December 31, 1977, provisions comparable to section 2055(e)(3) of the Internal Revenue Code of 1954 (as amended by paragraph (1)) shall be deemed to be included in sections 170 and 2522 of the Internal Revenue Code of 1954.

(r) INDEXING OF FEDERAL TAX LIENS.—

(1) IN GENERAL.—Paragraph (4) of section 6323(f) (relating to indexing of tax liens) in amended to read as follows:

"(4) INDEXING REQUIRED WITH RESPECT TO CERTAIN REAL PROPERTY.—In the case of real property, if—

"(A) under the laws of the State in which the real property is located, a deed is not valid as against a purchaser of the property who (at the time of purchase) does not have actual notice or knowledge of the existence of such deed unless the fact of filing of such deed has been entered and recorded in a public index at the place of filing in such a manner that a reasonable inspection of the index will reveal the existence of the deed, and

"(B) there is maintained (at the applicable office under paragraph (1)) an adequate system for the public indexing of Federal tax liens,

then the notice of lien referred to in subsection (a) shall not be treated as meeting the filing requirements under paragraph (1) unless the fact of filing is entered and recorded in the index referred to in subparagraph (B) in such a manner that a reasonable inspection of the index will reveal the existence of the lien.".

(2) REFILING OF NOTICE OF LIEN.—Section 6323(g)(2)(A) (relating to refiling of notice of lien) is amended to read as follows:

"(A) If—

"(i) such notice of lien is refiled in the office in which the prior notice of lien was filed, and

"(ii) in the case of real property, the fact of refiling is entered and recorded in an index to the extent required by subsection (f)(4); and".

(3) EFFECTIVE DATE.—

(A) The amendments made by this subsection shall apply with respect to liens, other security interests, and other interests in real property acquired after the date of the enactment of this Act.

(B) If, after the date of the enactment of this Act, there is a change in the application (or nonapplication) of section 6323(f)(4) of the Internal Revenue Code of 1954 (as amended by paragraph (1)) with respect to any filing jurisdiction, such change shall apply only with respect to liens, other security interests, and other interests in real property acquired after the date of such change.

(s) CLERICAL AMENDMENTS.—

(1) CLERICAL AMENDMENTS WITH RESPECT TO SECTION 6694.—

(A) IN GENERAL.—Section 6694 (relating to failure to file information with respect to carryover basis property) which was added by section

2005(d)(2) of the Tax Reform Act of 1976 is redesignated as section 6698.

(B) DEFICIENCY PROCEDURES NOT TO APPLY.—Section 6698 (as redesignated by subparagraph (A)) is amended by adding at the end thereof the following new subsection:

"(c) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assesment or collection of any penalty imposed by subsection (a)."

(C) TABLE OF SECTIONS.—The table of sections for subchapter B of chapter 68 is amended by striking out

"Sec. 6694. Failure to file information with respect to carryover basis property."

and inserting in lieu thereof the following:

"Sec. 6698. Failure to file information with respect to carryover basis property."

(2) CLERICAL AMENDMENT TO SECTION 2051.—Section 2051 (defining taxable estae) is amended by striking out "exemption and".

(3) CLERICAL AMENDMENT TO SECTION 1064 (a).—Subsection (a) of section 1016 (relating to adjustments to basis) is amended by redesignating paragraph (23) as paragraph (21).

(4) CLERICAL AMENDMENT TO SECTION 6324B(b).—Subsection (b) of section 6324B (relating to period of lien for additional estae tax attributable to farm, etc., valuation) is amended by striking out "qualified farm real property" and inserting in lieu thereof "qualified real property".

(5) EFFECTIVE DATE.—The amendments made by this subsection shall apply to estates of decedents dying after December 31, 1976.

SEC. 4. CORRECTIONS OF PUNCTUATION, SPELLING, INCORRECT CROSS REFERENCES, ETC.

(a) ERRONEOUS CROSS REFERENCE IN INVESTMENT CREDIT.—

(1) AMENDMENT OF SECTION 46(f)(8).—The first sentence of paragraph (8) of section 46(f) is amended by striking out "subsection (a)(6)(D)" and inserting in lieu thereof "subsection (a)(7)(D)".

(2) AMENDMENT OF SECTION 46(g)(5).—Paragraph (5) of section 46(g) (relating to definitions) is amended by striking out "Merchant Marine Act, 1970" and inserting in lieu thereof "Merchant Marine Act, 1936".

(3) AMENDMENT OF SECTION 48(d)(1)(B).—Subparagraph (B) of section 48(d)(1) is amended by striking out "section 46(a)(5)" and inserting in lieu thereof "section 46 (a)(6)".

(4) AMENDMENT OF SECTION 48(d)(4)(D).—Subparagraph (D) of section 48(d)(4) is amended by striking out "section 57(c)(2)" and inserting in lieu thereof "section 57(c)(1)(B)".

(b) PREPAID LEGAL SERVICES.—

(1) Paragraph (2) of section 2134(e) of the Tax Reform Act of 1976 is amended by striking out "section 120(d)(6)" and inserting in lieu thereof "section 120(d)(7)".

(2) Paragraph (20) of section 501(c) is amended by striking out "section 501(c)(20)" and inserting in lieu thereof "this paragraph".

(c) AMENDMENTS RELATING TO SECTIONS 219 AND 220.—

(1) AMENDMENT OF SECTION 219(c)(4).—Paragraph of section 219(c) (relating to participation in governmental plans by certain individuals) is amended by striking out "subsection (b)(3)(A)(iv)" each place it appears and inserting in lieu thereof "subsection (b)(2)(A)(iv)".

(2) AMENDMENT OF SECTION 220(b)(1)(A).—Subparagraph (A) of section 220(b)(1) (relating to retirement savings for certain married individuals) is amended by striking out "amount paid to the account or annuity, for the bond" and inserting in lieu thereof "amount paid to the account, for the annuity, or for the bond".

(3) AMENDMENT OF SECTION 220(b)(4).—Paragraph (4) of section 202(b) is amended by inserting "described in subsection (a)" after "any payment".

(4) AMENDMENT OF SECTION 408(d)(4).—Subparagraph (A) of section 1501(b)(5) of the Tax Reform Act of 1976 is amended to read as follows:

"(A) by inserting 'or 220' after '219' each place it appears, and".

(5) EFFECTIVE DATE.—The amendments made by this subsection shall apply to taxable years beginning after December 31, 1976.

(d) ACCRUAL ACCOUNTING FOR FARM CORPORATIONS.—Subsections (a) and (g) (2) of section 447 are each amended by striking out "preproductive expenses" and inserting in lieu thereof "preproductive period expenses".

(e) AMENDMENT OF SECTION 911.—Subsection (c) of section 911 is amended by redesignating paragraph (8) as paragraph (7).

(f) TRANSITION RULE FOR PRIVATE FOUNDATIONS.—Subparagraph (F) of section 101(l)(2) of the Tax Reform Act of 1969 (relating to private foundations savings provisions) is amended by striking out the period at the end of clause (i) and inserting in lieu thereof a comma.

(g) LOBBYING BY PUBLIC CHARITIES.—

(1) LOBBYING NONTAXABLE AMOUNT.—Paragraph (2) of section 4911(c) (defining lobbying nontaxable amount) is amended by striking out "proposed expenditures" in the heading of the table contained in such paragraph and inserting in lieu thereof "exempt purpose expenditures".

(2) TECHNICAL AMENDMENTS RELATING TO SECTION 501.—

(A) Section 2(a) of Public Law 95-568 is amended by striking out "subsection (h) as subsection (i) and by inserting after subsection (g)" and inserting in lieu thereof "subsection (i) as subsection (j) and by inserting after subsection (h)".

(B) Subsection (g) of section 501 of the Internal Revenue Code of 1954 (as inserted by section 2(a) of Public Law 94-568) is redesignated as subsection (i).

(C) The amendments made by this paragraph shall take effect on October 20, 1976, as if included in Public Law 94-568.

(3) MATH ERRORS RELATING TO EXCESS LOBBYING TAX OR UNDISTRIBUTED REIT INCOME TAX.—Paragraphs (1) and (2)(E) of section 6213(f) (relating to definitions relating to math errors) are each amended by striking out "chapter 42 or 43" and inserting in lieu thereof "chapter 41, 42, 43, or 44".

(4) REFUNDS OR CREDITS OF EXCESS LOBBYING TAX OR UNDISTRIBUTED REIT INCOME TAX.—Subsection (a) of section 6405 (relating to Joint Committee review of large refunds and credits) is amended by striking out "or any tax imposed with respect to private foundations and pension plans under chapter 42 and 43," and inserting in lieu thereof "or any tax imposed with respect to public charities, private foundations, pension plans, or real estate investment under chapter 41, 42, 43, or 44,".

(h) AMENDMENTS TO FOREIGN TAX PROVISIONS.—

(1) Paragraph (2) of section 1035(c) of the Tax Reform Act of 1976 (relating to tax credit for production-sharing contracts) is amended—

(A) by inserting "(as defined in section 907(c) of such Code)" after "gas extraction income" in subparagraph (A), and

(B) by striking out "(as defined in section 907(c)(1) of such Code)" in subparagraph (B) and inserting in lieu thereof "(as so defined)".

(2) Paragraph (1) of section 999(c) (relating to international boycott factor) is amended by striking out "995(b)(3)" and inserting in lieu thereof "995(b)(1)(F)(ii)".

(3) Paragraph (2) of section 999(c) is amended by striking out "995(b)(1)(D)(ii)" and inserting in lieu there of "995(b)(1)(F)(ii)".

(i) AMENDMENTS TO DISC PROVISIONS.—

(1) The last two sentences of section 995(b)(1) (relating to deemed distributions to shareholders of a DISC) are amended—

(A) by striking out "gross income (taxable income in the case of subparagraph (D))" and inserting in lieu thereof "income"; and

(B) by striking out "subparagraph (E)" and inserting in lieu thereof "subparagraph (G)".

(2) Paragraph (2) of section 996(a) (relating to qualifying distributions) is amended by striking out "section 995(b)(1)(E)" and inserting in lieu thereof "section 995(b)(1)(G)".

(3) Paragraph (5) of section 1101(g) of the Tax Reform Act of 1976 is amended by striking out "section 993(e)(3)" and inserting in lieu thereof "section 995(e)(3)".

(j) AMENDMENTS RELATING TO DEADWOOD PROVISIONS.—

(1) TAX EXEMPT GOVERNMENTAL OBLIGATIONS.—

(A) The heading of paragraph (1) of section 103(b) is amended to read as follows:

"(1) SUBSECTION (a) (1) OR (2) NOT TO APPLY.—

(B) Paragraph (1) of section 103(c) is amended by striking out "(a) (1) or (4)" each place it appears (including in the paragraph heading) and inserting in lieu thereof "(a) (1) or (2)".

(C) Subparagraph (A) of section 103(c)(2) is amended by striking out "subsection (a) (1) or (2) or (4)" and inserting in lieu thereof "subsection (a) (1) or (2)".

(D) Paragraph (5) of section 103(c) is amended by striking out "subsection (d)(2)(A)" and inserting in lieu thereof "paragraph (2)(A)".

(E) Subsection (d) of section 103 is amended by striking out "subsection (c)(4)(G)" and inserting in lieu thereof "subsection (b)(4)(G)".

(2) AMENDMENTS RELATING TO SECTION 311(d)(2).—

(A) Subsection (b) of section 2 of the Bank Holding Company Tax Act of 1976 is amended—

(i) by striking out "subparagraph (F)" and inserting in lieu thereof "subparagraph (E)", and

(ii) by striking out "subparagraph (G)" and inserting in lieu thereof "subparagraph (F)".

(B) Subparagraph (H) of section 311(d)(2) is redesignated as subparagraph (G).

(C) The amendments made by this paragraph shall take effect as if included in section 2(b) of the Bank Holding Company Tax Act of 1976.

(3) AMENDMENT TO SECTION 453(c).—Paragraph (3) of section 453(c) is amended—

(A) by striking out "(or by the corresponding provisions of prior revenue laws)" in the first sentence, and

(B) by striking out the last sentence.

(4) AMENDMENT OF SECTION 801(g).—Paragraphs (1)(B)(ii) and (7) of section 801(g) are each amended by striking out "subparagraph (A) (B), (C), (D), or (E) of section 805(d)(1)" and inserting in lieu thereof "section 805(d)".

(5) AMENDMENT OF SECTION 1033 (a)(2).—Clause (ii) of section 103(a)

(5) AMENDMENT OF SECTION 1033(a)(2).—Clause (ii) of section 103(a) (2)(A) is amended by striking out "subsection (c)" and inserting in lieu thereof "subsection (b)".

(6) AMENDMENT OF SECTION 1375(a). Paragraph (2) of section 1375(a) is amended by striking out "such excess" each place it appears and inserting in lieu thereof "such gain".

(7) AMENDMENT OF SECTION 1561(b)(3).—Paragraph (3) of section 1561(b) is amended by striking out "804(a)(4)" and inserting in lieu thereof "804(a)(3)".

(8) AMENDMENTS OF SECTION 1042.—

(A) The last paragraph of section 1402(a) of the Internal Revenue Code of 1954 (definition of net earnings from self-employment) is amended by striking out "subsection (i)" each place it appears and inserting in lieu thereof "subsection (h)".

(B) Section 1402(c)(6) of such Code (definition of trade or business) is amended by striking out "subsection (h)" and inserting in lieu thereof "subsection (g)".

(9) AMENDMENT TO SECTION 46(a).—Subparagraph (C) of section 1901 (b)(1) of the Tax Reform Act of 1976 is amended by striking out "Section 46(a)(3)" and inserting in lieu thereof "Section 46(a)(4)".

(10) AMENDMENT RELATING TO SECTION 6504.—Subparagraph (D) of section 1901 (b)(37) of the Tax Reform Act of 1976 is amended by striking out "6515" and inserting in lieu thereof "6504".

(11) TERRITORIES.—Subsection (c) of section 1901 of the Tax Reform Act of 1976 (relating to Territories) is amended by striking out paragraph (1) thereof.

(12) ESTATE AND GIFT TAXES EFFECTIVE DATE.—Subsection (c) of section 1902 of the Tax Reform Act of 1976 is amended to read as follows:

"(c) EFFECTIVE DATES.—

"(1) ESTATE TAX AMENDMENTS.—The amendments made by paragraphs (1) through (8), and paragraphs (12) (A), (B), and (C), of subsection (a) and by subsection (b) shall apply in the case of estates of decedents dying after the date of the enactment of this Act, and the amendment made by paragraph (9) of subsection (a) shall apply in the case of estates of decedents dying after December 31, 1970.

"(2) GIFT TAX AMENDMENTS.—The amendments made by paragraphs (10), (11), and (12) (D) and (E) of subsection (a) shall apply with respect to gifts made after December 31, 1976."

(13) EFFECTIVE DATE FOR AMENDMENT MADE BY SECTION 1904(a) (22) (A).—Notwithstanding section 1904(d) of the Tax Reform Act of 1976, the amendment made by section 1904(a) (22) (A) of such Act shall take effect on the date of the enactment of such Act.

(14) AMENDMENTS TO SOCIAL SECURITY ACT.—

(A) Section 202 (v) of the Social Security Act is amended by striking out "section 1402(h)" each place it appears and inserting in lieu thereof "section 1402(g)".

(B) Section 205(p) (3) of such Act is amended by striking out "Secretary of the Treasury" and inserting in lieu thereof "Secretary of Transportation".

(C) Section 210(a) (6) (B) (v) of such Act is amended by striking out "Secretary of the Treasury" and inserting in lieu thereof "Secretary of Transportation".

(D) Section 211(a) (2) of such Act is amended by striking out "(other than interest described in section 35 of the Internal Revenue Code of 1954)".

(E) Section 211(c) (6) of such Act is amended by striking out "section 1402(h)" and inserting in lieu thereof "section 1402(g)".

(k) CAPITAL LOSS CARRYOVERS.—Clause (ii) of section 1212(a) (1) (C) (relating to capital loss carryovers for foreign expropriation losses) is amended by striking out "exceeding the loss year" and inserting in lieu thereof "succeeding the loss year".

(l) AMENDMENTS RELATING TO CERTAIN AIRCRAFT MUSEUMS.—

(1) Paragraph (2) of section 4041(h) (defining aircraft museum) is amended by striking out "term 'aircraft' means" and inserting in lieu thereof "term 'aircraft museum' means".

(2) Subsection (i) of section 4041 (as added by section 1904(a) (1) (C) of the Tax Reform Act of 1976) redesignated as subsection (j).

(3) Subsection (d) of section 6427 (relating to repayment of tax on fuels used by certain aircraft museums) is amended by striking out "Secretary or his delegate" and inserting in lieu thereof "Secretary".

(4) Paragraph (1) of section 7609(c) (defining summons to which section applies) is amended by striking out "6427(e) (2)" and inserting in lieu thereof "6427(f) (2)".

(m) INSPECTION BY COMMITTEE OF CONGRESS.—Paragraph (2) of section 6104 (a) (relating to inspection by committee of Congress) is amended by striking out "Section 6103(d)" and inserting in lieu thereof "Section 6103 (f)".

(n) AMENDMENT OF SECTION 6501.—Subsections (h), (j), and (o) of section 6501 are each amended by striking out "section 6213(b) (2)" and inserting in lieu thereof "section 6213(b) (3)".

(o) CONFORMING AMENDMENTS TO NEW DEFINITION OF TAXABLE INCOME.—

(1) Subparagraph (A) of section 443(b) (2) (relating to computation based on 12-month period) is amended—

(A) by striking out "taxable income" the second and third places it appears in clause (i) and inserting in lieu thereof "modified taxable income", and

(B) by amending clause (ii) to read as follows:

"(ii) the tax computed on the sum of the modified taxable income for the short period plus the zero bracket amount."

(2) Paragraph (1) of section 443(b) is amended by striking out "gross income for such short period (minus the deductions allowed by this chapter for the short period, but only the adjusted amount of the deductions for personal exemptions)" and inserting in lieu thereof "modified taxable income for such short period".

(3) Subsection (b) of section 443 is amended by adding at the end thereof the following new paragraph:

"(3) MODIFIED TAXABLE INCOME DEFINED.—For purposes of this subsection the term 'modified taxable income' means, with respect to any period, the gross income for such period minus the deductions allowed by this chapter for such period (but, in the case of a short period, only the adjusted amount of the deductions for personal exemptions)."

(4) The amendments made by this subsection shall apply to taxable years beginning after December 31, 1976.

(p) CONFORMING AMENDMENTS TO REPEAL OF SECTION 317 OF TRADE EXPANSION ACT OF 1962.—

(1) AMENDMENTS OF SECTION 172.—

(A) Subparagraph (A) of section 172(b)(1) (relating to years to which loss may be carried) is amended to read as follows:

"(A) Except as provided in subparagraphs (D), (E), (F), and (G), a net operating loss for any taxable year shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss."

(B) Paragraph (3) of section 172(b) (relating to special rules) is amended by striking out subparagraphs (A) and (B) and by redesignating subparagraphs (C), (D), and (E) as subparagraphs (A), (B), and (C), respectively.

(C) Subparagraph (B) of section 172(b)(3) (as redesignated by subparagraph (B)) is amended by striking out "subparagraph (C)(iii)" each place it appears and inserting in lieu thereof "subparagraph (A)(iii)".

(2) AMENDMENT OF SECTION 6501(h).—Subsection (h) of section 6501 (relating to net operating loss or capital loss carryback) is amended by striking out the last sentence.

(3) AMENDMENT OF SECTION 6511(d)(2).—The first sentence of section 6511(d)(2)(A) (relating to special period of limitation for net operating loss or capital loss carrybacks) is amended by striking out "except that—" and all that follows down through the period at the end of such sentence and inserting in lieu thereof the following: "except that with respect to an overpayment attributable to the creation of, or an increase in, a net operating loss carryback as a result of the elimination of excessive profits by a renegotiation (as defined in section 1481(a)(1)(A)), the period shall not expire before the expiration of the 12th month following the month in which the agreement or order for the elimination of such excessive profits becomes final."

(4) EFFECTIVE DATE.—The amendments made by this subsection shall apply with respect to losses sustained in taxable years ending after the date of the enactment of this Act.

(q) EFFECTIVE DATE.—Except as otherwise provided, the amendments made by this section shall take effect on October 4, 1976.

Passed the House of Representatives October 17, 1977.

Attest:

EDMUND L. HENSHAW, Jr.,
Clerk.

[S. 1954, 95th Cong., 1st sess.]

A BILL To repeal the carryover basis provisions added by the Tax Reform Act of 1976

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

REPEAL OF CARRYOVER BASIS PROVISIONS

(a) REPEAL.—Section 2005 of the Tax Reform Act of 1976 (providing for carryover basis) is hereby repealed.

(b) REVIVAL OF PRIOR LAW.—Notwithstanding section 108 of title 1 of the United States Code, the Internal Revenue Code of 1954 shall be applied as if section 2005 of the Tax Reform Act of 1976 (and the changes made by such section) had not been enacted.

(c) EFFECTIVE DATE.—The provisions of this section shall take effect on October 4, 1976, the date of the enactment of the Tax Reform Act of 1976.

[S. 2227, 95th Cong., 1st sess.]

A BILL To postpone the effective date of the carryover basis provisions of the Internal Revenue Code of 1954

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That paragraphs (1) and (2) of section

2005(f) of the Tax Reform Act of 1976 (relating to effective dates for carryover basis) are amended by striking out "1976" each place it appears and inserting in lieu thereof "1978".

[S. 2228, 95th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 to make certain changes in the estate and gift tax provisions amended or added by the Tax Reform Act of 1976

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Estate and Gift Tax Amendments Act of 1977".

SEC. 2. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed 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 1954.

SEC. 3. AMENDMENTS RELATING TO CARRYOVER BASIS FOR CERTAIN PROPERTY.

(a) CARRYOVER BASIS PROPERTY NOT TO INCLUDE PROPERTY REFLECTING ADJUSTED BASIS OF PROPERTY HELD ON DECEMBER 31, 1976.—

(1) IN GENERAL.—Section 1023(b)(2) (relating to the definition of carryover basis property) is amended—

(A) by striking out "and" at the end of subparagraph (E);

(B) by striking out the period at the end of subparagraph (F) and inserting in lieu thereof "; and"; and

(C) by adding at the end thereof the following new subparagraph:

"(G) except as provided in paragraph (4), any other property the adjusted basis of which immediately before the death of the decedent reflects the adjusted basis of any property on December 31, 1976.".

(2) IMPROVEMENTS TO PROPERTY REFLECTING AN ADJUSTED BASIS ON DECEMBER 31, 1976.—Section 1023(b) (relating to definition of carryover basis property) is amended by adding at the end thereof the following new paragraph:

"(4) SUBSTANTIAL IMPROVEMENTS.—Under regulations prescribed by the Secretary, if there is a substantial improvement of any property, such substantial improvement shall be treated as a separate property for purposes of paragraph (2)(G). Similar rules shall apply with respect to transfers to a corporation, partnership, or trust.".

(3) TECHNICAL, CLARIFYING, AND CONFORMING CHANGES.—Section 1023 (relating to carryover basis for certain property acquired from a decedent dying after December 31, 1976) is amended by striking out subsection (h).

(b) INCREASE IN MINIMUM BASES OF CARRYOVER BASIS PROPERTY.—Section 1023(d) (relating to $60,000 minimum for bases of carryover basis properties) is amended to read as follows:

"(d) MINIMUM BASES OF CARRYOVER PROPERTIES.—

"(1) IN GENERAL.—If the applicable amount determined under paragraph (2) exceeds the aggregate bases of all carryover basis property, the basis of each appreciated carryover basis property (or, under regulations prescribed by the Secretary, each class of appreciated carryover basis property) shall be increased by an amount which bears the same ratio to the amount of such excess as—

"(A) the net appreciation in value of such property (or class), bears to

"(B) the net appreciation in value of all such property.

"(2) APPLICABLE AMOUNT.—

"(A) For purposes of paragraph (1), the applicable amount shall be the amount by which $175,000 exceeds the fair market value of all property which is not treated as carryover basis property solely by reason of subsection (b)(2)(G).

"(B) In the case of a decedent dying before 1981, subparagraph (A) shall be applied—

"(i) in the case of a decedent dying during 1977, by substituting '$120,000' for '$175,000',

"(ii) in the case of a decedent dying during 1978, by substituting '$134,000' for '$175,000',

"(iii) in the case of a decedent dying during 1979, by substituting '$147,000' for '$175,000', and "(iv) in the case of a decedent dying during 1980, by substituting '$161,000' for '$175,000'.

"(3) SPECIAL RULE FOR PERSONAL OR HOUSEHOLD EFFECTS.—For purposes of paragraph (1), the basis of any property which is a personal or household effect shall be treated as not greater than the fair market value of such property.

"(4) NONRESIDENT NOT CITIZEN.—This subsection shall no apply to any carryover basis property acquired from any decedent who was (at the time of his death) a nonresident not a citizen of the United States.".

(c) ADJUSTMENT TO BASIS FOR DEATH TAXES ATTRIBUTABLE TO APPRECIATION.—

(1) SINGLE DEATH ADJUSTMENT.—

(A) Section 1023(c) (relating to increase in basis for Federal and State estate taxes attributable to appreciation) is amended to read as follows:

"(c) INCREASE IN BASIS FOR DEATH TAXES.—The basis of each appreciated carryover basis property or, under regulations prescribed by the Secretary, each class of appreciated carryover basis property (determined after any adjustment under subsection (d) which is included in the gross estate for purposes of chapter 11, in the hands of the person acquiring it from the decedent shall be increased by an amount which bears the same ration to the Federal and State estate taxes attributable to appreciation as—

"(1) the net appreciation in value of such property or class of property, bears to

"(2) the net appreciation in value of all such property.".

(B) Section 1023 (relating to carryover basis for certain property acquired from a decedent dying after December 31, 1976) is amended by striking out subsection (e) and redesignating subsections (f), (g), and (i) as subsections (e), (f), and (g), respectively.

(2) BASIS ADJUSTMENT AND DEDUCTION FROM INCOME IN RESPECT OF A DECEDENT TO BE DETERMINED AT MARGINAL RATES.—

(A) Paragraph (3) of section 1023(e) (as redesignated by section 3 (c)(1)(B)) is amended to read as follows:

"(3) FEDERAL AND STATE ESTATE TAXES ATTRIBUTABLE TO APPRECIATION.—For purposes of subsection c), the term 'Federal and State estate taxes attributable to appreciation means—

"(A) the excess of the tax imposed by section 2001 or 2101, reduced by the credits against such tax except the credit allowable under section 2011, over such tax reduced by such credits determined without including the net appreciation with respect to appreciated carryover basis property, and

"(B) If the amount of estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia exceeds the credit allowable under section 2011, an amount which bears the same ratio to such excess as—

"(i) the amount determined under subparagraph (A), bears to

"(ii) the tax imposed by section 2001 or 2101, reduced by the credits against such tax except the credit allowable under section 2011.".

(B) AMENDMENTS RELATING TO SECTION 691.—

(i) Section 691(c)(2)(A) (relating to deduction for estate tax in case of income in respect of decedent) is amended to read as follows:

"(A) The term 'estate tax' means—

"(i) the tax imposed by section 2001 or 2101, reduced by the credits against such tax, and

"(ii) any estate, inheritance, legacy, or succession taxes, for which the estate is liable, actually paid by the estate to any State or the District of Columbia.".

(ii) Section 691(c)(2)(C) is amended to read as follows:

"(C) The estate tax attributable to such net value shall be an amount equal to the excess of—

"(i) the estate tax computed without including the net appreciation with respect to appreciated carryover basis property, over

"(ii) the estate tax computed without including in the gross estate the sum of such net value and the net appreciation with respect to appreciated carryover basis property.".

(C) AMENDMENT RELATING TO SECTION 1015.—

(i) Section 1015(d)(6)(A) (relating to basis increase for gift tax paid) is amended to read as follows:

"(A) IN GENERAL.—In the case of any gift made after December 31, 1976, the increase in the basis provided by this subsection with respect to any gift tax paid under chapter 12 shall be an amount equal to the excess of the gift tax for the calendar quarter over such gift tax computed without regard to the net appreciation in value of the gift.".

(ii) Section 1015(d)(6) is amended by adding the following at the end thereof:

"(C) STATE GIFT TAX.—Under regulations prescribed by the Secretary, an adjustment to basis for any gift tax paid to a State or the District of Columbia shall be made in accordance with the principles of this paragraph.".

(3) BASIS ADJUSTMENT AT MARGINAL RATE TO BE MADE FOR ALL APPRECIATED PROPERTY.—Subsection (e) of section 1023 (as redesignated by section 3(c)(1)(B)) is amended by striking out paragraph (4) and redesignating paragraph (5) as paragraph (4).

(d) MINIMUM BASIS ADJUSTMENT TO BE MADE BEFORE DEATH TAX ADJUSTMENT.—Paragraph (2) of section 1023(e) (as redesignated by section 3(c)(1)(B)) is amended to read as follows:

"(2) NET APPRECIATION.—For purposes of subsection (d), the net appreciation in value of any property is the amount by which the fair market value of such property exceeds the adjusted basis of such property immediately before the death of the decedent. For purposes of subsection (c) such adjusted basis shall be increased by the amount of any adjustment under subsection (d).".

(e) CONFORMING AMENDMENTS.—

(1) Paragraph (1) of section 1023(e) (as redesignated by section 3(c)(1)(B)) is amended by striking out ", (d), and (e)" in the heading and text and inserting in lieu thereof "and (d)".

(2) Paragraph (4) of section 1023(f) (as redesignated by section 3(c)(1)(B)) is amended by striking out ", (d), and (e)" and inserting in lieu thereof "and (d)".

(f) OTHER AMENDMENTS RELATING TO CARRYOVER BASIS.—

(1) INFORMATION REPORTING.—Section 6039A (relating to information regarding carryover basis property) is amended by adding at the end thereof the following:

"(c) EXCEPTION.—

"(1) This section shall not apply where the gross estate at the death of the decedent is less than $175,000.

"(2) In the case of a decedent dying before 1981, paragraph (1) shall be applied—

"(A) in the case of a decedent dying during 1977, by substituting '$120,000' for '$175,000',

"(B) in the case of a decedent dying during 1978, by substituting '$134,000' for '$175,000',

"(C) in the case of a decedent dying during 1979, by substituting '$147,000' for '$175,000', and

"(D) in the case of a decedent dying during 1980, by substituting '$161,000' for '$175,000'."

(2) ARTISTS, ETC.—Subparagraph (C) of section 1221(3) (relating to definition of a capital asset) is amended by inserting "(other than under section 1023 (relating to carryover basis))" after "the basis of such property is determined".

(3) CROPS AND LIVESTOCK.—

(A) Section 1221(1) (relating to the definition of a capital asset) is amended by inserting "(other than crops or animals whose basis is determined under section 1023 (relating to carryover basis)" after "trade or business";

(B) Paragraph (3) of section 1231(b) (relating to definition of property used in the trade or business) is amended by adding the following at the end thereof: "The 24-month and 12-month holding periods under subparagraph (A) and (B) shall not apply in the case of property whose basis is determined under section 1023 (relating to carryover basis)".

(4) AUTOMATIC LONG-TERM STATUS FOR GAIN AND LOSSES ON CARRYOVER BASIS PROPERTY.—Subparagraph (A) of section 1223(1) (relating to holding period) is amended by inserting "or 1023" after "section 1014".

SEC. 4. EXCLUSION FROM GROSS ESTATE OF GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH

(a) IN GENERAL.—Section 2035 (relating to adjustments for gifts made within 3 years of decedent's death) is amended to read as follows:

"SEC. 2035. ADJUSTMENTS FOR TAX ON GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

"The amount of the gross estate (determined without regard to this section) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.".

(b) LIFE ESTATE.—Section 2036(a) (relating to transfers with retained life estate) is amended by adding at the end therof the following new sentence: "For purposes of this subsection, a decedent shall be considered to have possessed at his death a retained estate if at any time after December 31, 1976, and during the 3-year period ending on the date of decedent's death, the decedent possessed such estate.".

(c) LIFE INSURANCE.—Section 2042(2) (relating to proceeds of life insurance) is amended by adding at the end thereof the following new sentence: "For purposes of the first sentence of this paragraph, a decedent shall be considered to have possessed at this death incidents of ownership of any policy of insurance on the life of the decedent if at any time after December 31, 1976, and during the 3-year period ending on the date of the decedent's death, the decedent possessed such incidents of ownership.".

(d) CONFORMING AMENDMENT.—

(1) The table of sections for part II of subchapter A of chapter 11 is amended by striking out the item relating to section 2035 and inserting in lieu thereof the following new item:

"Sec. 2035. Adjustments for tax on gifts made within 3 years of decedent's death.".

(2) Section 1023(b)(2)(D) (relating to certain property not carryover basis property) is amended by striking out "2035, 2038," and inserting in lieu thereof "2038".

(3) Section 2041 (relating to powers of appointment) is amended—

(A) by striking out "2035" in paragraph (1)(B) and (2) of subsection (a) and inserting in lieu thereof "2036", and

(B) by striking out "2035, 2036," in subsection (a)(3) and inserting in lieu thereof "2036".

(4) Section 2043 (relating to transfers for insufficient consideration) is amended by striking out "2035" and inserting in lieu thereof "2036".

(5) Section 2044 (relating to prior interests) is amended by striking out "2034" and inserting in lieu thereof "2034 and 2036".

(6) Section 2107 (relating to expatriation to avoid tax) is amended by striking out "2035" and inserting in lieu thereof "2036".

(7) Section 2602(e) (relating to amount of tax on generation-skipping transfers) is amended by inserting ", as in effect on the day before the date of the enactment of the Estate and Gift Tax Amendments Act of 1977;" after "2035".

(8) Section 6324(e)(2) (relating to special liens for estate and gift taxes) is amended by striking out "2034" and inserting in lieu thereof "2034 and 2036".

SEC. 5. CHANGES IN MATERIAL PARTICIPATION REQUIREMENT FOR SPECIAL USE VALUATION OF CERTAIN FARM AND OTHER REAL PROPERTY.

(a) Section 2032A(b)(1) (relating to qualified real property) is amended by adding at the end thereof the following sentence: "For purposes of this paragraph, the material participation requirement of subparagraph (C)(ii) shall be deemed to be met if there was material participation by the decedent or his spouse in the operation of the farm or other business for any 20 years prior to the death of the decedent.".

(b) Section 2032A(c)(7) (relating to cessation of qualified use) is amended by adding after subparagraph (b) thereof the following new subparagraph:

"(C) for purposes of subparagraph (B)(ii) the activities of an agent or fiduciary will be deemed to be material participation by a qualified heir with respect to a year if the activities are performed for a qualified heir who is—

"(i) a person who has not attained age 21,

"(ii) a student (as defined in section 151(e)(4)),

"(iii) a person who is under a physical or mental disability that prevents him from materially participating in the operation of the farm or other business, or

"(iv) a spouse of the decedent who has attained age 62.".

SEC. 6. ALLOWANCE OF NET OPERATING AND CAPITAL LOSS CARRYOVERS TO AN ESTATE.

(a) In General.—Section 462 (relating to special rules for credits and deductions for estates and trusts) is amended by redesignating subsection (k) as (l) and by inserting after subsection (j) the following new subsection:

"(k) Unused Loss Carryovers Available to Estate.—

"(1) In General.—If, for the last taxable year of the decedent, the decedent has a net operating loss carryover under section 172 or a capital loss carryover under section 1212, then such carryover shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary, to the estate of the decedent.

"(2) Exception.—Paragraph (1) shall not apply with respect to any net operating loss carryover or capital loss carryover which was incurred with respect to any property which reflects the adjusted basis of property held on December 31, 1976, by the decedent. For purposes of this paragraph, the portion of a loss which is attributable to property which reflects the adjusted basis of property held on December 31, 1976, shall be considered to have been carried to the earliest of the decedent's taxable years to which a loss was allowable as a carryback or carryover and such portion shall be considered used before any other loss which is included in the total amount of such loss.".

(b) Conforming Amendment.—Section 57(b)(2)(B) (relating to excess itemized deductions) is amended by inserting "642(k)," after "642(f),".

SEC. 7. TREATMENT OF CERTAIN STOCK REDEMPTIONS.

(a) Maximum Redemption Under Section 303.—Section 303(a) (relating to distributions in redemption of stock to pay death taxes) is amended by adding at the end thereof the following new subsection:

"(e) Special Rules for Income Taxes on Qualified Redemptions.—

"(1) In general.—If subsection (a) applies with respect to a distribution to a shareholder, the amount of the distribution which (but for this subsection) qualifies under subsection (a) with respect to such shareholder shall be increased by an amount equal to the additional taxes imposed by this chapter for the taxable year by reason of the inclusion in the shareholder's gross income of that portion of the distribution which qualifies under subsection (a) without regard to this subsection.

"(2) Gain computed on basis of estate tax valuation.—For purposes of this subsection, the amount realized by the shareholder on the distribution qualifying under subsection (a) shall be treated as not exceeding the amount taken into account with respect to the stock for purposes of chapter 11 (determined without regard to section 2032A).

"(3) Redemptions to pay generation-skipping transfer tax.—For purposes of this subsection—

"(A) a distribution which qualifies by reason of subsection (d) shall be treated as a distribution which qualifies under section (a), and

"(B) paragraph (2) shall be applied by substituting 'chapter 13' for 'chapter 11'.".

(b) Relationship of Stock to Gross Estate.—

(1) In general.—Section 303(b)(2)(A) (relating to relationship of stock to decedent's estate) is amended to read as follows:

"(A) IN GENERAL.—Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all stock of such corporation which is included in determining the value of the decedent's gross estate is either—

"(i) more than 35 percent of the value of the gross estate of such decedent, or

"(ii) more than 50 percent of the excess of the value of the gross estate of such decedent over the sum of the amounts allocable as a deduction under section 2053 or 2054.".

(2) TECHNICAL AMENDMENT.—Section 303(b)(2)(B) is amended by striking out "50 percent requirement" and inserting in lieu thereof "35 and 50 percent requirements.".

SEC. 8. MISCELLANEOUS AMENDMENTS RELATING TO ESTATE AND GIFT TAXES.

Section 6166A(c) (relating to extension of time for payment of estate tax) is amended to read as follows:

"(c) CLOSELY HELD BUSINESS.—For purposes of this section, the term 'interest in a closely held business' has the meaning set forth in paragraph (1) of section 6166(b).".

SEC. 9. EFFECTIVE DATE.

The amendments made by this Act shall apply with respect to decedents dying after December 31, 1976.

Senator BYRD. Today, the Subcommittee on Taxation and Debt Management Generally begins hearings on H.R. 6715, the technical corrections bill of 1977.

In general, this bill sets forth amendments clarifying provisions of the tax law enacted by the 1976 Tax Reform Act. However, the bill contains provisions which will help some taxpayers and will hurt other taxpayers. It is therefore necessary for the subcommittee to give careful scrutiny to this measure.

The hearings today are limited to testimony by the Treasury Department. I think it is important for the Treasury Department and the subcommittee to have an opportunity to have a full presentation of the Treasury's views on this bill. I hope the Treasury will give us their thoughts about what they consider to be both the good and bad parts of the bill.

The Treasury's witness is Mr. Donald C. Lubick, Deputy Assistant Secretary of the Treasury for Tax Policy.

Mr. Lubick, you may proceed as you wish.

STATEMENT OF HON. DONALD C. LUBICK, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Thank you, Mr. Chairman. I am pleased to appear before the subcommittee and present the Treasury Department's views on the Technical Corrections Act of 1977. I shall also present the Treasury's views on those sections of S. 2228, introduced by you, the chairman of this subcommittee, and Senator Dole, which are not related to the carryover basis provisions enacted by the Tax Reform Act. And then, if you so choose, I would be pleased to discuss S. 2227, which you and Senator Dole have introduced, and the balance of S. 2228.

Senator BYRD. However, as I understand it, your first testimony will be in regard to the technical corrections bill?

Mr. LUBICK. Yes, Mr. Chairman. It is simply a question of accommodating to your time. If you prefer, I would be glad to come back tomorrow, but if you wish to address those matters today to expedite the Senate's business, I would be very pleased to do whatever you choose.

Senator BYRD. Thank you. I think we had first better take up the technical corrections bill and then see what the time situation is after your initial testimony.

Mr. LUBICK. The 1976 act was the product of more than 3 years of exhaustive congressional effort. Extensive hearings were held by both of the taxwriting committees of the Congress to identify problem areas and legislative solutions. Indeed, in 1976, the Senate Finance Committee held 22 days of hearings on the House bill. The final product was comprehensive. Virtually every taxpayer was affected by one or more of the act's more than 190 separate provisions.

Senator BYRD. I think it might be well, at this point, to clarify that, so far as the carryover basis provisions of the 1976 act, there were no hearings on that before the Senate Finance Committee, is that not correct?

Mr. LUBICK. That is correct.

Senator BYRD. And that matter was not considered by the Finance Committee, nor by the Senate prior to the conference report being reported back to it.

Mr. LUBICK. That is correct. It was considered by the House, and of course, you have conducted hearings on the subject and have introduced legislation which we believe makes some very substantial improvements in the law. I will address myself to that at the appropriate time.

Senator BYRD. Thank you.

Mr. LUBICK. I think the bill is a very marked improvement and has a great many things which we would adopt and recommend.

Our experience in drafting regulations to implement major tax reform legislation has shown that no matter how much time is devoted to the legislative effort, technical errors are inevitably discovered. In the past, we have had to make do with the statute as enacted.

This year, for the first time, corrective legislation has been proposed shortly after a major act. The original provisions of H.R. 6715, the Technical Corrections Act, were developed by the staff of the Joint Committee on Taxation in close cooperation with the Treasury staff. After the bill was introduced by Mr. Ullman in April, the Treasury and the joint committee staff received many comments from interested groups.

In fact, the written comments submitted to the Ways and Means Committee prior to August 1977, are contained in a committee print which is more than 400 pages long. Comments of these interested groups, including the American Bar Association, the American Institute of Certified Public Accountants and other groups in the professional tax community have, in many cases, been incorporated into the bill.

In other words, we took the technical changes which the staff and the Treasury saw as necessary and added many of the suggestions which were made by these various taxpaying groups.

In the context of the 1976 act, this corrective legislation is urgently needed. We commend the Congress for taking the important and innovative step of making technical corrections to a major tax reform bill.

In its present form, the Technical Corrections Act does not present any major new issue of tax policy and virtually all of its provisions are noncontroversial. For the most part, the bill either grants relief to taxpayers or remedies internal inconsistencies which, if left unresolved, would lead to difficulties in administration.

Although not controversial, it is nevertheless of great importance to affected individual taxpayers. Therefore, it is crucial to enact this legislation quickly so the public will recognize that both the Congress and the Treasury are vitally concerned that the Tax Code operate fairly and are responsive to the need to correct the imposition of undue burdens on taxpayers.

Senator BYRD. Maybe I had best interrupt you at that point.

As you know, next week may very well be the last week of this session so far as legislation is concerned, other than energy conference reports. Now, frankly I have some doubt as whether it is going to be possible to handle this proposal in this short period of time.

We will attempt to do that.

Are there certain parts of the technical corrections bill that are more important than other parts that could be, if necessary, singled out, or do you feel that the entire piece of legislation needs to be handled?

Mr. LUBICK. I think that the entire piece of legislation needs to be handled, Mr. Chairman. Basically, we are dealing with a collection of disparate elements, items that will affect individual taxpayers or groups of taxpayers one by one. It is not an overall coherent package that deals with a single theme. Therefore, if you gave relief and clarity to one group of taxpayers you would be leaving out another group, and I think——

Senator BYRD. What you are saying, then, is that it really needs to be tackled—either all or none?

Mr. LUBICK. I believe so, Mr. Chairman. I think that is really the only sensible way to do it. I do not know how one could pick one group over another.

Senator BYRD. Thank you.

Mr. LUBICK. I do not believe the bill is controversial, however. I think the House handled it very expeditiously. So long as we do not get into complex and complicated policy issues, then I would hope that the Senate could also address the bill expeditiously.

If it cannot, we would expect that the corrective changes would be made retroactive to January 1, 1977, or whatever the appropriate date is. But there will be a period of lingering uncertainty for practitioners and taxpayers during which they will not know what the outcome will be. I would suggest that because of the noncontroversial nature of these amendments and the fact that they are almost entirely accepted by the tax community, by the Treasury, by the staff of the Joint Committee on Taxation, it might very well be appropriate for the Senate to move expeditiously.

In that regard, we strongly believe that the scope of the bill should be limited to essential technical clarification of the underlying policy decisions embodied in the 1976 act. In our judgment, this criterion was satisfied when the bill was passed by the House of Representatives. It is for that reason, and for the reason to which you allude, the necessity to make these changes quickly and noncontroversially, that we urge the committee to continue to do what the House did—to maintain the essential line of demarcation between necessary technical correction and legislation which requires substantial policy debate.

H.R. 6715 should not become the vehicle to reopen debate on the carefully considered policies which underlie the 1976 act. If that happens, we fear that the bill will fail in its purpose of making sorely needed technical corrections, and the burden of that failure will not be so much upon us as upon deserving taxpayers.

At present, H.R. 6715 contains 98 separate technical amendments. To illustrate the importance of this legislation I would like to review with you several of these amendments and the reasons for them. I have tried to pick examples which are illustrative of the types of problems the bill addresses. I have not necessarily picked ones which vastly exceed in importance others, but I wanted to give you some feel for the type of legislation that this is.

Let me give one illustration.

The Tax Reform Act amended the mutual fund provisions of the Internal Revenue Code to permit mutual funds to invest in municipal bonds and to pass through to the shareholders of the mutual funds the tax-exempt nature of the interest received by the mutual fund.

Under the existing provisions of the Internal Revenue Code, for a mutual fund to qualify for this paragraph to shareholders, it must meet certain percentage tests which are based upon gross income. There are 90 and 30 percent of gross income limitations under Code section 851.

Now, in the absence of any special provision, tax-exempt interest is not included in gross income. If we do not include the tax-exempt interest in gross income for purposes of computing these percentage tests only, and not for purposes of taxation, the mutual fund fails to qualify as a mutual fund, and it cannot do the very thing which the Congress intended, which was to invest in tax-exempt interest and pass it on, tax exempt, to the shareholders.

Section 2(r) of the bill simply makes the technical change to solve the problem and to carry out the intention of the Congress that the tax-exempt nature of receipt of interest on tax-exempt bonds be passed through to shareholders.

An example of concern to small business involves the definition of permissible shareholders of subchapter S corporations; corporations that do not, themselves, pay a tax, but as to which the taxable income of the corporation is taxed to the shareholders at the shareholder level.

Before the Tax Reform Act, a trustee of a trust could not be a shareholder of a subchapter S corporation. The only persons who were permitted to be shareholders of subchapter S corporations were individuals or an estate of a deceased individual.

If shares were placed in a trust, the corporation automatically lost its subchapter S status and became subject to the regular corporate tax.

As I indicated, estates could be shareholders.

The Tax Reform Act expanded the category of permissible shareholders of subchapter S corporations to include grantor trusts during the lifetime of the grantor. A grantor trust is one where the grantor has such close connection with the trust that the trust is disregarded. The grantor is treated directly as the owner, as an individual. There was no particular reason why a formal trust, if disregarded for tax purposes, should not be permitted to be a shareholder of a subchapter S corporation.

The Tax Reform Act also provided that a trust funded under the terms of a will or other testament entry disposition would be an eligible shareholder for 60 days after funding. That was to cover the situation where an estate which had been a shareholder funded the trust under the will and then, automatically, by virtue of that act, subchapter S status would be destroyed. The Tax Reform Act gave people 60 days to arrange their affairs to avoid this result.

Senator BYRD. Let me ask you this. Why should not any trust of a limited number of people be eligible for subchapter S?

Mr. LUBICK. One of the problems is that which you have mentioned, the number of shareholders. There are limits on the number of shareholders of subchapter S corporations. If you have a trust with multiple beneficiaries, you could go over the limit and you could get into some difficulties. But I think you have a point—and, as a matter of fact, in connection with our tax reform studies, we have been looking into the question whether we can expand the eligibility of trusts in appropriate situations where the trust income is taxed currently to certain beneficiaries.

Now, in the Technical Corrections Act we are trying to limit eligibility to the policy areas where the Tax Reform Act made a change. I think what you suggest might very well be appropriate. We are studying it, and I hope we would have some recommendations on broadening the applicability of subchapter S to trust shareholders at a future time.

Senator BYRD. So long as it does not exceed the present number of eligible shareholders which is 10, or perhaps more?

Mr. LUBICK. We are up to a larger number now. It can be as many as 15 and, indeed, in reviewing all of the subchapter S provisions we may even suggest a further expansion. There are also differences in the kinds of trusts. One would have to distinguish the trust which accumulates income without passing it on to the individual beneficiaries; we may have to have a different rule for that type of trust. It is those complications that we are trying to work with. But in the Tax Reform Act, we are dealing with the simplest situations, those situations where there was a grantor trust and the trust was disregarded. It was as if there were no trust. We are dealing also with a provision for testamentary distributions to trusts.

The Tax Reform Act created an anomalous situation. On the one hand, subchapter S status terminated on the death of a grantor who, for nontax reasons, had chosen to fund a grantor trust with subchapter S stock during his lifetime. Under the act, if a grantor trust owned subchapter S stock and the grantor died, ipso facto, on that date, the corporation ceased to be a subchapter S corporation because the trust is not an eligible subchapter S shareholder.

On the other hand, if a decedent retained ownership in his own name, for tax purposes he is in the same position as the grantor of a grantor trust who is treated as the owner. Nonetheless, if he retained the stock in his own name until death, he is entitled to have the stock go into his estate, and during the period of estate administration, subchapter S status continues. In addition, such a grantor is permitted to have a trust own the shares for 60 days after distribution from the estate.

The practical result of this is to preclude many taxpayers who have subchapter S corporations from using a revocable trust, which is a very common estate planning tool. A decedent, for reasons that have nothing to do with taxes, but for management of his affairs, may put his assets into a trust which is revocable. He has the right to take it back. He is treated as the owner.

The revocable trust is also frequently used as a substitute for a will to avoid various probate difficulties. But owners of subchapter S stock will not fund lifetime revocable trusts with that stock because upon death, instantly the subchapter S status of the corporation ends.

Here, again, the Technical Corrections Act, in section 2(Y) remedies this problem. A funded intervivos grantor trust will remain an eligible shareholder of a subchapter S corporation for 2 years after the grantor's death if the entire corpus of the trust is included in the grantor's estate. Thus, the amendment results in rough parity between funded intervivos trusts—usually the revocable intervivos trust—and those that are funded under a will by testamentary direction.

The 2-year period approximates a reasonable period of estate administration and produces substantial equality with the timing opportunities presented by delayed testamentary funding.

By limiting the application of the section to trusts included in the grantor's gross estate, the bill assures that the opportunity to remain an eligible shareholder is available only in those instances where there can be no income or estate tax abuse.

Another important clarifying change made by the bill relates to the partnership-at-risk rule. Under the Tax Reform Act, there is an exception for the at-risk rule for any partnership, the principal activity of which is investing in real property. Many comments have been received indicating that the terms "principal activity" and "investing" are ambiguous.

Section 2(J) of the bill clarifies the scope of the real estate exception from the at-risk rules. The amendment makes it clear that both active and passive real estate activities are exempt. It also requires substantially all of a partnership's activities to involve investing in real property for the exception to apply. We do not want the exception to apply where there is a combination of shelter activities, a small amount of real property activity and a substantial amount of those activities to which the at-risk rule was to apply.

Section 2(b) of the bill provides a needed exception from the excess itemized tax preference item for wholly charitable trusts and charitable income trusts which were created prior to January 1, 1976. Under the Tax Reform Act, even where all of the income of a trust was distributed to charity, the trust would nonetheless be liable for payment of the minimum tax on tax preferences. The only charitable trusts that should be subject to the minimum tax preference base are those were the grantor or the noncharitable beneficiary can use the trust as a device to avoid the limitation on excess itemized deductions.

If everything is going to charity, you cannot have that result.

Therefore, we suggest that the provision of the Technical Corrections Act which eliminates the charitable contribution deduction as an itemized deduction in the computation of the excess itemized deduction tax preference item for trusts which are wholly charitable, is appropriate.

The bill contains a series of amendments to section 644 of the code, added by the Tax Reform Act. That section provides that where certain property is sold or exchanged within 2 years of its transfer to a trust, a tax is imposed on the trust in an amount not less than the amount which would have been paid by the transferor—the person who transferred the property to the trust—if the transferor had sold the property.

The special tax is imposed upon includable gain, which is defined as gain realized by the trust on a sale or exchange. Now, the problem is that section 644 imposes tax on a realized gain in a transaction where other code sections would make it nontaxable. In other words, if a trust which received the property entered into a tax-free exchange—and we know of a case where that has happened—where there would be no tax payable if the grantor himself had entered into the transaction, nevertheless, under the present law the trust would have to pay tax. There has been an exchange, and under technical Code concepts, the gain has been realized.

The problem is the use of the words "realized gain" rather than "recognized gain." The legislative history of section 644 indicates that only recognized gain was intended to be subject to tax. Section 2(n) of the bill corrects this oversight.

Now, we have described in my statement—and I would ask that it be included in the record in full, and I will try and summarize some of this material for you——

Senator BYRD. Give me a clarification, if you will, between "recognized gain" and "realized gain."

Mr. LUBICK. Yes, all right.

Supposing you are a shareholder of A Corp. A Corp. decides to enter into a merger with B Corp. and you turn in your A Corp. stock and you receive back B Corp. stock. Now, that is a realized gain because you have exchanged A stock for B stock and therefore, under the Code section, you have something new, you have something different. Therefore, you have realized your profit in the A stock.

But the Internal Revenue Code in the reorganization provisions says essentially what has happened is simply the putting together of a couple of businesses and you are not in a position where you should pay tax because essentially you are continuing in business in a different form. Even though technically you have shares of a new corporation, which means that there is a realization—you have disposed of your A shares—the code says, we will not recognize it. We will not require you to pay tax on that particular realization, but we will wait until you sell your new, B shares.

Senator BYRD. Well, that is the existing law now, is it not?

Mr. LUBICK. That is the existing law now, but through oversight, it was not included in section 644 which imposed a tax on the trust in a realized situation. What it should have said is we will not impose tax unless it is a recognized gain situation. It is purely a drafting error. These are the sorts of things the Technical Corrections Act is trying to cover.

We know of a situation where taxpayers were placed in this situation. The property was in the trust, the corporation entered into a reorganization and the trustee had no choice. He was a minority stockholder. He had to go along with the merger and received the new shares. We would be imposing a tax, but it is not really appropriate to do it. The trustee had no control over that situation.

At the same time, we are trying to correct the operation of section 644 to make sure that we do not have double counting of benefits. The tax to the trust under section 644 is calculated by reference to the transferor's taxable income, so we get some difficult problems about carryovers and carrybacks. We want to make sure that these tax attributes are not counted twice, that the tax attribute does not benefit both the transferor and the trust. Section 2(n) of the bill takes care of that problem, too.

Section 3 of the bill contains 35 amendments to the estate and gift tax provisions of the Tax Reform Act. Those are the provisions which, Senator Byrd, you recognized did not have a hearing in the Finance Committee. Perhaps some of these changes might have been made had you had that opportunity.

Now, these corrections are somewhat more substantial than those made to the income tax provisions of the 1976 act, but nevertheless, they do not do any more than implement the policy decision underlying the section being amended.

For example, one major source of concern after the 1976 act was whether a redemption of certain preferred stock by a corporation, known as section 306 stock, to raise funds to pay death taxes would be taxed at capital gain rates. Section 306 stock is stock that is normally issued as a dividend or a dividend equivalent. Section 306 was enacted to prevent a shareholder from bailing out corporate earnings by selling his preferred stock and then having the purchaser turn around and redeem the stock.

The amount realized on a disposition of section 306 stock is generally treated as ordinary income. The question is whether a redemption of this section 306 stock meets the requirements of section 303 of the code. Now, section 303 of the code permits a shareholder whose estate consists largely of stock of a closely held corporation, to turn in enough of that stock to pay his death taxes and expenses of administration. It was designed to meet the liquidity problems which might arise for estates that were very heavily invested in closely held corporations and would have some difficulty raising funds from sources other than the corporations.

If the estate turned in only some of its stock, it could run into a very difficult, ordinary income tax, because the redemption would have been treated as a dividend. Section 303 taxes the gain at capital gains rates.

Under the 1976 act there was a question whether the section 306, this tainted preferred stock, would be eligible for the capital gains treatment afforded by section 303. If it was not, the amount would be taxed as ordinary income.

Section 3(a)(2) of the bill provides that a redemption of section 306 stock will be granted capital gains treatment to the extent the redemption meets the requirements of section 303. Thus, section 303, the purpose of which is to relieve the liquidity problems in estates holding large blocks of corporate stocks is made available on a nondiscriminatory basis to holders of both common and preferred stock.

H.R. 6715 also makes an important clarification with regard to the amount of income that will be recognized when carryover basis section 306 stock issued before December 31, 1976, is sold or redeemed. It provides that the section 306 stock is entitled to the fresh start basis which, in effect, puts it in the position it would have been under prior law. I will not spend a lot of time on the details, but we thought this was a problem that ought to be recognized. The tax treatment of persons holding that stock ought not to be changed retroactively by the carryover basis provisions.

Another important amendment to the estate and gift tax provisions relates to the holding period of assets acquired from a decedent. The 1976 act failed to grant automatic long-term capital gains holding period status to these assets. In 1978, when the holding period becomes 1 year, this omission could have an adverse effect on the use of so-called flower bonds to pay estate taxes.

In every case in which a decedent acquired flower bonds to pay his estate taxes within 3 months of death, the gain recognized upon the redemption of the bonds to pay estate taxes would be taxed to the estate as ordinary income rather than as capital gains.

Section 3(c)(4) alleviates this problem by providing an automatic, long-term capital gains holding period for property acquired from a decedent.

I could go on and illustrate many more examples of the important and necessary corrections made by the bill, but I am going to spare you the burden of that monolog. But I think you can see, from these few examples, that the Technical Corrections Act is an important piece of legislation.

As I stated earlier, in its present form the bill does not present any major new issues of tax policy. Virtually all of its provisions are noncontroversial. We hope that this will remain the case.

There are, however, other items which we think should be added to the act. In our testimony before the Ways and Means Committee, we submitted 30 detailed recommendations with respect to the act, almost all of which have the concurrence of the joint committee staff.

Not all of our recommendations were incorporated in H.R. 6715 by the House because of the press of time. The remaining recommendations, together with several new ones which we have discovered since our testimony before the Ways and Means Committee, are set forth in detail in the appendix to my statement.

Senator BYRD. Let me get this clear. You have 30 additional recommendations?

Mr. LUBICK. We are down to 19 now, Mr. Chairman. If you will permit me, I will tell you the categories that they relate to. I will give you a general description. Then I will be very pleased to answer any questions you may have with respect to any specific changes.

These recommendations fall into two basic categories. The first are those which relate to the provisions of H.R. 6715, as passed by the House.

Senator BYRD. Now, excuse me, these are over and beyond what has been done by the House and are not in the bill?

Mr. LUBICK. Yes, sir, and in some cases, we recommend a change, a perfecting change.

For example, we have recommended, as an amendment to section 2035 relating to the estate tax includibility of gifts made within 3 years of the date of the decedent's death, a change which is similar to section 4 of S. 2228 introduced by you and Senator Dole. We would make a minor change in that. We would include in the transferor's gross estate reversionary interests relinquished within 3 years of the transferor's date of death, but basically we have been recommending exactly the provision you have included in your bill.

In addition, for purposes of proposals for increasing the minimum basis adjustment for carryover basis property, which you have suggested in your bill and which we will talk about either tomorrow or later, if we have the time, the maximum amount allowable as a minimum basis should be reduced by the amount of cash and the basis of any other property transferred within 3 years of death. This is necessary to prevent the transfer of cash and high-basis property to manipulate the minimum basis adjustment which you are proposing.

Furthermore, for purposes of special relief sections, 303—that was the redemption for death taxes; 2032A which is special use valuation; 6166 and 6166A which determine when a taxpayer's estate is eligible for special installment payment relief—for these purposes only, the percentage qualification requirements should be calculated by including in the gross estate the gift tax value of any property transferred within 3 years of death.

We would not include this property in the estate, but in determining eligibility for the special relief provision, it should be brought in, in order, again, to prevent manipulative transfers to secure the benefits of those sections.

Now, our second category of recommendations, aside from those which relate to H.R. 6715, relates to remedies for technical defects beyond those included in the version passed by the House.

Again, these recommendations are confined to proposals which implement the expressed intent of Congress. For the most part, they clarify ambiguities or give relief to taxpayers from unintended hardships.

For example, the purpose of section 1040, added by the Tax Reform Act of 1976, was to retain the prior law income tax consequences of funding pecuniary bequests with appreciated property. Under prior law recognized gain was limited to the difference between date of distribution and estate tax values. If you paid off a money bequest with appreciated property, you were only taxed on the appreciation which arose after death.

The Tax Reform Act did not coordinate the recapture provisions of section 1245 and section 1250 with section 1040. As a result, the recapture rules, which generally provide that on a sale or exchange income is recaptured to the extent of the difference between the amount realized and the adjusted basis, presently override section 1040 and could therefore cause the taxpayer to have to recognize ordinary income in an amount in excess of the income recognized under section 1040.

Therefore, we recommend that the recapture sections be amended to make clear that recapture is limited by the amount of gain that would be recognized under 1040 where appreciated carryover basis property is used to satisfy a pecuniary bequest rather than trying to get all of the tax on the recapture at that time.

We urge the subcommittee to accept our recommendations. Statutory language necessary to effect them has been drafted. We have reviewed them all with the joint committee staff. Their adoption will not, therefore, delay the passage of this important legislation.

We are also aware that additional technical corrections may be necessary.

Section 8 of your bill, S. 2228, which conforms the definition of interest in a closely held business for purposes of both the estate tax installment payment provisions—that is, section 6166 and 6166A—is a good example of this. We support that section of the bill. It is a technical correction which will result in significant simplification.

We also do not oppose section 5 of the bill which will amend the special use estate tax valuation provision by relaxing the material participation requirements in farm situations for eligibility and continued qualification under certain limited circumstances.

However, I did not want you to think that we were going to surprise you by approving everything that you introduced, Senator Byrd. We have found one or two things to oppose.

Senator BYRD. I was under no illusions.

Mr. LUBICK. We thought you might worry that you had done something wrong if we approved everything you introduced.

We are opposed to section 7 of S. 2228 which extends capital gains treatment to a redemption to pay the income tax resulting from a qualified section 303 redemption. It is a substantive change which raises the fundamental policy question of the extent to which section 303 should be available to permit the bailout of corporate earnings and profits at capital gains rate. Debate over the Technical Corrections Act is not the appropriate time to raise this issue. Indeed, when this argument was raised, the Ways and Means Committee dropped it.

Moreover, on the merits, the purpose of code section 303 was to permit a limited bailout of earnings which would normally be taxed as a dividend to the extent of death taxes and funeral expenses. As a practical matter, we believe this is sufficient relief. In my experience, which has been to a great extent in the field of planning estates in private practice since 1949, and in talking with other practitioners where experience covers the entire span that section 303 has been in the code, we have found that section 303 is used primarily as a one-time opportunity to bail out corporate earnings and property without regard to liquidity needs. If an estate still has a liquidity problem after a section 303 redemption, it can use the generous installment and postponement of payment provisions placed in the law last year. Thus, we believe the extension of section 303 is unnecessary and unwarranted.

For the same reasons, we oppose a return to the percentage qualification requirements of prior law as proposed by section 7(b) of S. 2228.

I also have comments to make on S. 2227 and sections 3 and 6 of S. 2228. I can either make them tomorrow or at such time as you wish to hear them, and we will indicate to you that the Treasury Department is largely in accord with the major thrust of S. 2228.

But I would like to conclude on the Technical Corrections Act by saying that the Treasury Department strongly supports the concept of technical correction. We urge expeditious, favorable action on H.R. 6715. At the same time, I want to repeat the Treasury's view that it is vital to the integrity of the technical corrections process that this bill not be the mechanism to review the underlying policy provisions contained in the 1976 act. Otherwise, the technical corrections, which are so urgently needed, will not be achieved.

I will be very pleased to answer questions or to go on to talk about the two bills that you have introduced.

Senator BYRD. First, let me ask you what is the revenue effect of H.R. 6715?

Mr. LUBICK. The net revenue effect for fiscal 1978 is a decrease in revenue of $17 million. Thereafter, the continuing effect declines—1979 through 1982 at $7 million or $8 million each year.

Senator BYRD. There is no significant revenue effect?

Mr. LUBICK. It is not significant; that is right. These are technical corrections.

Senator BYRD. I feel that tax matters, not just the technical corrections bill, but tax legislation in general is so technical and so complex that those of us who do not deal with it full time everyday need to rely very heavily on experts like yourself.

Mr. LUBICK. We have worked very carefully with the staff of the Joint Committee on Taxation and I believe we all agree that these are technical amendments which are needed to implement decisions you made last year, the broad policy decisions. We recognize that they are very complex. In many cases they are almost incomprehensible and it is very hard to remember them for 2 days. You can study them and you can know them at the time—and I must say, from the time the bill was in the House I had forgotten what most of them were and I have had to rebrief myself.

So I can understand your reaction. But both the staff and we have been very careful to screen these. We have had a lot of cooperation from the various bar associations, accounting groups and so on, and I think everybody has been approaching this bill in the spirit of trying to polish last year's bill simply to make it work and to relieve unintended hardships. I think the government has a responsibility to do that and not to leave people hanging out there with uncertainties and inadequacies of draftsmanship.

Senator BYRD. I think so. I think it is very important in these tax matters that we be fair, not only to the Treasury—and I think it is very important to be fair to the Treasury, and the total population—but also be fair to the individual taxpayers.

Mr. LUBICK. We have tried to do that. Most of the provisions we have recommended would give relief to taxpayers and are appropriate in carrying out the policy decisions.

Senator BYRD. Who initiated this technical corrections bill?

Mr. LUBICK. Well, I believe the chairman of the Ways and Means Committee thought it was appropriate to do it and he directed the staff of the joint committee to prepare the language necessary and to screen the act to see what changes should be made.

Senator BYRD. What role did Treasury play in proposing legislation?

Mr. LUBICK. Well, the Treasury had shared the objective of the chairman of the Ways and Means Committee and of the staff. We were trying to perfect the statute. We were doing many of the things that we would have done in 1976 when we were drafting the statute had we known them then. Our staff worked very closely with the staff of the joint committee. We have a very good relationship. One might even say we have an interlocking directorate, now that Dr. Woodworth is there, and therefore, we both worked it over and we have been working on all of these matters. I want to say that the work of the staff of the joint committee has been invaluable. They have done an outstanding job in going through the act and dealing with these very technical and complicated problems. I know that we could not have carried that load ourselves. There was a job that had to be done for the taxpayers and I think it is such an outstanding job that is important if for no other reason than to preserve the work they have done to get this bill through.

Senator BYRD. I understand that the bill contains certain provisions which apply retroactively. Could you point out the major retroactive provisions in the bill?

Mr. LUBICK. You do not mean the Tax Reform Act; you mean H.R. 6715?

Senator BYRD. Yes; H.R. 6715.

Mr. LUBICK. Well, I would say, Mr. Chairman, that almost every one of these provisions is retroactive because we are trying to—

Senator BYRD. It is designed to correct problems which occurred in connection with the 1976 Tax Reform Act.

Mr. LUBICK. It is designed to correct, and if we do not go back and correct, then we have left taxpayers stranded high and dry. I cannot think of anything offhand that is not retroactive. The whole purpose of the bill is to go back and correct, and there may be some, but offhand, I cannot think of them.

Senator BYRD. The very nature of the bill is one of retroactive effect.

Mr. LUBICK. That is right. If it were not retroactive it would not serve its purpose.

Senator BYRD. Yes.

So as we might get some indication as to what the hearing on Friday might bring forth, are there persons in the hearing room today who would wish to oppose any sections of the technical corrections bill?

[No response.]

Senator BYRD. I see no opposition this morning.

Mr. LUBICK. Well, I think, in part that is a tribute to the work of the staff and the fine job that it has done in ferretting out these problems which, as I indicated, are noncontroversial and essentially technical.

Mr. Chairman, we have found a nonretroactive provision in the bill and it was one where——

Senator BYRD. That was just by mistake?

Mr. LUBICK. We found one where we were tightening up and we did not want to make that retroactive because some taxpayer might have relied on the more liberal provision. So we have found one, but again, it is for the taxpayer's benefit.

Senator BYRD. Thank you.

Thank you very much. I think it might be best to adhere to the original schedule with regard to S. 2227 and S. 2228.

Mr. LUBICK. Well, that would enable us to prepare a written statement. If I had to talk to you about that today, it would have been ex tempore.

Senator BYRD. Senator Dole would like to be here when it is taken up and he is unable to be here today.

Mr. LUBICK. Well, I think it is important because, as I gave you a preview, we think that you have done a very fine job in this bill. We do have some suggested changes to make in a few sections and I think perhaps that some of the changes we suggest you will readily agree are appropriate because they are technical changes. We are very sympathetic, for example, with your concept of a liberalized minimum basis which will, in effect, take out of the system 98 percent of those who would otherwise be involved, and we think that is very desirable. We also think your idea of using marginal tax rates for the basis adjustment rather than average tax rates is fair. We have gone through it and we think it is the right result. Therefore, we are going to talk to that as well, and we have, perhaps, an additional proposal to make which we think will help the taxpayers make the system work better.

So we will be very pleased to see you tomorrow morning, again at 9 o'clock, to——

Senator BYRD. Very good.

Just one final question on H.R. 6715. I assume that you, Treasury, approve of the legislation as approved by the House? But you would like to see added to it 19 amendments, is that it?

Mr. LUBICK. Yes; the 19 amendments are stated in our appendix. I believe that there are several that make changes in the bill as passed, but they are not major changes.

Senator BYRD. But basically, you favor the House version?

Mr. LUBICK. Basically we favor the House bill. There are several changes we would like to make in it and then there are some additional changes.

I can give you an illustration of one of those that just came to our attention. In the 1976 act, Congress enacted a special provision that dealt with the withholding tax liability of certain fishermen. It appears that there were certain fishermen off the coast of Massachusetts and some lobster fishermen off the coast of Maine who were the owners of small boats. They would have one or two crewmembers who would go out on their boats with them and share in the catch. Instead of being paid money they would get maybe 10 or 15 percent of the lobsters or fish and, in point of fact, these crewmembers also bore the expenses, so if the catch were unprofitable, they would have a loss.

The Internal Revenue Service took the position, starting in 1972, that these crewmembers were really employees of the owners of the boats and was trying to collect employment taxes and withholding taxes in very large amounts from the owners of the vessels. The Internal Revenue Service had put liens on the boats and on the property of the boatowners. Congress passed legislation to deal with this problem which said that for services performed after December 31, 1971, these persons, these crewmembers, would be treated as self-employed persons so that the vessel owners would not be subject to this tax.

We thought that had taken care of the problem. Then, 2 days ago, it came to my attention that there were other cases where the Service was attempting to collect back tax liability that dealt with 1971 services. Congress had intended to deal with all of these back cases, but it specified services after December 31, 1971, so when we got the call we instantly added to our appendix our 19th amendment which proposes to go back and clean up that job.

These are the sorts of things that——

Senator BYRD. Would not the statute of limitations take care of that?

Mr. LUBICK. No; because the Service had levied their assessment before the statute ran and the case had just been in process. Most of the cases the statute of limitations would take care of, but we found four cases where the assessment had been levied and avoided the statute of limitations. We know that you had intended—this was actually an amendment of Senator Hathaway—he had intended that this be taken care of. Therefore we think that it is appropriate to make a very little change; if you change 1971 to—change two numbers, to 1954, you will make sure, unless there are some cases that are lying around some 20 years, that the problem is solved.

Senator BYRD. Just one final question. There are certain provisions in the bill which are of benefit to specific taxpayers. Could you explain these provisions?

Mr. LUBICK. Yes; there are a number of them, particularly in the foreign area. These are generally provisions that deal with effective dates where perhaps the decision of the conferees was not correctly drafted. Let me give you an illustration of one of them that you referred to that benefits General Electric Co., but it does more—we happen to know that it benefits General Electric Co., but I think the matter is correct as a question of principle.

Senator BYRD. And the Treasury Department approves it?

Mr. LUBICK. Yes; we do. This is simply a question of the source rule. The Tax Reform Act put in a provision that in the case of sales or exchanges of personal property outside the United States those sales would be regarded as U.S. source income rather than foreign source income. The purpose was to prevent persons from taking their property and selling it outside of the United States and therefore having the benefits of it being foreign source income.

Well, the General Electric situation happened to be one where they liquidated a foreign subsidiary. The liquidation of a foreign subsidiary is treated as a sale or exchange of personal property. If General Electric had distributed the earnings of that foreign subsidiary as a dividend, that clearly would have been foreign source income because most of the income of that corporation was foreign source income. Therefore there is no reason why the liquidation of a subsidiary, most of whose earnings were effectively connected with a business outside the United States, should be caught up in this particular rule.

There are a number of situations like that where we have dealt with specific taxpayers. In each case there may be other taxpayers involved as well, but the ones that we know about came to us and said we have this problem and it was an unfair application of the law. Therefore we went along with the proposals to make the change.

Senator BYRD. You might, for the record, not today, identify what taxpayers are—where you can identify them—are affected by the legislation.

Mr. LUBICK. We will be very pleased to send you a letter to that effect.

Senator BYRD. Thank you very much, gentlemen.

[The letter referred to above and the prepared statement of Mr. Lubick follows:]

DEPARTMENT OF THE TREASURY,
DEPUTY ASSISTANT SECRETARY,
Washington, D.C., November 15, 1977.

HON. HARRY F. BYRD, JR.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD. This letter is in response to your October 26, 1977 request that the Treasury Department identify for the record of the hearings held by the Subcommittee on Taxation and Debt Management, Committee on Finance, on H.R. 6715, the "Technical Corrections Act of 1977" specific taxpayers affected by provisions of the bill.

We have limited our response to those provisions of H.R. 6715 which are restricted in scope and, therefore, may reasonably be expected to affect only a small number of taxpayers. We have identified those taxpayers we know will be affected. However, these provisions may also affect others.

We have not listed specific taxpayers who we know will be affected by provisions of general applicability. In most cases, we became aware of these taxpayers because either they or their representatives contacted us or the Staff of the Joint Committee on Taxation to point out a problem for which technical correction was appropriate or to comment upon specific provisions of H.R. 6715. We do not think you intended to encompass these situations in your request.

The following is a list of the sections of H.R. 6715 which affect the specific taxpayers listed opposite the section number:

Bill section:	*Taxpayer*
2(t)(7)(B)	Pittsburgh Plate Glass
2(t)(2)(C)	General Electric
2(t)(9)	Reading & Bates Co.
	Tidewater Marine
2(t)(12)(A)	Evra Corp.

We note that section 2(t)(2)(C) is a provision which in all probability will apply to taxpayers other than General Electric.

We will be pleased to submit whatever further information you may desire.

Sincerely yours,

DONALD C. LUBICK.

STATEMENT OF DONALD C. LUBICK, DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY

Mr. Chairman and members of the subcommittee: I am pleased to have this opportunity to appear before the subcommittee and present the Treasury Department's views on H.R. 6715, the "Technical Corrections Act of 1977" which makes clarifying and conforming amendments to the Tax Reform Act of 1976 (Public Law 94-455). I shall also present the Treasury Department's views on those sections of S. 2228, introduced by the Chairman of this Subcommittee and Senator Dole, which are not related to the carryover basis provisions enacted by the Tax Reform Act.

The 1976 act was the product of more than three years of exhaustive congressional effort. Extensive hearings were held by both tax writing committees to identify problem areas and legislative solutions. Indeed, in 1976 the Finance Committee held 22 days of hearings on the House bill. The final product was comprehensive. Virtually every taxpayer was affected by one or more of the Act's more than 190 separate provisions.

Our experience in drafting regulations to implement major tax reform legislation has shown that no matter how much time is devoted to the legislative effort, technical errors are inevitably discovered. In the past, we have had to make do with the statute as enacted. This year, for the first time, corrective legislation has been proposed shortly after a major Act. The original provisions of H.R. 6715 were developed by the Staff of the Joint Committee on Taxation in close cooperation with the Treasury staff. After the bill was introduced by Mr. Ullman in April, the Treasury and the Joint Committee staff received many comments from interest groups. In fact, the written comments submitted to the Ways and Means Committee prior to August 1977 are contained in a committee print which is more than 400 pages long. Comments of these interested groups, including the American Bar Asociation, the American Institute of Certified Public Accountants and other groups in the profesional tax community have in many cases been incorporated into the bill.

In the context of the 1976 act, this corrective legislation is urgently needed and we commend the Congress for taking this important and innovative step. In its present form, the Technical Corrections Act does not present any major new issues of tax policy and virtually all of its provisions are noncontroversial. For the most part, the bill either grants relief to taxpayers or remedies internal inconsistencies which, if left unresolved, would lead to difficulties in administration. Although not controversial, it is of great importance to affected individual taxpayers. Therefore, it is crucial to enact this legislation quickly so the public will recognize that both the Congress and the Treasury are vitally concerned that the tax Code operate fairly and not impose undue burdens on taxpayers.

At the same time, we strongly believe that the scope of the bill should be limited to essential technical clarification of the underlying policy decisions embodied in the 1976 act. In our judgment, this criterion is satisfied by the bill as passed by the House of Representatives. We urge this Committee to continue to maintain the essential line of demarcation between necessary technical correction and legislation which requires substantial policy debate. H.R. 6715 should not become the vehicle to reopen debate on the carefully considered policies which underlie the 1976 act. If that happens, we fear that the bill will fail in its purpose of making sorely needed technical corrections and the burden of that failure will not be so much upon us as upon deserving taxpayers.

At present, H.R. 6715 contains 98 separate technical amendments. To illustrate the importance of this legislation. I would like to review with you several of these amendments and the reasons for them.

The Tax Reform Act amended the mutual fund provisions to permit those funds to invest in municipal bonds and to pass through tax exempt interest to their shareholders. However, the legislation failed to amend the 90 and 30 percent of gross income limitations of Code section 851 to include the tax exempt interest in gross income for the purposes of those tests. If tax exempt interest is not treated as gross income, mutual funds which invest in tax exempt securities will be disqualified from mutual fund status simply as a result of engaging in the specific activity Congress intended to permit. Section 2(r) of the bill amends the code to solve this problem.

An example of concern to small business involves the definition of permissible shareholders of subchapter S corporations. Before the Tax Reform Act a trustee could not be a shareholder of a subchapter S corporation. If shares were placed in trust a corporation automatically lost its subchapter S status. Estates, however, could be shareholders. The Tax Reform Act expanded the category of permissible shareholders of a subchapter S corporation to include grantor trusts during the lifetime of the grantor (where the grantor is taxed individually on trust income and the trust is ignored) and, for sixty days after funding, trusts funded with subchapter S stock by the terms of a will or other testamentary disposition. These provisions of the Tax Reform Act created an anomalous situation. On the one hand, subchapter S status terminated upon the death of a grantor who, for nontax reasons, had chosen to fund a grantor trust with subchapter S stock during his lifetime; this type of trust, after the death of the grantor, is not an eligible subchapter S shareholder. On the other hand, a decedent who retained ownership of subchapter S stock until death is entitled to have his estate own subchapter S stock during the period of estate administration without disqualification and, in addition, is permitted to have a testamentary trust own the shares for 60 days after distribution from the estate. The practical result is to preclude taxpayers from using a revocable trust, which is standard nontax motivated estate planning tool, frequently used as a will substitute, to own shares of subchapter S stock.

Section 2(u) of the bill remedies this problem. A funded inter vivos grantor trust will remain an eligible shareholder of a subchapter S corporation for two years after the grantor's death if the entire corpus of the trust is included in the grantor's estate. The amendment results in rough parity between funded inter vivos trusts and those that are funded by testamentary direction; the two-year period approximates a reasonable period of estate administration and produces substantial equality with the timing opportunities presented by delayed testamentary funding. By limiting the application of the section to trusts included in the grantor's gross estate, the bill assures that the opportunity to remain an eligible shareholder is available only in those instances where there can be no income or estate tax abuse.

Another important clarifying change made by the bill relates to the partnership "at risk" rule. Under the Tax Reform Act there is an exception from the "at risk" rule for "any partnership the principal activity of which is investing in real property." Many comments have been received indicating that the terms "principal activity" and "investing" are ambiguous. For example, individuals operating hotels have asked whether their activity constitutes "investing" in real property. Section 2(q) of the bill clarifies the scope of the real estate exception from the "at risk" rules. The amendment makes it clear that both active and passive real estate activities are exempt. It also requires substantially all of a partnership's activities to involve investing in real property for the exception to apply.

Section 2(b) of the bill provides a need exception from the excess itemized deduction tax preference item for wholly charitable trusts and charitable income trusts created prior to January 1, 1976. Under the Tax Reform Act, even where all the income of a trust was distributed to charity, the trust would none theless be liable for payment of the minimum tax. The only charitable trusts that should be subject to inclusion in the minimum tax preference base are those where the grantor or a noncharitable beneficiary can use the trust as a device to avoid the limitation on excess itemized deductions. This is not the case where the trust is wholly charitable. Thus, these trusts are appropriately exempted from the special tax on preference items.

The bill contains a series of amendments to section 644 of the code, added by the Tax Reform Act. Section 644 provides that where certain property is sold or exchanged within two years of its transfer to a trust, a tax is imposed on the trust in an amount not less than the amount which would have been paid by the transferor of such property if the transferor had sold the property. The special tax is imposed on "includible gain", which includes in its measure gain realized by the trust on a sale or exchange. Section 644, therefore, imposes tax on a realized gain from those transitions which other code sections would not treat as nontaxable. The problem is the use of the words "realized gain" rather than "recognized gain." The legislative history of section 644 indicates that only recognized gain was to be subject to the tax. Section 2(n) of the bill corrects this oversight.

In addition, the tax on includible section 644 gain is calculated by reference to the transferor's taxable income for the year in which a trust has sold transferred property. However, there is no provision for adjusting the transferor's tax attributes to take account of the fact that the section 644 tax has been calculated by reference to the transferor's tax profile. Thus, under the 1976 Act, some tax attributes of a transferor, such as capital or operating loss carryovers, could be used both to reduce the tax on the includible gain and also to reduce the transferor's own income tax. In other words, these tax attributes were counted twice. Section 2(n) of the bill remedies this problem as well.

Section 3 of the bill contains 35 amendments to the estate and gift tax provisions of the Tax Reform Act. In some cases, these corrections are more substantial than those made to the income tax provisions of the 1976 Act. However, even the more substantial revisions do no more than implement the policy decision underlying the section being amended.

For example, one major source of concern after passage of the 1976 act was the question whether a redemption of certain preferred stock, known as "section 306 stock", in a transaction which met the requirements of section 303 would be eligible for the capital gains treatment afforded by that section. If not eligible for section 303 treatment a redemption of section 306 stock to provide funds to pay death taxes and estate administration expenses would be taxed as a dividend. Section 3(a)(2) of the bill provides that a redemption of section 306 stock will be granted capital gains treatment to the extent the redemption meets the requirements of section 303. Thus, section 303, the purpose of which is to relieve liquidity problems in estates holding large blocks of corporate stock, is made available on a nondiscriminatory basis to holders of both common and preferred stock.

H.R. 6715 also makes an important clarification with regard to the amount of income that will be recognized when carryover basis section 306 stock issued before December 31, 1976 is sold or redeemed. Under the act, the holder of carryover basis section 306 stock issued prior to December 31, 1976 is not entitled to any reduction in the amount realized on a sale or redemption of that stock even though, under prior law, the death of the prior holder of that stock would have removed the section 306 taint. Section 3(a)(1) of the bill remedies this omission. It provides that the amount treated as ordinary income on the sale or redemption of section 306 stock issued before January 1, 1977, and which is carryover basis property in the hands of the person disposing of the stock, is to be reduced by the sum of the adjusted basis of the section 306 stock on December 31, 1976 and any available fresh start adjustment.

Another important amendment to the estate and gift tax provisions relates to the holding period of assets acquired from a decedent. The 1976 act failed to grant automatic long-term capital gains holding period status to these assets. In 1978, when the holding period becomes one year, this omission could have an adverse effect on the use of "flower" bonds to pay estate taxes. In every case in which a decedent acquired "flower" bonds within three months of death, the gain recognized on the redemption of those bonds to pay estate taxes would be taxed to the estate as ordinary income rather than capital gain. Section 3(c)(4) alleviates this problem by providing an automatic long-term capital gains holding period for property acquired from a decedent.

I could go on and illustrate many more examples of the important and necessary corrections made by the bill. I will spare you the burden of that monologue. However, Mr. Chairman and Members of the Subcommittee, I am sure you can see from these few examples that the Technical Corrections Act is an important piece of legislation. As I stated earlier, in its present form, the bill does not present any major new issues of tax policy and virtually all of its provisions are noncontroversial. We hope that this will remain the case. However, there are other items which we think should be added to the act. In our testimony before the Ways and Means Committee we submitted 30 detailed recommendations with respect to the act, almost all of which have the concurrence of the Joint Committee staff. Not all of our recommendations were incorporated in H.R. 6715 by the House. The remaining recommendations, together with several new items we have discovered since our testimony before the Ways and Means Committee, are set forth in detail in the appendix to my statement.

Our recommendations fall into two basic categories. The first are those which relate to the provisions of H.R. 6715 as passed by the House. For example, we have recommended an amendment to section 2035, relating to the estate tax includibility of gifts made within three years of the date of a decendent's death, which is similar to section 4 of S. 2228 introduced by the chairman of this subcommitee and Senator Dole. However, we would also include in the transferor's gross estate reversionary interests relinquished within three years of the transferor's death. In addition, for purposes of proposals to increase the minimum basis adjustment for carryover basis property, the maximum amount allowable as a minimum basis should be reduced by the amount of cash and the basis of any other property transferred within three years of death. This is necessary to prevent the transfer of cash and high basis property to manipulate the minimum basis adjustment. Furthermore, for purposes of special relief sections 303, 2032A, 6166 and 6166A only, the percentage qualification requirements should be calculated by including in the gross estate the gift tax value of any property transferred within three years of death. These limitations are also necessary to prevent manipulative transfers to secure the benefits of those sections.

Our second category of recommendations relate to remedies for technical defects beyond those included in the version of H.R. 6715 passed by the House. Again, these recommendations are confined to proposals which implement the expressed intent of Congress. For the most part, they clarify ambiguities or give relief to taxpayers from unintended hardships. For example, the purpose of section 1040, added by the Tax Reform Act of 1976, was to retain the prior law income tax consequencies of funding a pecuniary bequest with appreciated property under which recognized gain was limited to the difference between date of distribution and estate tax values. However, the act did not coordinate the recapture provisions of the code with section 1040. As a result, the recapture rules, which generally provide that on a sale or exchange income is recaptured to the extent of the difference between the amount realized and adjusted basis, presently override section 1040 and could, therefore, cause the recognition of ordinary income in an amount in excess of the amount of income recognized under section 1040. To illustrate, if property subject to recapture has an adjusted basis of $10, an estate tax value of $50 and a date of distribution value of $60, only $10 of gain would be recognized under section 1040 but $50 would be recognized under section 1245. This result is contrary to the purpose of section 1040. We, therefore, recommend that the recapture sections be amended to make clear that recapture is limited by the amount of gain recognized under section 1040 where appreciated carryover basis property is used to satisfy a pecuniary bequest.

We urge the subcommittee to accept our recommendations. The statutory language necessary to effect them has bene drafted and we have reviewed them all with the Joint Committee staff. Their adoption will not, therefore, delay the passage of this important legislation.

We are also aware that additional technical corrections may be necessary. Section 8 of S. 2228, which conforms the definition of "interest in a closely held business' form purposes of both of the estate tax installment payment provisions (sections 6166 and 6166A) is a good example. We support that section of the bill. It is a technical correction which will result in significant simplification. Also, we do not oppose section 5 of the bill, which would amend the special use estate tax valuation provision (section 2032A) by relaxing the material participation requirements for eligibility and continued qualification in certain limited circumstances.

We are, however, opposed to section 7 of S. 2228, which extends capital gains treatment to a redemption to pay the income tax resulting from a qualified section 303 redemption. It is a substantive change which raises the fundamental policy question of the extent to which section 303 should be available to permit the bail-out of corporate earnings and profits at capital gains rates. Debate over the Technical Corrections Act is not the appropriate time to raise this issue. Moreover, we would also oppose this amendment on the merits. The purpose of code section 303 was to permit a limited bail-out of earnings, which would normally be taxed as a dividend, to the extent of death taxes and funeral expenses. As a practical matter, we believe this is sufficient relief. In my experience, which covers the entire span of section 303's existence, and that of other practitioners with whom I have spoken, we have found that section 303 is used primarily as a one-time opportunity to bail out corporate earnings and profits without regard to liquidity needs. If an estate still has a liquidity problem after a section 303 redemption, there are generous installment and postponement of payment provisions in the code. Thus we believe the extension of section 303 is unnecessary and unwarranted. For the same reasons, we oppose a return to the percentage qualification requirements of prior law as proposed by section 7(b) of S. 2228.

I will defer my comments on S. 1954, S. 2227 and sections 3 and 6 of S. 2228 until tomorrow's hearing on carryover basis. At that time, I shall also present a Treasury Department proposal which we believe will greatly simplify the carryover basis provisions.

In conclusion, the Treasury Department strongly supports the concept of technical correction and urges expeditious favorable action on H.R. 6715. At the same time, I want to reiterate the Treasury's view that it is vital to the integrity of the technical correction process that this bill not be the mechanism to review the underlying policy provisions contained in the 1976 act. Otherwise, the limited purpose of technical corrections will not be achieved.

Appendix

Treasury Department's Recommendations on H.R. 6715, the "Technical Corrections Act of 1977

The Treasury Department makes the following recommendations for clarifying and conforming amendments:

(1) *Fresh start adjustment for certain carryover basis property.* (Section 3(c) (1) of the bill and section 1023 of the Code).

The bill seeks to eliminate the difficulty in determining the "fresh start" basis of tangible property where either or both the acquisition date and cost of the property are unknown. The bill provides a formula to determine a minimum basis; December 31, 1976 value is determined by reference to date of death value and an assumed interest rate of eight percent.

We recommend that the provisions be limited to tangible personal property which is not described in section 1221(1) or 1221(2).

(2) *Only one fresh start adjustment for carryover basis property.* (Section 3(c)(3) of the bill and section 1023 of the code).

The bill provides that only one fresh start basis adjustment is to be made with respect to any carryover basis property.

To make clear that the fresh start adjustment is to be made only at the death of the first decedent owning carryover basis property we recommend that the word "change" replace the word "increase" in proposed code section 1023(h)(4).

(3) *Adjustment to carryover basis property for state estate.* Taxes (Section 3(c)(5) of the bill and section 1023 of the code).

The bill clarifies the circumstances under which the payment of State estate taxes will result in an adjustment to the basis of carryover basis property.

We recommend that the words "by the estate" be deleted from proposed code section 1023(f)(3)(B), thus permitting an adjustment to basis where the State estate tax liability has been discharged by an entity other than the estate, e.g., a funded inter vivos trust created by the decedent.

(4) *Gain recognized on use of special use valuation property to satisfy pecuniary bequest.* (Section 3(d)(3) of the bill and section 1040 of the code).

The bill clarifies the application of code section 1040 to pecuniary bequests of property subject to special use valuation under code section 2032A. It provides that gain will be recognized to the extent the fair market value of such property on the date of distribution exceeds the estate tax value of such property with both date of distribution and estate tax values to be determined without regard to code section 2032A. Thus, appreciation calculated on the basis of the "highest and best use" value of such property from the estate tax valuation date to the date of distribution wil be subject to tax under code section 1040.

We recommend that taxpayers be given the option to calculate the code section 1040 gain by applying either "highest and best use" values or special use values on the relevant valuation dates.

(5) *Bond to relieve qualified heir of personal liability for recapture of tax where special use valuation is utilized.* (Section 3(d)(5) of the bill and section 2032A of the code).

The bill provides that a qualified heir may be discharged from personal liability for payment of the code section 2032A recapture tax upon filing a bond in the amount of the maximum amount of additional tax which could be attributed to such heir's interest in the property.

We recommend that this provision be extended to all persons party to the agreement required by code section 2032A(d)(2).

(6) *Transfer within three years of death.* (Section 3(f) of the bill and section 2035 of the code).

The bill seeks to clarify the availability of the exception to automatic includibility of gifts made within three years of death for gifts excludable under the $3,000 annual present interest gift tax exclusion. It provides that the exception will be available for gifts to a donee made within three years of death if the donor was not required to file a gift tax return with respect to gifts made during the calendar year to such donee.

We recommend that (1) code section 2035 (a) and (b) be repealed; (2) code section 2035(c) be redesignated section 2035(a); (3) code sections 2036 and 2037 be amended to include in the gross estate of the transferor transfers within three years of death of any retained estate which, if held by the transferor at death, would have resulted in inclusion of the transferred property in the transferor's gross estate; and (4) code section 2042 be amended to include in the gross estate of the transferor any transfer with respect to a life insurance policy made within three years of the transferor's death; (5) for purposes of proposals to increase the minimum basis adjustment for carryover basis property, the maximum amount allowable as a minimum basis be reduced by the amount of cash and the basis of any other property transferred within three years of death; and (6) for purposes of special relief sections 303, 2032A, 6166 and 6166A only, the percentage qualification requirements be calculated by including in the gross estate the gift tax value of any property transferred within three years of death.

(7) *Coordination of gift tax exclusion and estate tax marital deduction.* (Sections 3 (g)(1) and (g)(2) of the bill and section 2056 of the code).

Section 3(g)(1) of the bill provides that the estate tax marital deduction will not be reduced under the code section 2056(c)(1)(B) to the extent inter-spousal gifts of a decedent are subsequently included in the decedent's estate under code section 2035.

Section 3(g)(2) of the bill clarifies the method of computing the Code section 2056(c)(1)(B) reduction of the estate tax marital deduction on account of inter-spousal gifts of a decedent by excluding from the computation of the reduction any gift not required to be in a gift tax return.

We recommend that (1) section 3(g)(1) be amended in a manner consistent with our recommendation regarding Code section 2035; and (2) section 3(g)(2) of the bill be deleted and instead that code section 2056(c)(1)(B)(ii) be amended by inserting after the words "percent of" the words "the excess of the value of such gift over the section 2503(b) amount, if any, allowable with respect to such gift."

(8) *Split gifts made within three years of death.* (Section 3(h) of the bill and section 2001 of the code).

The bill clarifies the transfer tax consequences to a consenting spouse of gifts which were included in the estate of the donor spouse by reason of code section 2035. It provides that the portion of such gifts attributable to the consenting spouse shall not be included in the total of adjusted taxable gifts of such spouse for estate and generation-skipping tax purposes and that any gift tax treated as a tax payable by the consenting spouse with respect to such gifts shall, for estate and generation-skipping tax computation purposes, be deducted from the aggregate amount of gift tax payable by such spouse.

If our recommendation regarding code section 2035 is adopted, this provision should be applicable only to transfers within three years of death of retained estates under Code sections 2036, 2037 and 2038 or with respect to a life insurance policy.

(9) *Inclusion in gross estate of stock transferred by the decedent where the decedent retained voting rights.* (Section 3(i) of the bill and section 2036(b) of the code).

The bill clarifies the intended scope of code section 2036(b) by providing that the section will apply only where the decedent and his relatives own, or the decedent possessed the right to vote, at least 20 percent of the combined voting power of the corporation the shares of stock of which have been transferred.

We recommend that the automatic application of Code section 318 to determine indirect ownership be deleted and that the Secretary be granted specific authority to promulgate regulations similar to the attribution rules of Code section 318 to proposed Code section 2036(b)(2) in a manner consistent with the purposes of that section.

(10) *Amendments relating to orphan's exclusion.* (Section 3(l)(1) of the bill and section 2057(d) of the code).

The bill clarifies the scope of the orphan's deduction by creating a statutory entity, the "qualified minor's trust" to which a decedent's property may pass and qualify for the orphan's deduction.

We recommend that section 3(l)(1) be deleted from the bill and that the Secretary be granted specific authority to promulgate regulations regarding the type of trust to which property may pass and qualify for the orphan's deduction.

(11) *Disclaimers.* (Section 3(m) of the bill and section 2518 of the code).

The bill clarifies code section 2518(b)(4) by providing that a disclaimer by any party (including a surviving spouse) will constitute a qualified disclaimer for purposes of code section 2518 where the surviving spouse receives an interest in the disclaimed property.

We oppose the enactment of section 3(m) of the bill. We recommend instead that code section 2518 be amended to make clear that a qualified disclaimer will not result if, pursuant to the disclaimer, the disclaimed property passes to a trust or trust equivalent in which the disclaiming party has an interest.

(12) *Termination of certain powers of independent trustees not subject to tax on generation-skipping transfers.* (Section 3(n)(1) of the bill and section 2614 of the code).

The bill clarifies the situations in which an individual trustee having discretionary powers to allocate trust income and principal among beneficiaries will be treated as a beneficiary of such trust by reason of holding such powers. The bill provides that an individual trustee will not be treated as having a power in a trust where such individual has no interest in the trust, is not a related or subordinate trustee, and has no present or future power in the trust other than the power to dispose of trust income and corpus among beneficiaries designated in the trust instrument.

We recommend that the definition of related or subordinate trustee be expanded to include (1) partners and employees of the grantor or of any beneficiary and (2) employees of any partnership in which the partnership interest of any or all of the grantor, the trust, and the beneficiaries of the trust are significant from the viewpoint of either or both operating control and distributive share of partnership income.

(13) *Alternate valuation date in the case of a generation-skipping trust.* (Section 3(n)(3) of the bill and section 2602(d) of the code).

The bill provides that the alternate valuation date will be available for taxable terminations postponed beyond the death of a single deemed transferor because of the existence of an older generation beneficiary at the death of the deemed transferor.

We recommend that the alternate valuation date be available also where a taxable termination is postponed beyond the death of a single deemed transferor because of the existence, at the death of the deemed transferor, of a beneficiary in the same generation as the deemed transferor.

(14) *Disclosure of returns and return information.* (Section 1202(a)(1) of the Tax Reform Act of 1976 and code section 6103(k)(4)).

Code section 6103(k)(4) exempts from the general disclosure rules of Code section 6103 the disclosure of tax return information to a competent authority of a foreign government "which has an income tax convention with the United States but only to the extent provided in . . . such convention." (Emphasis supplied.) The provision inadvertently excludes estate and gift tax conventions and the Swiss Mutual Assistance Treaty, which have tax exchange of information provisions.

We recommend that the exemption provided by Code section 6103(k)(4) be revised to apply to a foreign government which has an income tax or an estate or gift tax convention or treaty with the United States. Also, the exemption should include a treaty such as the Swiss Mutual Assistance Treaty.

(15) *Declaratory judgments regarding tax-exempt status of charitable organizations.* (Section 1306 of the Tax Reform Act of 1976 and code section 7428).

Section 1306 of the Tax Reform Act of 1976 added code section 7428, which provides for declaratory judgments relating to the tax-exempt status or classification of charitable organizations.

Code section 7428(c) provides that certain contributions shall remain deductible even though made during the period that the declaratory judgment litigation with respect to the revocation of the exempt status of the organization was pending and even though the court subsequently determines that the revocation was proper. As presently drafted, this provision only applies where the District Court or the Court of Claims decision is adverse to the organization. If the organization is successful in this court but is reversed in a subsequent appeal, no protection is afforded to the donors during any period after the notification of revocation. However, if the declaratory judgment proceedings were initiated in the Tax Court, this is not the result.

We recommend that contributions within the limits of code section 7428(c)(2) remain deductible until a declaratory judgment proceeding instituted in the Tax Court or in the District Court or the Court of Claims is finally adjudicated, including the appellate process.

(16) *Inclusion of certain generation-skipping transfers in the gross estate of a deemed transferor for estate tax marital deduction purposes.* (Section 2006 (a) of the Tax Reform Act of 1976 and Section 2602(c)(5)(A) of the code.)

Under code section 2602(c)(5)(A) if a generation-skipping transfer occurs at, or within nine months of, the death of a deemed transferor, the amount of the generation-skipping transfer is included in the gross estate of the deemed transferor for estate tax marital deduction purposes. Thus, the amount of the marital bequest of a testator whose will or trust contains a formula marital deduction bequest is automatically increased if that testator is the deemed transferor of generation-skipping transfer occurring at or within nine months of death. To avoid the inclusion of such amounts in a deemed transferor's gross estate, the will or trust of the deemed transferor must be specifically amended. We believe that the automatic increase of a marital bequest in these circumstances constitutes a trap for an individual who is unaware that an his death a generation-skipping transfer of which he is the deemed transferor may occur.

We recommend that in the case of decedent whose will or trust contains a formula marital deduction bequest, the presumption of Code section 2602(c)(5)(A) be reversed so that a generation-skipping transfer of which the decedent is the deemed transferor will not be included in the decedent's gross estate for estate tax marital deduction purposes unless a contrary intention is specifically stated in the decedent's will or trust.

(17) *Recapture in the case of satisfaction of a pecuniary request with appreciated carryover basis property.* (Section 2005(b) of the Tax Reform Act of 1976 and sections 617, 1040, 1250, 1251(a), 1252, and 1254 of the code).

Code section 1040, added by the Tax Reform Act of 1976, provides that where appreciated property is used to satisfy a pecuniary bequest recognized gain will be limited to the difference between date of distribution and estate tax values. The purpose of code section 1040 is to retain, under present law, the prior law income tax consequences of funding a pecuniary bequest with appreciated property. However, it is unclear whether recapture under code sections 617, 1245, 1250, 1251, 1252 and 1254 is limited by the amount of gain recognized upon the satisfaction of a pecuniary bequest with appreciated carryover basis property.

We recommend that code sections 1245(b), 1250(d) and 1251(d) be amended to make clear that recapture income is limited by the amount of gain recognized where appreciated carryover basis property is used to satisfy a pecuniary bequest.

(18) *Contributions of certain government publications.* (Section 2132 of the Tax Reform Act of 1976 and section 1231(b) of the code).

The Tax Reform Act generally provided that U.S. Government publications which are received from the Government without charge or below the price at which they are sold to the general public are not to be treated as capital assets either in the hands of the taxpayer so receiving the publications, or in the hands of a taxpayer whose basis in such a publication is determined by reference to its basis in the hands of a person who received it free or at a reduced price. However, because of a technical oversight, such publications were only excluded from the definition of "capital asset" under section 1221 of the code, but were not similarly excluded from the definition of "property used in the trade or business" under section 1231(b) of the code. Because of this technical oversight, the act fails to accomplish its intended purpose in respect of this issue.

We recommend that section 1231(b) be amended to provide that the term "property used in the trade or business" does not include U.S. Government publications received from the Government without charge or below the price at which they are sold to the general public.

(19) *Withholding of Federal taxes on certain individuals engaged in fishing.* (Section 1207(e) of the Tax Reform Act of 1976 and section 3121(b)(20) of the code).

The Tax Reform Act provided that certain individuals engaged in fishing were to be treated as self-employed persons for Federal tax purposes. In general, these changes were effective for services performed after December 31, 1971. Since the enactment of the Tax Reform Act, it has come to Treasury's attention that the Internal Revenue Service has opened several cases relating to fishing services performed prior to December 31, 1971 in which it is attempting to collect retroactively employment taxes from affected boat operators.

To alleviate this problem, we recommend that the date "December 31, 1954" be substituted for "December 31, 1971" in section 1207(f)(4) of the Tax Reform Act, the effective date provision of the amendment.

Senator BYRD. The committee will stand in recess until 9 o'clock tomorrow morning.

[Thereupon, at 10:05 a.m., the subcommittee recessed, to reconvene at 9 a.m. Thursday, October 27, 1977.]

TECHNICAL CORRECTIONS ACT OF 1977

(Including Carryover Basis Provisions)

THURSDAY, OCTOBER 27, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Hansen, and Dole.

Senator BYRD. The committee will come to order.

Today, the Subcommittee on Taxation and Debt Management Generally begins consideration of several measures dealing with the estate tax portions of the 1976 Tax Reform Act. More specifically, the hearings will focus on the carryover basis portions of the 1976 law and S. 1954, S. 2227, and S. 2228.

One of the most disturbing parts of the 1976 tax law was the enactment of a carryover basis for assets transferred at death. Not only was this provision a radical departure from prior law, it also increased the complexity of the estate tax laws.

Furthermore, carryover basis was made a part of the 1976 bill during the conference committee deliberations on the 1976 Tax Reform Act without any consideration by the Senate or by the Senate Finance Committee.

The hearings today are designed to give the Senate an opportunity to look at carryover basis for the first time. Bills considered in these hearings seek either to repeal or postpone carryover basis or to modify the law to make it more workable.

The witness today is Hon. Donald C. Lubick, Deputy Assistant Secretary of the Treasury for Tax Legislation who will give the Treasury's view on this legislation.

Welcome, Mr. Lubick, and you may proceed as you wish.

STATEMENT OF HON. DONALD C. LUBICK, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. Thank you, Mr. Chairman. I am pleased to be here on a daily basis and have the opportunity today to present the Treasury's views on S. 2227 and S. 2228, introduced by you and Senator Dole and——

Senator BYRD. And, incidentally, Senator Hansen is now a cosponsor.

Mr. LUBICK. We received a copy last night of a bill introduced by Senator Hathaway which deals with the same subject matter and that, I understand, has been given the number of S. 2238. Our comments will relate to that bill as well.

Senator BYRD. That is fine. I think that is desirable.

Mr. LUBICK. All of these bills relate to the carryover basis provisions, as you have stated, and they relate to certain other matters regarding the taxation of estates. We shall also comment on S. 1954, which Senator Curtis introduced, to repeal the carryover basis provisions.

S. 2227 would postpone the effective date of the carryover basis provisions to the end of 1978. S. 2228, as well as Senator Hathaway's bill, S. 2238, would make a series of amendments to the carryover basis provisions by providing an increased minimum basis for carryover basis property, by changing the method of computing the tax adjustment for the portion of death taxes which are added to the carryover basis property and, in the case of S. 2228, but not S. 2238, there would be the elimination from the application of carryover basis of property held by a decedent on December 31, 1976. There are a number of other changes which I shall describe at the time I comment on them.

Before we address the specific provisions of the bills, I believe it is in order to review the problems which led to the enactment of carryover basis. Under the law, as it stood before 1977, the basis of property acquired from a decedent was its fair market value for estate tax purposes in the estate of the decedent.

The effect of the prior law was to eliminate entirely from income taxation all appreciation which had accrued during the lifetime of the decedent. The result of forgiving the tax on gain which had accrued prior to death was a very strong lock-in effect which constituted a severe impediment to mobility of capital.

The pre-1977 law created a major incentive for older persons to hold appreciated property until death and thus to escape income taxation on the gain. Even more important, the ability to escape income taxation entirely simply by holding property until death led to very different burdens in income taxation as between similarly situated taxpayers.

Perhaps this can be illustrated concretely. Let us assume under prior law, that two taxpayers, A and B, each owned a share of stock worth \$110 which cost each one \$10. The result is that each held property with untaxed appreciation of \$100. Let us assume that each would pay a capital gains tax at a rate of 25 percent if the property were sold and let us further assume that the marginal estate tax bracket of each was 30 percent. A sells his stocks; as he walks out of his broker's office, he steps in front of a passing truck and is annihilated. B is crossing the street at the same time to go into the same broker's office to sell his stock but he is run over by the same truck before he arrives there.

A's stock was sold immediately before his death and B has the consolation of having died without having sold his stock. Under pre-1977 law, A's estate must file a final income tax return for the last year of A's life and in that must report his capital gain of \$100 subject to a tax of \$25. \$25 is subtracted from the \$110 value of A's stock leaving

$85 subject to an estate tax of 30 percent. After subtracting the estate tax, the net proceeds received by A's heirs are $59.50.

Compare B's situation. Under prior law, there was no income tax whatsoever on the appreciation which existed on the date of B's death. B is simply subject to an estate tax of 30 percent on $110 and his heir is left with $77. Under prior law, the share of stock which B owned could now be sold immediately without any income tax consequences. Thus through the happenstance of B having been killed on his way into the broker's office as opposed to A on his way out of the broker's office, B's heir will receive $77 and A's heir will receive $59.50.

Senator BYRD. Do you really believe that you are going to take care of every possible contingency that could possibly exist between two taxpayers at any point in their lives?

Mr. LUBICK. No, I——

Senator BYRD. It seems to me that that is exactly what you are getting at, and I think that is impossible.

Mr. LUBICK. I agree with you that we cannot take care of every contingency but, Senator Byrd, this is a very fundamental difference and I can——

Senator BYRD. Well, I agree that there is a fundamental difference, but the example you give, you give the impression that you are doing the taxpayer a favor by changing the law.

Mr. LUBICK. Well, we are doing a favor to the taxpayer who happens to have to sell before death. We are relating the impact of taxation between two taxpayers who are basically similarly situated to put them in a position of equality. That element of fairness was what prompted the Congress to do that.

From my own experience throughout 25 years of private practice, I can testify that I advised clients who were in the position of having appreciated property not to dispose of that property in order to avoid the income tax on it. There is no question that prior law had that effect. Any counselor who did not advise his client in that situation to hold his property and not realize the gain would be derelict in his duty in not preventing his client from incurring an unnecessary income tax liability which someone who was not in that position could not avoid.

In my statement, at page 3, I have another illustration, but to save the time of the committee, I will not——

Senator HANSEN. Mr. Chairman, your example seems extreme. I can cite you a letter from a lady who lives in Wyoming, whose husband is a diabetic. They had a ranch out there and he finally had to have his leg amputated. Because of the distressed situation that characterizes livestock ranching now, Mr. Lubick, and because their family had grown—they had three children—they concluded, that, because of his impending extreme disability to cease ranching. They went to their tax accountant and they went to their lawyers and tried to get the best advice they could as to what should be done. They had their accountant run some figures on what they might get out of their ranching operation if they were to sell it all, which they eventually decided to do. In the meantime, that same law that you speak about went back retroactively and saddled them with about $31,000 more in taxes than they had any reason to believe would be required, because we passed four-and-a-half pages of effective dates; and we made some of the changes in the law retroactive.

I make that observation simply to call attention to the fact that while you may be balancing out, as you believe you have, a situation where two people are both annihilated, one before he sells his stock and another one just after he sells it. I do not think that you did a fair and equitable thing by everyone.

It would seem to me that when that law was made, and some of those effective dates were made retroactive, there was no way on earth that an average citizen, getting the best advice he could and trying to make the best judgment he could, could have anticipated the caprice of the tax law in making those changes.

Mr. LUBICK. Senator Hansen, I infer that the problem of this particular family in Wyoming arose out of the increase in minimum tax applicable to capital gains derived during lifetime. In effect, the act did increase the effective rate on very large capital gains.

Senator HANSEN. Well, I guess those are relative terms. I would suggest that most of the appreciation that you are talking about and are concerned with results from the fiscal policies of this Government.

When you talk about how much property has appreciated, what we are, in most instances, saying is that the Government has done a pretty lousy job of trying to balance the budget and, as a consequence, the appreciation is attributable primarily to inflation.

Mr. LUBICK. Well, obviously I do not have the specific figures or the dollar amounts that are involved, and I certainly do not want to be in the position of endorsing retroactive increases in taxation where persons were planning their affairs based on the law.

Senator HANSEN. Well, on that point, Mr. Lubick, I thought that most of those dates were worked up by you and Dr. Woodworth, were they not? Now, we had 4½ pages, and I certainly did not know what all of those dates amounted to.

Is that or is that not a fact?

Mr. LUBICK. I personally can disclaim, Senator Hansen, because I was in private practice at the time.

Senator HANSEN. Good. I am glad to know that. Welcome aboard.

Mr. LUBICK. But the Treasury Department has a long continuity, going back to Alexander Hamilton. I suppose to that extent I will assume some responsibility.

Senator HANSEN. Will you do your best to undue the damage that those retroactive dates did?

Mr. LUBICK. We have been working at it. I think the reason for those dates was in order to meet certain budgetary objectives which the Congress had set for itself in a budget resolution. As a matter of fact, there are some instances where I, as a private practitioner, wrote to Congress pointing out that the possible taxation from some of those changes could amount to over 80 percent.

But I do not think that is the issue in comparing the situation of taxpayers who have appreciation which, under the law as it has existed for a long time, is subject to tax when a capital asset is sold and, under the prior law, escapes taxation when the asset is not sold. I think the basic question is, is it fair to have a broad class of taxpayers subject to tax on their appreciation if either voluntarily or through economic circumstances they are forced to dispose of their property during their lifetime as opposed to those who have sufficient financial resources to defer sale until they shuffle from this mortal——

Senator HANSEN. I will not pursue the point further, Mr. Chairman. I think your illustration served you well in making the point you wanted to make, and I was just trying to suggest by the questions that I raised that there were other situations that prove precisely the opposite of the point you sought to make.

Mr. LUBICK. Well, we at Treasury, Senator Hansen, are willing to crusade against inequity wherever it shall exist, and try to root it out.

It has been suggested that perhaps the easiest solution to this problem is to require all taxpayers to settle their income tax accounts at least once in a lifetime, and obviously the last opportunity for a taxpayer to settle his accounts once in a lifetime if he has not done so previously is at the last moment of his lifetime.

Some persons have suggested that it might be appropriate to tax the gains realized by a decedent through disposition of his property to his heirs at his death. The resulting income tax would be a deduction from the estate of the decedent, and complete equity would result as to taxpayers who have sold before death and those who did not sell before that time, except, of course, for the deferral advantage which the taxpayer who did not sell enjoyed by having his gain accumulated and compounded without any earlier taxation.

Congress has not, thus far, been prepared to enact legislation imposing an income tax on property transmitted to one's heirs at death. Last year, however, Congress decided that it was appropriate to end the inequity of total escape from taxation of gains which were accrued during a decedent's lifetime even though no taxation was to be imposed at the date of death. Instead, Congress provided for a carryover basis; that is, the basis of the property would not be stepped up to fair market value at the date of death but would continue in the hands of the heirs to be the same as that of the decedent.

I should point out parenthetically that similar carryover basis provisions had been in effect in the law both as to gifts and as to items of income in respect to a decedent. Thus, the carryover basis concept was not new, but was a familiar one. Last year's provisions were simply an extension of provisions already operative for many years.

Now, a number in the Congress argued that the estate tax at death and the income tax on the appreciation at death, when taken together, imposed too great a burden on decedents. With that in mind, Congress evaluated the inequity of totally forgiving tax on appreciation which had accrued during a decedent's lifetime with a measurement of the proper burden of taxation on estates.

Congress enacted carryover basis as part of a complete package with a number of liberalizing amendments to reduce estate taxes. For example, the estate tax exemption was converted into a credit which gives an exemption equivalent, when fully in effect, of slightly over $175,000 of assets rather than prior law's $60,000. The marital deduction was liberalized to provide a minimum marital deduction of $250,000 where that amount exceeded one-half of the decedent's gross adjusted estate. A number of other liberalizations of the estate tax were enacted on the premise that carryover basis would be applied in order to end the complete escape from income taxation on appreciation accrued at death.

The combination of estate tax liberalization and the enactment of carryover basis was part of a single package designed to create a fairer distribution of the burden of taxes at the time of a taxpayer's death. Thus, we are completely opposed to S. 1954 which would repeal the carryover basis provision. We are equally opposed to S. 2227 which would postpone the operation of carryover basis for 2 years. It is not reasonable to continue the beneficial part of the package, the liberalization of estate tax provisions, and either eliminate or postpone the quid pro quo which was enacted to justify those provisions, namely carryover basis.

Carryover basis is a solution to a difficult problem which has vexed and concerned the Congress for over 15 years. To repeal it or to postpone its effective date would be to take a major step backward, to return to a system which Congress recognized was operating inequitably. Either action would aggravate the inequity by leaving reduced estate tax burdens in effect for those persons who would, by such action, totally escape income taxation on gains accrued at the date of their death.

Congress recognized that with the introduction of the new system some transitional relief was appropriate. Congress therefore worked out a system to give a fresh-start basis to property held on December 31, 1976. I will not take the time in my oral presentation to go into it, but basically, Congress decided that it would set up a system to exempt from the tax—and this is in line with Senator Hansen's desire for nonretroactivity—appreciation which had accrued prior to 1977 and the new rules would apply to appreciation arising after 1976.

Furthermore, Congress provided, for small estates which normally do not have significant amounts of appreciated property and as to whom involvement in the estate tax system is unusual, a minimum basis of $60,000. To the extent that an estate acquired assets from a decedent which had a basis of less than $60,000, the basis will be increased either to their fair market value, as under old law, or to that $60,000, if that is less.

Congress also recognized that a decedent transmitting property to his heirs under a carryover basis system was transmitting that property with a contingent income tax liability on the post-1976 appreciation which had accrued at the date of his death. When the heir sold the inherited property, he would have had to pay the income tax attributable, not only to the appreciation from the date of his own acquisition, but also on the appreciation from the date of the original acquisition from the decedent, or, in the case of property held on December 31, 1976, from that date.

Since it would be appropriate under a system which imposed income tax at the date of a decedent's death to make the income tax payable a deduction from the gross estate, it is appropriate in a carryover basis system to compensate for the estate tax in an amount equal to the contingent income tax liability.

The compensation for this overpayment of estate tax is accomplished by adding to the basis of the appreciated property and adjustment for the death tax attributable to the appreciation. The adjustment to basis compensates roughly by reducing the income tax at the time of the sale of the transferred property by an amount equal to the increase in estate tax over the amount that would have been paid had the accrued gains at the time of testamentary disposition by the decedent been subject to income tax.

Now, since the enactment of carryover basis, the bar, accountants, the staff of the joint committee, Treasury, have all been reviewing the practical operations of the provisions. Treasury has concluded that Congress, by and large, did a pretty good job of enacting carryover basis, although we concur with Senators Byrd and Dole and Senator Hathaway that there are some significant improvements which can be made to make it operate more equitably and simply.

We were very pleased to see the provisions of S. 2228 because we believe that they represent a reasonable and constructive approach to the practical problems of carryover basis. While there are a number of details in S. 2228 which we think require modification, we are in accord with the three major concepts of S. 2228, as well as Senator Hathaway's bill, S. 2238, and I guess S. 2228 is also your bill too, now, Senator Hansen, so we commend you as well.

Senator HANSEN. Thank you.

Mr. LUBICK. Liberalization of the minimum basis requirement, a combination of the separate death tax adjustments into one, and application of the new single death tax adjustment at marginal, rather than average, rates contribute major improvements.

We believe that the bill sponsored by Senators Byrd, Dole, and Hansen and the bill sponsored by Senator Hathaway, if modified by suggestions made by our staff and by expert practitioners with whom we have consulted, take care of all of the significant problems that anyone may have with carryover basis.

The bill introduced by Senators Byrd and Dole and cosponsored by Senator Hansen, as well as Senator Hathaway's bill, provides a minimum basis that corresponds to the exemption equivalent of the increasing estate tax credit which rises to $175,000 by 1981. This will be a major simplification. It eliminates all estates which are not required to file Federal estate tax returns from the carryover basis provision. Thus, 96.3 percent of the population or, as I say, more accurately, the ex-population, will not be affected by carryover basis at all because estate tax returns will not be required. Indeed, our estimates show that only 2 percent of all decedents' estates will be in the carryover basis system and it is likely that many of the 2 percent will not have significant problems because they will be composed largely of liquid, nonappreciated assets.

We also believe that your bill, which rolls the Federal and State tax adjustments into a single computation to be applied after the minimum basis adjustment will result in great simplification. We concur that the application of the adjustment at marginal estate tax rates, the highest estate tax rate, is the correct solution since the income tax which would have been applicable had the property been sold immediately before death or had an income tax been imposed on a transfer at death, would have been a deduction at the highest marginal estate tax rate.

We also favor relief in one case beyond that emcompassed by the Byrd-Dole-Hansen bill and the Hathaway bill. We suggest a special minimum basis of the first $75,000 of the fair market value at date of death for a home occupied by a decedent at the time of his death as his principal residence. The comments we have received and the testimony we have heard indicate that a personal residence is one of the assets where taxpayers have experienced some difficulty in calculating basis and determining holding periods. It is not usually difficult to know what price a decedent paid for or when he originally acquired his residence, and it may even be ascertainable from public records. On the other hand, many persons do not keep track of improvements to their residence which they make after original acquisition.

To relieve those persons from difficulty in ascertaining basis where the value of their residence is such that they are not likely to be able to afford professional advice in reconstructing that basis, we propose the minimum basis of $75,000 for a principal residence. This is similar to the $10,000 exclusion applicable to personal and household effects.

We point out that a minimum, fresh start basis for tangible personal property will be determined under a formula under the Technical Corrections Act which we discussed before the subcommittee yesterday.

Enactment of these changes will eliminate most of the difficulties that low and middle income taxpayers would have in establishing basis for their property, if indeed the $175,000 minimum basis did not take them out of the system altogether.

Let me now review S. 2228 and the Hathaway bill section by section to suggest the modifications we believe would make it a workable, acceptable improvement over present law. Again, let me point out that, for the reasons I have already stated, we are opposed both to S. 1954, the repeal of carryover basis, and S. 2227, postponement of the effective date.

Senators Byrd and Dole and Hansen and Hathaway have demonstrated that it is possible to make relatively straightforward amendments to carryover basis which make both repeal and postponement unnecessary and undesirable.

Enactment of the Byrd-Dole-Hathaway-Hansen amendments, as modified by our suggestions will not signal an end to our efforts to make the administration of the carryover basis provisions as simple and equitable as possible. We at the Treasury, as well, I am sure, as our friends on the staff of the Joint Committee on Taxation, intend to continue working with the bar, the accounting profession and professional fiduciaries to see where further improvements can be made to ease administration of the law. We are confident, however, that if S. 2228 is modified as we propose, we will have a truly workable carryover basis provision which will affect only that part of the population able to manage any problems it might cause.

The first substantive provision of S. 2228 is section 3(a) which repeals the fresh start adjustment and eliminates from the applicability of carryover basis all assets held by a decedent on December 31, 1976. As I indicated earlier, we strongly oppose this provision. While it may be appropriate through the fresh start adjustment to permit the escape from taxation of appreciation which arose through December 31, 1976, there is surely no reason to permit the escape from taxation of appreciation which arises after 1976. To grandfather all pre-1977 assets would increase the undesirable lockin and would create great inequity between similarly situated taxpayers with respect to their continuing post-1976 appreciation.

Moreover, enactment of a grandfather clause applicable to all assets held on December 31, 1976, would be subject to great abuse. Let me give you an illustration. Suppose a taxpayer has a closely held corporation, the stock of which he acquired just before December 31, 1976. There is nothing to prevent him from having his corporation acquire assets after December 31, 1976, and thereby completely escape the carryover basis provisions with respect to property acquired after 1976. The stock of that corporation, and presumably all of the value which it represents, would, under the bill, be exempt from the carryover basis provision.

Furthermore, the benefits of estate tax reduction were given those assets which were in the hands of the decedent on December 31, 1976. If those assets are exempted from the carryover basis provisions as to their post-1976 appreciation, they should also be excluded from the estate tax reductions which became applicable following 1976.

In point of fact, the Byrd-Dole-Hansen bill and the Hathaway bill in their other provisions simplify carryover basis sufficiently that we do not believe the grandfather provision is necessary or appropriate.

Section 3(b) of the Byrd-Dole-Hansen bill, as well as the Hathaway bill, increases the minimum basis in increments which correspond to the increases in the estate tax exemption equivalent. We approve so long as the minimum basis is reduced not only by the basis of all carryover basis property, but also by the proceeds of life insurance included in the estate. The Byrd-Dole-Hansen and Hathaway bills accomplish their purpose of eliminating small estates from the operation of the carryover basis provision. However, to avoid abuse of the new provision, increase in minimum basis, account must be taken of assets which are included in the estate but are not carryover basis property. The only significant one of these is life insurance proceeds, and therefore the minimum basis should be reduced by life insurance proceeds included in the estate. To do otherwise would be to give a minimum basis to other assets of a taxpayer who might have $1 million of insurance on his life and whose estate would be very large.

Of course, the subcommittee is aware that generally any gain realized from the proceeds of life insurance is excluded from income tax under existing law. That exclusion from income tax for life insurance proceeds would continue.

Section 3(c) of the bill provides for a single adjustment for Federal and State estate and succession taxes at the marginal rate. The bill provides that this adjustment should follow the minimum basis adjustment and should be allocated to all appreciated property including marital deduction property and property contributed to charity. We endorse the general concept of a single adjustment for Federal and State taxes at the marginal rate and an adjustment which follows in sequence the minimum basis. We have serious problems however, and practitioners with whom we have discussed the matter concur, with extending the adjustment to property used to fund the marital deduction, a charitable deduction or the orphans' exclusion. Inasmuch as property which funds the marital or charitable deduction or the orphans' exclusion does not bear any death tax, it is inappropriate to give it a basis adjustment.

I have set forth on the bottom of page 9 and the top of page 10 of my statement the method we would recommend to compute the applicable marginal rate. What we are suggesting is that we convert the tax attributable to the appreciation to a rate and simply apply that rate to the appreciation in any property which is included in the taxable estate. For example, if the marginal estate tax rate is 35 percent, simply take 35 percent and apply it to the appreciation in any asset which is part of the taxable estate. If an item of carryover basis property is actually used to fund a deductible marital, charitable or orphans' bequest, the adjustment for taxes, that 35 percent, would not apply because that property did not bear any tax. And we have also indicated that, in cases where there is no Federal estate tax, but there are State taxes, two simple rules that could be applied. If the estate is under $175,000 you have taken care of the problem. Even if there are State taxes the minimum basis will bring the basis of the assets up to fair market value and you will not need estate tax adjustments. If you have a federally marketable estate, which could be as high as $425,000 with the new marital deduction, we believe it is too difficult to start computing the various State taxes with and without appreciation. A simple pro ration of the total State taxes in the ratio that net post-1976 appreciation bears to the total estate could be used in those situations.

As I indicated before, we agree with section 3(d) of the Byrd-Dole-Hansen bill, and Senator Hansen's bill deals in this area in the same way as your bill, which provides that the minimum basis adjustment is to be made before the adjustment for death taxes attributable to appreciation. That will be a great reduction in computation.

Section 3(f) of S. 2228 provides for capital asset treatment for objects of art, literary assets, and the like which, in the 1976 act, lost capital asset status in the hands of an heir. We agree that such assets should not lose capital asset status solely because they have become carryover basis property. Of course, if they would be noncapital assets in the hands of the heir without regard to the decedent, they should retain that characterization on the basis of the circumstances of the heir.

Section 3(f) would also treat crops and livestock which are carryover property as capital assets. We do not believe it is appropriate to make crops and livestock, which are almost invariably inventory property, capital assets in the hands of one engaged in the farming business. In any case where the crop or livestock would be a capital asset under the circumstances of the heir, however, it should have capital asset status.

We would, however, be willing to accept a complete exemption from the carryover basis provisions of livestock and poultry held by the decedent on December 31, 1976. This presents a different issue from the general grandfathering provision because it will phase out very quickly. Most livestock and poultry held on December 31, 1976, will be disposed of within a very few years after 1976 and it is desirable to avoid the complication of calculating a fresh start adjustment with respect to that property.

Section 4 of the bill deals with a simplification of the contemplation of death provision in the 1976 act and was the subject of our testimony yesterday. Under section 4 of the bill, the gross estate would include gift taxes paid and life insurance contracts transferred within 3 years of death as well as the value of any property which would have been included in the decedent's gross estate under sections 2036 and 2038 by virtue of a retained life estate or power if the decedent relinquished that estate or power within 3 years of death. All other transfers within 3 years of death would not be included in the gross estate.

We agree that this is an appropriate amendment if there is also included in the transferor's gross estate the value of the property which would have been included under section 2037 where a reversionary interest is relinquished within 3 years of the transferor's death.

The reason for this is that the new, unified rate schedule operates well in the case of outright gifts but operates only imperfectly in the case of split-interest gifts. It is therefore necessary to bring those transfers, along with life insurance, back into the estate.

Senator BYRD. Excuse me. What do you mean by split interest gifts?

Mr. LUBICK. Where the transferor has either a revision or a life estate. For example, a trust to pay the income to the grantor for life and on his death to someone else. In other words, there are two persons having beneficial interests.

Senator BYRD. I understand. Thank you.

Mr. LUBICK. We also indicated yesterday that it would be necessary to include in the transferor's gross estate cash and the basis of other property transferred within 3 years of death for purposes of the new Byrd-Dole minimum basis adjustment. Otherwise, there would be a strong incentive for a decedent to make deathbed transfers of cash and other high-basis assets to manipulate the minimum basis adjustment to his advantage.

For similar reasons, we recommend that for purposes of the special relief sections, 303, 2032(A), 6166, 6166(A) only the percentage qualification requirements for special relief should be calculated by including in the gross-estate the gift tax value of any property transferred within 3 years of death. For example, in determining whether closely held stock constitutes a sufficient portion of a decedent's estate to qualify it for the special provisions of section 303, the percentages should be calculated with reference to the estate inclusive of transfers within 3 years of death. This would prevent transferring assets out of the estate at the last moment to qualify in a situation where the illiquid property is really a minimal portion of the decedent's predeath assets.

Section 5 of the Byrd-Dole-Hansen bill, as well as the Hathaway bill, provides that eligibility for estate tax special use valuation for farms and closely held business real property is not to be lost on account of the material participation requirements under circumstances where either because of age, status of a minor, or other handicap, it is necessary for the farm to be leased out or operated by a manager. We do not object to this change since it is consistent with the concept of special use valuation.

Section 6 of the bill provides that the estate should succeed to unused net operating and capital loss carryovers. We oppose the extension of net operating loss carryovers to the estate. Such extension has little to do with carryover basis and is inappropriate. The effect could very well be to allow artificial losses generated through tax shelter investments to continue beyond the decedent to his estate.

On the other hand, we agree that there is logic to allowing the capital loss carryover to go forward into the estate where it can be used to offset gains which may be realized by the estate on carryover basis property which it acquired from the decedent. We would therefore not object to extending the capital loss carryover of a decedent to his estate. It would, however be inappropriate to allow the decedent's capital loss carryover to flow from the estate into the hands of the heirs where it could be used to offset the gain on property of the heirs which was their own property and not carryover basis property.

Section 7 of S. 2228 would liberalize the amount of stock that would be redeemed under section 303 at capital gains rates rather than being treated as a dividend. As we indicated in our testimony yesterday, this amendment is inappropriate on the merits.

The purpose of Code Section 303 was to permit a limited bailout of earnings which would normally be taxed as a dividend to the extent of death taxes and funeral and administration expenses. In my experience in practicing in this area since 1949, and in the experience of other practitioners with whom I have spoken, we have found that section 303 is used primarily as a one-time opportunity to bail out corporate earnings and property without regard to real liquidity needs. The 1976 act introduced liberalized and generous installment and postponement of payment provisions. Therefore, the extension of section 303 is unnecessary and unwarranted.

Section 8 provides that the definition of a closely-held business is to be the same for the purposes of section 6166 and 6166(A) relating to extensions of time for payment of estate taxes attributable to closely-held businesses and we do not object to the change in this section.

We would also like to call to your attention one other problem that has arisen as a result of carryover basis in the practical world of estate planning for stockholders of closely-held corporations. It may be illustrated by the non-infrequent situation of a corporation the stock of which is owned by two stockholders. It is normal practice to provide that, on the death of one of them, the corporation will redeem the decedent's stock, leaving the other stockholder in sole control. It is usual to fund these arrangements by life insurance purchased by the corporation.

There are two reasons for such an arrangement. One is to provide liquidity for the heirs of the deceased stockholder who will need the funds to maintain their living and pay taxes. At the same time, it is usually undesirable to introduce the heirs as partners into the business. They are strangers to the survivor, and that can be disruptive.

An alternative arrangement to having the corporation redeem the stock is a cross purchase agreement where each of the two stockholders purchases insurance on the life of the other and agrees to use the proceeds of that insurance to buy the stock of the other.

With the enactment of carryover basis, in many cases it becomes more advantageous to use the cross purchase arrangement because the surviving stockholder will then receive as a basis in this newly acquired stock the purchase price which is represented by the proceeds of the insurance.

If the stock is redeemed by the corporation, any basis represented by the cost of acquisition is lost; it disappears in the corporation. The advantage to the survivor in obtaining the higher basis is greater in a carryover basis world since, after his death, the higher basis would be available to his heirs.

Now, in order to change preexisting funding arrangements, it may be necessary to transfer existing insurance policies which have been owned by the corporation to each stockholder. There we run into a problem under section 101 of the Internal Revenue Code. That is the section which exempts from taxation the proceeds of life insurance, and there is an exception that says the exemption does not apply where the transfer of the insurance policy has been for a valuable consideration. In that case, if the corporation transferred the policy to a shareholder in order to enable the shareholder to fund the cross purpose agreement, when the shareholder collected the proceeds to buy the stock, he would be subject to an income tax on the proceeds of that life insurance.

The categories of exemption under the law today—and these are not considered transfers for valuable consideration—include the insured himself, the corporation in which the insured is a shareholder or officer, the partnership in which the insured is a partner or a partner of the partnership, but they do not include a shareholder of a corporation in which the insured is a shareholder.

We believe it is appropriate to permit rearrangement of these affairs by allowing the transfer of an insurance policy by a corporation to a shareholder if the insured person under that policy is a coshareholder of that corporation; and we would recommend legislation to that effect.

Now, again, I want to commend Senators Byrd, Dole, and Hansen and Senator Hathaway for the legislation which they have introduced with respect to carryover basis. There are a few provisions in Senator Hathaway's bill which are not in the other bills and I would like to give my comments on them.

One section of Senator Hathaway's bill allows the fresh start adjustment for assets held on December 31, 1971 for purposes of loss so that a taxpayer could realize a loss if, the fresh start basis, the value on December 31, 1976, was more than the original cost. We concur that that would be an equitable change.

Another section of Senator Hathaway's bill provides for a fresh start minimum basis determined by formula for a personal residence and all nonbusiness property. We now think that we have taken care of that problem by providing a $75,000 minimum basis on a residence. The 1976 act already provides an exclusion for $10,000 of personal property, there is a formula in H.R. 6715 to determine the fresh start basis of tangible personal property and the Byrd-Dole-Hansen bill would raise the minimum basis totally to $175,000. So we think we have anticipated the problem which Senator Hansen has dealt with. I think we are in the spirit of his proposal, but we think it is not necessary to extend the formula basis to items like intangible property.

Senator Hansen's bill would also treat nonvoting, nonconvertible preferred stock as having a December 31, 1976, fair market value each equal to the redemption price. If you own preferred stock that has a redemption price of $100 on December 31, 1976, and it is not a marketable stock, the fresh start adjustment would gradually be dissipated under the fresh start formula because the further out you went from December 31, 1976, the more proration there would be between the value before and after.

Senator HANSEN. Mr. Lubick, if you would allow me to interrupt, inadvertently you said Senator Hansen. I am sure you meant Senator Hathaway.

Mr. LUBICK. We concur that, in this case, it is appropriate to give the more liberal redemption price because the fresh start adjustment does not operate accurately in the case of preferred stock which cannot appreciate because the redemption price is a ceiling on it. You cannot have post-1976 appreciation.

Senator Hathaway's provisions on minimum basis are very similar to your bill and our comments apply to his as well.

The provision with respect to section 2035 on contemplation of death, we believe, does not operate quite right. We prefer the Byrd-Dole-Hansen approach, with the few modifications which we suggested.

The material participation changes for the farms are identical to yours. We endorse them. He also conforms section 6166 and 6166A and we agree with that.

There is a provision with respect to foreign conventions which is already part of the Technical Corrections Act, and we agree with that.

Finally, you remember yesterday, Senator Byrd, I spoke about the problem of the poor fishermen. Senator Hathaway has added that provision to his bill, and we agree with that.

So, in summary, we are very pleased that Senators Byrd, Dole, Hansen, and Hathaway have introduced constructive legislation to make carryover basis an administerable and equitable part of the income tax law. With the modifications that we have suggested today, with respect to the new minimum basis provisions and the provisions for tax adjustment, we believe that Senators Byrd, Dole, Hansen, and Hathaway will have performed a real service to taxpayers and practitioners. The bill, as modified, will preserve the equitable aspects of carryover basis but eliminate from its impact the 98 percent of the estate tax population as to which the amount of appreciation is insignificant and as to which, therefore, the necessity for making the calculations involved is also unnecessary.

And now, I would be very pleased to respond to any questions which you might have.

Senator BYRD. Thank you, Mr. Lubick. I will ask just a few questions and then I will yield to Senator Hansen and Senator Dole.

As I understand it, you would—or Treasury does favor the bulk of the proposals in S. 2228, some with modifications.

Mr. LUBICK. I think the modifications are within the basic thrust of the provisions. They are very constructive steps forward.

Senator BYRD. What would be your attitude toward taking S. 2228, assuming the committee and the Treasury can work out an agreement on the modifications, and put that bill as an amendment to the technical corrections bill?

Mr. LUBICK. Well, we would be willing to do that, Senator Byrd, because, while these are substantive changes, you pointed out quite correctly that there was not the same opportunity for consideration by both Houses of Congress.

Senator BYRD. Well, there was not any consideration by the Senate Finance Committee, was there?

Mr. LUBICK. I do not believe so, Senator Byrd.

Senator BYRD. There was not any consideration by the Senate of the United States, was there?

Mr. LUBICK. Well, the Senate of the United States did pass the conference report, so——

Senator BYRD. Well, in the form of the conference report, but there was no consideration by the Finance Committee and there was no consideration by the Senate prior to the time that the conference report came to the Senate.

Mr. LUBICK. I believe that is correct.

So we are willing to go along with that on H.R. 6715. I think it would be appropriate, in particular, to allow practitioners to operate under the more liberal rules.

I would like to get that 98 percent of the population out of having to worry about the problem. I think that would be a tremendous step forward and if there is a way to expedite it, Treasury will certainly cooperate with you in doing it.

Senator BYRD. Well, let me ask you this. What damage would be done by deferring the time in which carryover basis would go into effect for 2 years, from December 31, 1976, to December 31, 1978?

Mr. LUBICK. First of all, it is inequitable. As I indicated, this was part of a package. We were giving estate tax decreases and I think this is an essential part of the package. I think you have worked out the problems, basically, with your amendments and there is no need to do it. I think we should get this in place, get our regulations out, allow the 2 percent or less of the population that is concerned with it to go ahead and we will continue as we do in all sections of the law to polish and work with practitioners to straighten it out.

We do not see having a process that enacts a package of revenue raisers and revenue losers and then the next year we go back in and we say, well, we will cut out the revenue raisers and push them back and we will keep the revenue losers. We look at that as a no-win proposition, at least for us.

Senator BYRD. Will President Carter be making recommendations to change carryover basis?

Mr. LUBICK. Well, the recommendations that I have made today, I think are the administration position. Are you asking a question as to whether he will recommend taxation of gains at death?

Senator BYRD. Yes.

Mr. LUBICK. He has not made up his mind on that proposition. I cannot answer that question.

Senator BYRD. Well, let us assume for the moment that he did. What effect would that have on carryover basis?

Mr. LUBICK. I do not think it would have any—other than repealing it, I do not think that it would have any effect at all.

Senator BYRD. Other than repealing it.

Mr. LUBICK. It would be substituting a system, but I think it would cause no particular problem for persons who died in the interim because along with Senator Hansen's suggestion, I think that no one would attempt to do this retroactively.

I do not even mean to imply that there is a chance that it will be imposed. I just do not know one way or the other and, in point of fact, he has not made a decision on that.

Senator BYRD. I will hold other questions which I want to ask until later in this hearing.

Senator Hansen? Senator Dole?

Senator DOLE. I have just one question.

There has been some proposal on an appreciation tax. Does the administration have a position on that?

Mr. LUBICK. No; we have not. I know the American Bankers Association has suggested that might be appropriate, and that is something that one might evaluate.

If one were to decide that one wanted to do anything further in this area, it may very well be that the decision would be to have a period of quiescence to work out the problems. But an appreciation tax is certainly something that commentators have talked about and one might think about again. I do not think that would have any impact on decedents who had been subject, in the interim period, to carryover basis.

Senator BYRD. Let me ask just one question at this point.

Is it not correct that there would be only a minimal revenue loss associated with a 2-year deferral of carryover basis?

Mr. LUBICK. Well, it is my understanding—and these are not our figures because we had a very short time, but these are the staff figures, that there would be about $36 million revenue in fiscal 1979. The longrun effect is $1.8 billion. The Byrd-Dole-Hansen and Hathaway amendments would reduce that. The longrun revenue effect of the marginal tax rate adjustment to basis is a $120 million reduction in revenues, and the $175,000 minimum basis is $90 million reduction annually. And the $75,000 minimum basis for principal residence which we propose is $30 million, so that creates a longrun revenue effect of $240 million.

In the short run, the problem is equity among similarly situated taxpayers and the principal problem—and the reason the revenue estimate is not more, of course—is that we have provided a transition through the fresh-start adjustment, and that relief, I think, is appropriate.

Senator BYRD. Thank you. Senator Hansen?

Senator HANSEN. I think maybe if I could, Mr. Chairman, I would yield to Senator Dole. He had a followup question.

Senator DOLE. I just have a couple of questions.

Testimony several months ago showed that it took the accountant about 12 hours and 15 pages of computations to figure out the carryover basis for an estate consisting of $200,000 in total assets with a mutual fund investment plan worth about $20,000, according to the testimony.

Would the bill introduced by the chairman of this subcommittee and myself and Senator Hansen will reach this problem? What can we do to take care of this?

Mr. LUBICK. I think you have taken care of that problem, Senator Dole. First of all, there is $175,000 minimum basis, so that in that particular estate—was the entire asset mutual fund shares, all $200,000?

Senator DOLE. I think that was it.

Mr. LUBICK. All right. So therefore, the basis immediately goes up——

Senator DOLE. There was $20,000 in mutual funds, with the total assets of $200,000.

Mr. LUBICK. I guess I would have to know the composition of the other assets. I am sure that the problem has either completely evaporated or become one of very small magnitude, because the $175,000 minimum basis leaves only a differential of $25,000 at the most. There would presumably be no Federal tax adjustment at all, because I am assuming that there was a surviving spouse, a marital deduction, and no Federal taxes payable.

I do not know whether there would be State taxes—that turns on the State—but I——

Senator DOLE. The point is, we continue to talk about tax simplification, but we keep adding additional provisions that require additional expense for the taxpayer. As I understand it, the carryover basis rule requires executors to report to the IRS a carryover basis on each item of property. I assume you are going to accumulate millions of reports.

Should there not be some exemption there to prevent this?

Mr. LUBICK. The statute does not require that all of these reports be filed with the Internal Revenue Service. I think all that is required is you give the Internal Revenue Service such information as the Internal Revenue Service may require by regulations, and I know from talking to the Commissioner about it, he is not anxious to accumulate paper.

In the regulations, we are going to try to work out this problem to minimize that as well. But I think, more than that, your bill has really completely broken the back of that problem, because when you have removed better than 98 percent of the population from the application of the problem, you have confined it only to those areas where you usually have professional fiduciaries who are able to handle the problem.

I think, really, you have done an excellent service in just defusing the whole situation. These provisions make it much, much more simple and confine it to those persons who will be able to handle it.

Senator HANSEN. If Senator Dole would yield to me, with your permission, Mr. Chairman, just on that point, I think it may be just a little bit deceptive to suggest that the problem has largely been overcome, though I agree with Senator Dole that the bill which he and Senator Byrd have introduced and which I cosponsored will be helpful.

I would observe that, in this area, when you talk about trying to produce all of the records and establish a carryover basis, from what I understand—I am not an accountant, but I have heard from a number of accountants who say that this is the most impossible situation that you can imagine. And to say that it is for practical purposes largely been resolved because it only affects 2 percent of the population, I think fails to take into account that by the very nature of income taxes, would it not be true, Mr. Lubick, a heck of a lot of people are not going to come under it, but for those who do come under it, it is almost an impossible situation.

I have gotten letters from accountants all over Wyoming, and some outside of the State, who say there is just no way, there is absolutely no way you can go back and establish a cost basis for estates. So it seems to me to say, well, it only affects 2 percent of the population, is really not to suggest or to make the point that we have solved the problem.

Mr. LUBICK. I think you are being too modest, Senator Hansen, as to what you have accomplished in your bill, because——

Senator HANSEN. We have not accomplished anything in the bill until it becomes law.

Mr. LUBICK. Well, that is right. But I think the letters you are receiving are dealing with a different situation. If your bill becomes law as we suggest, first of all, you would have removed the 98 percent. Second, by giving to personal residences the minimum basis of $75,000, you will have taken out, really, the only remaining extremely difficult area.

Let me review the common types of property which a decedent might have. First of all, he could have marketable stocks and bonds, and I do not believe that on marketable stocks and bonds there should be any real problem on establishing the basis, because you have to keep track of it today in case you sell.

Second, you have stock in a closely-held corporation. Now, really, there is not any problem there, because the corporation has to keep a balance sheet and the balance sheet has a capital account and that tells what was put in for capital and that is normally the basis for the stock.

Third, you could have investment real estate, and you have to set it on your books, for income tax purposes, what your basis is in order to take depreciation.

And fourth, you have a personal residence. As I indicated, I think that can get to be a little sticky because of the improvements. That is one of the reasons we responded in that area because that is one where you might not know.

Fifth, you have tangible personal property and that got the $10,000 exclusion and the $175,000 minimum basis. So I think those problems are significant.

Senator HANSEN. If I could interrupt just at that point, Mr. Lubick, let me observe that part of the energy package that we are working on now includes a number of credits and incentives to encourage people to install devices and modifications and insulation and one thing and another that hopefully would result in a savings of energy.

I would suggest that if that bill, indeed, becomes law, and I am ambivalent about whether it should at this moment, it occurs to me that you are going to find a heck of a lot of people who say we are that 2 percent whose problems have not been solved. Because I just do not think that if this has the applicability, apparently, that the Administration hopes that it might have, it is going to be very questionable that all of those millions of homeowners will keep accurate records, and I guess what you are saying is that they are going to be taken care of anyway with the $75,000 overall exemption.

Mr. LUBICK. Right.

Senator HANSEN. The way we are going, if you think 5 years from now that might buy you a good tent——

Mr. LUBICK. Well, I would assume, and I would recommend, if that indeed happens that you adjust the $75,000. I am not trying to impose burdens on homeowners that they cannot meet, and I recognize that problem.

Senator HANSEN. Historically, of course, I recall the old exemptions, the $30,000 and the $60,000 and it was a long, long time, during which much inflation had occurred, and I did not see any response to that on the part of Congress to make these allowances.

I apologize for taking up your time, but I just wanted to follow up.

Senator DOLE. I think you emphasized the point that I wanted to make. I have read your statement and there is a great deal of thought behind it.

Because of my agricultural interest, I want to get back to the farm provisions for a minute and see if I understand section 3(f) on page 11. Maybe it is not proper to treat crops and livestock as capital assets, but I do not think that the exemption which you have proposed does too much either.

I wonder if you could go through that section again, perhaps, to see if we are really providing some relief for the farmer. I understand that there have also been some problems with the special valuation provisions, particularly because of the 15-year lien on the property which makes financing difficult. Could you please comment on both these items?

Mr. LUBICK. I believe the special valuation, Senator Dole, is the farm itself. I do not believe the special valuation applies to crops and livestock. We are willing to work with you to make the special valuation work as best it can, but I do not think that has to do with the crops or livestock problem.

I think the problem of crops and livestock is that usually they have a zero basis because the farmer has expensed as he is permitted to do, the cost of the crop or raising of the livestock.

Senator DOLE. You indicate you are willing to accept a complete exemption from the carryover basis provision of livestock and poultry held by the decedent on December 31, 1976. Now, what does that actually——

Mr. LUBICK. Well, the reason for that is that fresh start is equal to the fair market value of that property on December 31, 1976, and the fresh start is calculated by taking the period that the livestock was held after 1976 and the period before and prorating it. And sometimes it is difficult to know exactly when the chicken is born.

Senator DOLE. It is hard to tell around here when the chicken was born.

Mr. LUBICK. So we are trying to eliminate that problem. It is not a long-lived problem, so it is just easier to take that out of the system.

Senator DOLE. How is timber treated? Is that covered in this section, or is that in another section?

Mr. LUBICK. Well, I do not think timber has any—timber real estate would——

Senator DOLE. That is still a capital asset?

Mr. LUBICK. Yes, sir; no changes.

Senator DOLE. There is one other area that is not specifically related to the bill, but is of interest to me. Senator Haskell and I, on last July 29 put a statement in the record on tax preparers. It relates to the Tax Reform Act of 1976 providing penalties where there is an understatement of tax liability, where there is negligence or intentional disregard of tax rules and regulations. The statement gets into a definition of rules and regulations.

If you look at the House Ways and Means Committee report and the Senate Finance Committee report on the 1976 Tax Act, it indicates that rules and regulations can include published IRS rulings. I do not know if you are familiar with this, but it is an area that we think ought to be corrected and, in fact, we thought we had clarified it some with the joint statement. It appears that the IRS in its proposed regulations under the provisions added by the 1976 act may ignore the congressional intent. We hoped to offer a technical amendment to the Technical Corrections Act to again demonstrate the intent.

It was our intention in our joint floor statement that rulings were not to be treated the same as provisions as Code or Department of the Treasury regulations.

I do not know if you could comment on that or not, but we would like to clarify that with an amendment at the appropriate time.

Mr. LUBICK. I am just a little bit familiar with the problem because I did not receive a letter on it. I referred it to the Internal Revenue Service.

I agree with you that rulings certainly do not have the dignity of regulations. I must say that, in my practice from time to time, I deliberately contravened rulings of the Internal Revenue Service when I thought they were wrong.

I do not think anybody should attempt to assess a negligence penalty where a taxpayer decides he wants to put in issue the validity of a ruling. That is why we have courts. The Internal Revenue Service may take one interpretation and the taxpayer takes another——

Senator DOLE. I do not want to raise it now, because we will be offering an amendment. At least it has been brought to the attention of the appropriate officials, and we appreciate your consideration of what we thought we clarified in a statement.

Thank you, Mr. Chairman.

Senator BYRD. In S. 2228, a minimum basis is established, but it does not give the executor the discretion to choose the assets which would be stepped up if the estate exceeds $175,000.

Is this the best approach, or would it be better to permit the executor to choose.

Mr. LUBICK. Well, we think this is really the best approach, but I think there might be limited areas which the executor could choose. For example, I do not think I would have any real objection if he decided he wanted to allocate some of it to his tangible household and personal effects if he thought he might be having some difficulty knowing that basis. But, generally speaking, I think when you are dealing with the mass of assets, the fairest way is to spread.

Senator BYRD. When section 303 was enacted, carryover basis was not in the Code. Does not the provision in S. 2228 conform to the intent of section 303 by permitting a section 303 redemption to cover income tax from the sale of carryover basis property as well as estate taxes?

Mr. LUBICK. Well, section 303 is in the Code to deal with a liquidity problem. Let's assume that stock of a closely held corporation is the major asset of a decedent's estate. In order to raise the money to pay the taxes which are due, he may not have sufficient assets other than the stock of the closely held corporation, and therefore he has to sell the stock of that corporation.

You cannot go out and sell a few shares of your closely held corporation because there is no market for it. No one wants to buy a minority interest. So the only market is the corporation itself.

Ordinarily, if you turn in a few shares to the corporation by way of redemption, under the normal rules of the Internal Revenue Code, that would be a dividend and would be taxable at ordinary rather than capital gains rates.

But to deal with that situation where the stock of the closely held corporation was a major asset of the estate, section 303 permitted shares to be turned into the corporation up to the amount of the estate taxes, both State and Federal, and funeral and administration expenses; those things which had to be paid.

It provided that that would be a capital transaction rather than a dividend. And this came in in 1954, I believe, and we did not have the very liberal provisions dealing with hardship to permit installment payment of the estate tax over a long period of time at really quite favorable rates of interest.

Again, I can just refer to my own experience in practicing law. This was a bonanza, as far as I was concerned, because just about every estate where we had a closely held corporation we made it perfectly clear that we wanted to qualify and that, whether you needed the money or not, this was your one opportunity to take money out of a corporation without it being taxed as a dividend.

Here was your chance to get money out as a capital transaction, rather than as a dividend. And I must say I have heard people talk about these cases where there was not sufficient liquidity—and I do not say that there are not such cases—but in my experience, I have not seen one where you could not work it out.

As a result, we are not suggesting that there be any change in section 303 for the amount necessary to pay the estate taxes. What we are saying is if you want to expand it, we do not believe that is necessary. We do not believe that there are cases of sufficient frequency that cannot be handled by the other liberalization provisions that were put in by the 1976 act.

There are very liberal provisions to permit the estate tax to be paid in installments, and the payment could be deferred until the taxpayer is able to be financially able to do it. I think we ought to try those devices to deal with the liquidity problem, and let's see if in actual practice there is a problem. My experience indicates to me that there is not the problem. I think the section, as it has been operating, has been used more for corporate bailout than it has for relief for liquidity.

Senator BYRD. Now, you are opposed to section 303(a), the grandfathering of pre-1977 assets, of S. 2228. The fresh-start provisions of the law is our major source of complexity. Also, the fresh-start basis works unfairly against property such as nonmarketable securities and real estate.

Is there not a need to remedy these problems; and furthermore, could not possible abuses be remedied by regulations drafted by the IRS?

Mr. LUBICK. I think if you tried to remedy all of the problems with grandfathering, we would have infinitely more complexity than you would have under fresh start because you would have to start tracing property through all of the highways and byways of closely held corporations. The fresh-start complexity I do not think is really particularly onerous any more, because I think there have been a couple of changes in the area.

One is the Technical Corrections Act, which in the case of tangible personal property, which is perhaps the area where it is most difficult to use the fresh start, allows a lookback formula, a discounting. You get to the fresh start from the date of death by a mechanical formula.

Now, some people are saying that fresh start does not operate properly. You have indicated the case of closely held corporations and real property. And the alternative in that situation, I suppose, is to go out and have appraisals as of December 31, 1976, which is much more complicated and expensive and maybe unnecessary when the property might have been sold before death.

The test-shot formula regards the appreciation as accruing ratably over the life of the asset. If the asset was acquired in 1974 and the death occurred in 1984, that was a 10-year holding period, and we say for the 2 years before 1976, 0.2 of the appreciation occurred then and the balance afterward.

Now, of course, as Senator Hansen points out, you can pick bad illustrations to show how anything could be difficult, and you could show me the case where there was a big appreciation between 1974 and 1976, and then business conditions in that particular industry turned around so that stock just did not grow at all. On the other hand, I could show you situations where it started out on a plateau and then all the appreciation, really, was post-1976. I think Congress wanted to avoid that when it adopted the pro ration formula. It said that fresh start is an additional relief provision we are giving for nonretroactivity and we are going to do it in a mechanical way so that we do not get into difficult problems. I think there are individual cases where it will be too generous or not generous enough, but, by and large, I think it operates pretty well and, in one area where there are some difficulties—the poultry and livestock—let's just take them out of the system.

On the tangible personal property, I think the Technical Corrections Act does provide for the discounting back which is, again, the technical way to handle the problem where somebody might have it. And the minimum basis for personal residence, again, is aimed at that other class of assets where we might have difficulties.

I think when you put together this package that you have carefully worked out in your bill, you have really gone 96 percent of the way down the road to make life, if not completely pleasant and enjoyable to a decedent's estate, at least bearable.

Senator BYRD. Well, you have laid great emphasis this morning on the fact that if the legislation under consideration is enacted that 96 or 98 percent of the estates will have their problem solved.

I happen to feel that we have an obligation, both you and the Congress, to be fair to the 4 percent or 2 percent or 1 percent of 0.1 percent whose problems are not solved.

Mr. LUBICK. I agree with that, Senator Byrd. I guess I am in that category myself, so I would like to have the problem solved. But I think what you have done beyond the minimum basis, that is your change in the tax adjustment, has solved the problems for most people.

That is not only my opinion. We have conversed with students of this matter who are practitioners around the country and tried out some of these things on them and tested them out. They have indicated that the provision will operate with no more complexity than is normal or inherent in all other provisions of the tax law—not all of them, but in the normal ones that people have to live with.

Senator BYRD. Just this morning I got a letter signed by six Senate colleagues, Senator McClellan, Senator Sparkman, Senator Muskie, Senator Allen, Senator Hathaway and Senator Bumpers. And I am not sure that this proposal outlined in this letter would fit into the Technical Corrections Act, but I would like to read it into the record and get your view.

It is addressed to me, as chairman of the subcommittee.

We understand you will be holding hearings later this week on H.R. 6715, the Technical Corrections Act of 1977. We would like to call your attention to a technical matter that you might consider appropriate for inclusion in this bill.

Section 207 of the Tax Reform Act of 1976 requires most farming corporations to change from the cash to the accrual basis of accounting for tax purposes. An exception was made for family corporations, but the definition for family was drawn in such a way as to exclude certain taxpayers whose situation is not materially different from many taxpayers who were permitted to continue to use the cash basis.

We brought this problem to the attention of the Senate last April and an amendment was agreed to at that time by a roll call of 85 to 11 to permit the excluded family companies to continue using the cash basis for all taxable years beginning on or before December 31, 1977.

This was, in effect, a one-year extension of the effective date of the 1976 Act. The rationale for the extension was simply that the President's Tax Reform package would probably come before us this fall, at which time there would be a chance to address these and similar issues of tax accounting and come to a final conclusion about them that would be fair to all similarly situated taxpayers.

By way of further explanation, I enclose a copy of the debate on the Senate Floor on the amendment that was agreed to last spring. The amendment is now Section 404 of the Tax Reduction and Simplification Act of 1977, P.L. 95-30.

As it turns out, of course, the President's Tax Reform proposal has not been submitted to us. The one-year extension is about to expire and it seems appropriate to seek a further extension so that the status quo can be preserved until the matter can be thoroughly reviewed in the context of a general tax reform.

We have therefore prepared an amendment to H.R. 6715 and are enclosing a copy of it. If you would look it over and consider including it in the bill at this time, we would be most grateful.

We also ask that this letter be made a part of your hearing record. There is a possibility that we may offer the same amendment to some other appropriate vehicle, if one becomes available before this session adjourns.

It is important to resolve the matter one way or the other before the end of the year.

Many thanks for your courtesy and cooperation.

Signed: John L. McClellan, John Sparkman, Edmund S. Muskie, James D. Allen, William D. Hathaway, Dale Bumpers.

Mr. LUBICK. Do you want me to comment on that, Senator Byrd?

Senator BYRD. Yes, would you comment on that?

Mr. LUBICK. Well, the corporations to which you are referring presently keep their books for non-tax purposes on an accrual method of accounting. They have to; they cannot get bank financing without it. We are talking about very large agricultural corporations. They do point out, quite rightly, that perhaps the resemblance between them and some of those that come within the family exception is difficult to justify, but on the other hand, the——

Senator BYRD. Now, wait a minute. Let me see—I am taking this from memory and it may not be correct, but it goes back to when the amendment was presented in the Senate which was some time ago.

But, as I recall it, under the present law, if there are two families involved, that corporation is exempt. But if there are three families involved, the corporation is not exempt. Is that about right, do you recall?

Mr. LUBICK. I think that is roughly correct. I think that two families that perhaps own 60 percent, or there are percentage requirements as well.

Senator BYRD. In this case, as I recollect, three families were involved instead of two families.

Mr. LUBICK. And there are some situations, I think, where you have one family and a pension plan—there were various combinations that were put in, and I think they dealt with poultry farms——

Senator BYRD. I think so.

Mr. LUBICK [Continuing]. Whose gross annual income, I think, ran anywhere from $85 to $120 million, I think it is just not possible to say that they are incapable of managing the complexities of accrual accounting, because they have to do it for their own internal financial accounting.

Other than——

Senator BYRD. What about the principle? Is there substance to the principle that—why would you say that a two-family corporation would be exempt, but not a three-family corporation?

Mr. LUBICK. I would say that a family corporation ought not to be exempt simply because it is a family. If it is a large corporation and is not exempted by the general rule that protects all corporations, the fact that the ownership is in one family or 500 families should not make any difference.

Senator BYRD. But is that not what the law specifies. The 1976 act, as I recall, gives the exemption based on the amount of the family ownership, on the numbers of families, not the size of the corporation.

Mr. LUBICK. The exception as it reads now is if 50 percent or more in value of the stock in a corporation is owned by members of the same family.

The original 1976 act had the one-family exception and then in the 1977 act the extender was put on to defer it where members of two families own at least 65 percent of the voting stock; or, if members of three families own 50 percent and substantially all of the balance of the stock beyond the three families was owned by an employee's pension trust.

You press me very hard, and I find it very hard to justify a differentiation between 1 family, 2 families, 3 families, 4 families, or 500 families. If the corporation is very large and has to run a business that involves $100 million a year and keep its books and do its banking and financing operations on an accrual basis, it seems to me that it is of no consequence who the owners are. It is the size of the operation and its ability to manage the complexity of the accrual method as opposed to the cash method which is the criterion that should be applied.

Senator BYRD. Now, what you just read, is that not what the Senators are seeking to have extended?

Mr. LUBICK. Yes; I think they are seeking another extension of the amendment which was added to the Simplification Act last April where, in this two- or peculiar three-family situation, there was a postponement of the applicability of the new accounting methods. We opposed it at that time and nothing has come to our attention since then to cause us to change our position. If you are large and you have $120 million of receipts from the sale of chickens, we think that you must have accountants who are able to keep their books on the accrual method of accounting. I do not think it should be overwhelming.

Senator BYRD. Thank you.

Senator Hansen?

Senator HANSEN. Mr. Lubick, when we are talking about the carryover basis, my recollection is that the Finance Committee specifically voted against adopting the carryover basis provision when it was raised by Senator Haskell during the Tax Reform Act markup.

The reasons given were the complexities and problems without adequate time to consider.

My question is, Would not a 2-year moratorium be an appropriate way to permit the Finance Committee and the full Senate to work its will and to try to resolve the difficulties and the complexities of this problem?

Mr. LUBICK. Well, I harken back to what I said originally. I think you have done an excellent job, Senator Hansen, in solving the complexities and difficulties which prevail. I think it is appropriate to go ahead, it is fair to go ahead. We gave the reduction in the estate tax. It was all part of the package.

I think that we should make the modifications you are suggesting and they would be retroactive to December 31, 1976. I think that there has been time and study since 1976. You have gotten the comments and you have responded to comments of practitioners. You have done it very well and I think we should enact your recommendations as we have proposed they be modified. And we are not going to stop. We are going to constantly seek perfection even though we will never achieve it.

Senator HANSEN. I would just observe that this is a subcommittee of the full committee. The full committee has not been exposed to the opportunities that we have had to hear testimony, and considering the urgency that is placed on the energy package, I do not know how successful we are going to be, Senator Byrd, in trying to get the full committee and the Senate to give the attention early on that I would hope is desirable and that I think would seem indicated.

Mr. LUBICK. Well, if we can get the language which you have proposed with our modifications, which have been drafted, enacted this year, we will continue to work with you to consider the situation starting——

Senator HANSEN. Maybe we can put a 2-year moratorium on death here.

Mr. LUBICK. I will vote for that, too.

Senator HANSEN. All right.

I do have one other question, Mr. Chairman.

You made some references to life insurance and, as I understand it, under present law, life insurance is not considered to be part of the carryover basis. Why do you propose to raise the minimum basis and then subtract life insurance?

Mr. LUBICK. I am not proposing that life insurance be made carryover basis property. I am simply saying that the $175,000 minimum basis is designed to take small estates out of the system. I can conceive of a situation where a person's taxable estate consisted of $1 million of life insurance and $175,000 of mutual funds which had $1,000 basis. I do not think that is the sort of situation where you intend to take the decedent out of the operation of the law by giving him a new basis of $175,000.

The reason life insurance is in the section is somewhat of a fluke. In that section which defines items that are not carryover basis property are a number of things other than life insurance which really are carryover basis property; things that were carryover basis property under section 691, for example, income in respect to a decedent, under another provision of preexisting law. These items were not integrated into this system. And, in point of fact, next year one of the things we might do is to integrate all of those sections.

I am just saying that I thought the minimum basis provision quite properly aimed to deal with the small estates and not benefit the very large estates.

Senator HANSEN. Mr. Chairman, I know it is an unusual procedure, but in trying to respond to queries that have been directed to my office, I have been working with Mr. Heinhold. Might he be permitted to enter into a colloquy with Mr. Lubick to explore this just a little bit further?

Senator BYRD. Yes.

Mr. LUBICK. I would welcome it.

Senator BYRD. Please identify yourself for the record.

Mr. HEINHOLD. Certainly. My name is James Heinhold, and I am a member of the Finance Committee staff.

Mr. Lubick, I think Senator Hansen's question related to life insurance and the minimum basis provision. The concern seems to be that, considering that life insurance was not included as carryover basis property under the 1976 act, that Senator Byrd's bill, by raising the minimum basis to $175,000, would go a long way toward solving much of the problem.

You seem to agree with that, and then you take it away with the other hand. You propose a minimum basis of $175,000 and then you take out life insurance, which is a major part of virtually all estates. The smaller the estate, the larger the percentage of life insurance.

Your example of a $1 million estate is not realistic, I do not think. Because if you have $1 million in life insurance the odds are you are going to have other assets well in excess of $175,000.

Mr. LUBICK. Well, I am not sure—I do not have $1 million in life insurance, unfortunately, but my estate is very largely life insurance and the other assets are not really very significant.

Mr. HEINHOLD. Would you consider yourself to have a very large estate?

Mr. LUBICK. I personally do not, but in terms of the statistics of income, I do.

Mr. HEINHOLD. If we are only aiming at the large estate, the point is that we should be——

Mr. LUBICK. I think you should be aiming at me.

Mr. HEINHOLD. Would your proposal to subtract out life insurance, would that not run the risk of putting people in a worse position than they are now, that if they had $150,000 gross estate, including life insurance, that if you take out the life insurance, it would be lower than it was before?

Mr. LUBICK. No. Perhaps I have not made myself clear. If you have $150,000 estate, if you have $160,000 estate or a $175,000 estate, gross estate, which includes the life insurance, you are out. You are not in the proposal. The life insurance is simply used as a measure in determining the size of the estate. You would not need to use the whole $175,000 minimum basis because the life insurance automatically is exempt from the carryover basis provision.

But let us assume the case with $150,000 of life insurance and $25,000 of stocks and bonds and those $25,000 of stocks and bonds had a $5,000 cost; $175,000 minimum basis would be reduced by the $150,000 of life insurance which would leave $25,000 of minimum basis left. The stocks and bonds would go to fair market value and the estate would not be subject to carryover basis. It is simply using the measure of what a small estate is and again, as I have indicated, that is 96.3 percent of the estates.

Now, I can point out, as an old estate planner, that I can get around the problem very easily. I can do what I have been advising my clients to do for years, and that is have the life insurance owned by my spouse. Then it is not in the estate.

But I think if you are trying to get out gross estates less than $175,000 I think the only way to do it is to consider the insurance in determining whether it is a small estate, and then you apply the balance of the minimum basis. The small estates will not be included. If you are $175,000 with or without life insurance, that size estate is out of the system.

Mr. HEINHOLD. Just one final question.

Since we have already said, or we know, that life insurance is not considered carryover basis, at the same time, something that you said a little while ago about lumping all of this together, or bringing all of this together next year in some sort of a tax package, is your proposal now to subtract out life insurance from the new minimum basis, is this the first step in the taxability of life insurance?

Mr. LUBICK. Absolutely not. Absolutely not. We are suggesting—and we do not believe that even in an ideal world these mortality gains in life insurance should be subject to tax. Nothing could be further from our mind.

Senator HANSEN. Mr. Chairman, thank you very much for permitting me to have the member of our staff raise the questions.

Mr. LUBICK. I will be very pleased to continue our discussions in private, too, because we are genuinely interested in working this out and making a provision which will operate smoothly and fairly for everyone. We appreciate your efforts in that regard very much.

Senator HANSEN. Thank you very much, Mr. Lubick.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Hansen.

Thank you, Mr. Lubick.

I might say that tomorrow we have scheduled some 16 to 18 witnesses. We will not be able to accommodate all of those tomorrow. I will ask the staff to try to work out a reduced list for tomorrow, and then we will carry over next week, schedule another hearing some time next week, for those witnesses we are not able to hear tomorrow.

I think that that many witnesses does indicate that there is quite a bit of interest in S. 2227 and S. 2228. We will hear as many witnesses as we can tomorrow, but I do not see how we could hear more than 6 or 7 or 8, but we will schedule another hearing for the next week.

Thank you, Mr. LUBICK. That does not involve you, but I wanted——

Mr. LUBICK. I want to thank you for giving me so generously of your time.

[The prepared statement of Mr. Lubick follows:]

STATEMENT OF DONALD C. LUBICK, DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY

Mr. Chairman and Members of the Subcommittee: I am pleased to have the opportunity to appear before you to present the Treasury Department's views on S. 2227 and S. 2228, introduced by Senator Byrd and Senator Dole. These bills relate to the carryover basis provisions (section 1023) added to the Internal Revenue Code by the Tax Reform Act of 1976 and certain other matters related to the taxation of estates. I shall also comment upon S. 1954, introduced by Senator Curtis.

S. 1954 would repeal the carryover basis provisions enacted in 1976. S. 2227 would postpone the effective date of the carryover basis provisions to the end of 1978.

S. 2228 would make a series of amendments to the carryover basis provisions by providing an increased minimum basis for carryover basis property, by changing the method of computing the tax adjustment for the portion of death taxes to be added to the basis of carryover basis property and by eliminating from the application of carryover basis all property held by a decedent on December 31, 1976. The bill would make certain other changes which I shall describe as I comment on them.

Before addressing specific provisions of the bills, it is in order to review the problems which led to the enactment of carryove basis. Under pre-1977 law, the basis of property acquired from a decedent was its fair market value for estate tax purposes in the estate of the decedent. The effect of the prior law was to eliminate entirely from income taxation all appreciation which had accrued during the lifetime of the decedent. The result of forgiving the tax on gain which had accrued prior to death was a very strong "lock-in" effect which constituted a severe impediment to the mobility of capital. The pre-1977 law created a major incentive for older persons to hold appreciated property until death and thus to escape income taxation on the gain. Even more important, the ability to escape income taxation entirely simply by holding property until death led to very different burdens of income taxation as between similarly situated taxpayers.

Perhaps this can be made most clear through a concrete illustration. Let us assume under prior law that two taxpayers, A and B, each own a share of stock worth $110 which cost each one $10. The result is that each held the property with untaxed appreciation of $100. Let us assume that each would pay a capital gains tax at a rate of 25 percent if the property were sold and let us further assume that the marginal estate tax bracket of each is 30 percent. A sells his stock and as he leaves his broker's office, steps in front of a passing truck and is annihilated. B was crossing the street at the same time to go into his broker's office to sell his stock but was annihilated by the same truck before he could arrive there.

A's stock was sold immediately before his death and B has the consolation of having died without having sold his stock. Under pre-1977 law, A's estate must file a final income tax return for the last year of A's life and in that must report his capital gain of $100 subject to a tax of $25. The $25 is subtracted from the $110 value of A's stock, leaving $85 subject to an estate tax of 30 percent. After subtracting the estate tax, the net proceeds received by A's heirs are $59.50.

Compare B's situation. Under prior law, there is no income tax whatsoever on the appreciation which existed at the date of B's death. B is simply subject to an estate tax of 30 percent on the $110 and his heir is left with $77. Under prior law, the share of stock which B owned could now be sold immediately without any income tax consequences. Thus, through the happenstance of B having been killed on his way into the broker's office as opposed to A on his way out of the broker's office, B's heir will receive $77 and A's heir will receive $59.50.

Let me give one further illustration of the inequity of prior law. Suppose that two taxpayers, X and Y, are each in a 50 percent income tax bracket. X invests $100 in a corporate bond which pays an annual interest rate of 5 percent, the net after tax proceeds of which are invested in a savings account earning 5 percent. Y invests $100 in a share of corporate stock which does not pay dividends, but because the corporation retains its earnings, has a growth rate of 5 percent annually. Both X and Y dies 10 years later. Because X has been receiving taxable interest of 5 percent annually, on which he has paid income tax of 50 percent, his estate is $128. This takes into account the compounding factor at a 2½ percent after tax rate. Y's estate compounds at a 5 percent rate of growth annually and is $163. Each is in a 30 percent estate tax bracket. The result is that X passes $89.60 to his heirs and Y passes $114.10 to his heirs.

There is a significant difference in the amount that X and Y can pass to their respective heirs because of two factors. The first is that the wealth accumulated through unrealized appreciation compounds at a faster rate because it compounds tax free and perhaps this is appropriate to encourage this type of investment. But second, and of greater importance, the earnings of X have all been subjected to income tax, but under prior law the earnings of Y escaped taxation entirely because of the step up in basis to fair market value at the date of death. This escape from taxation of appreciation through dying gave a large and unwarranted advantage to those who were able to accumulate large amounts of wealth through unrealized appreciation.

Perhaps the easiest solution to the problem is to require all taxpayers to settle their income tax accounts at least once in a lifetime. Obviously, the last opportunity for a taxpayer to settle his accounts once in a lifetime, if he has not done so previously, is at the last moment of his lifetime. For that reason, it has appeared logical to some to suggest that it would be appropriate to tax the gains realized by a decedent through the disposition of his property to his heirs at his death. The resulting income tax would be a deduction from the estate of the decedent and complete equity would result as between taxpayers who had sold before death and those who did not sell before that time, except of course for the deferral advantage which the taxpayer who did not sell enjoyed by having his gain accumulated and compounded without any earlier taxation.

Congress has not this far been prepared to enact legislation imposing an income tax upon property transmitted to one's heirs at death. Last year, however, Congress decided that it was appropriate to end the inequity of total escape of taxation on gains which were accrued during a decedent's lifetime, even though no taxation was to be imposed at the date of death. Instead, Congress provided for a carryover basis. That is, the basis of the property would not be stepped up to fair market value at date of death, but would continue, in the hands of the heirs, to be the same as that of the decendent. I should point out, parenthetically, that similar carryover basis provisions had been in effect in the law both as to gifts and as to items of income in respect of a decedent. Thus the carryover basis concept was not new, but was a familiar one. Last year's provisions were simply an extension of provisions already operative for many years.

A number in the Congress argued that the estate tax at death and the income tax on the appreciation at death, when taken together, imposed too great a burden on decendents. With that in mind, Congress evaluated the inequity of totally forgiving tax on appreciation which had accrued during a decedent's lifetime with a measurement of the proper burden of taxation on estates. It enacted carryover basis as part of a complete package with a number of liberalizing amendments to reduce estate taxes. For example, the estate tax exemption was converted into a credit which gives an exemption equivalent when fully in effect of slightly over $175,000 of assets, rather than prior law's $60,000. The marital deduction was liberalized to provide a minimum marital deduction of $250,000 where that amount exceeded one-half of a decedent's adjusted gross estate. A number of other liberalizations of the estate tax were enacted on the premise that carryover basis would be applied in order to end the complete escape from income taxation of appreciation accrued at death. The combination of estate tax liberalization and the enactment of carryover basis was part of a single package designed to create a fairer distribution of the burden of taxes at the time of a taxpayer's death.

Thus, we are completely opposed to S. 1954, which would repeal the carryover basis provisions. We are equally opposed to S. 2227, which would postpone the operation of carryover basis for two years. It is not reasonable to continue the beneficial part of the package, the liberalization of the estate tax provisions, and either eliminate or postpone the *quid pro quo* which was enacted to justify those provisions, namely, carryover basis.

Carryover basis is a solution to a difficult problem which has vexed and concerned the Congress for over 15 years. To repeal it or to postpone its effective date would be to take a major step backwards, to go back to a system which Congress recognized as operating inequitably. Either action would aggravate the inequity by leaving reduced estate tax burdens in effect for those persons who would, by such action, totally escape income taxation on gains accrued at the date of their death.

As I indicated earlier in my statement, carryover basis is not a novel concept in the tax law. It has existed since 1921 with respect to property transferred by gift and in the case of income in respect of a decedent, it has been in the law since the 1942 Act.

Nevertheless, Congress recognized that with the introduction of a new system, some transitional relief was appropriate. Congress, therefore, worked out a system to give a "fresh start" basis to property held on December 31, 1976. In the case of marketable bonds and securities, the basis of such property acquired from a decedent was to be not less than its fair market value on December 31, 1976. In case of property which did not consist of marketable securities, and hence was more difficult to value, a formula was instituted to give a rough approximation of the pre-1977 appreciation and that which arose after December 31, 1976, the effective date of the carryover basis provision. In effect, the fresh start basis eliminates in the hands of persons acquiring property from a decedent any income tax on appreciation accrued to December 31, 1976. Furthermore, in order to eliminate from the operation of the provisions of carryover basis those small estates which normally do not have significant amounts of appreciated property and as to which involvement in the estate tax system is unusual, Congress provided a minimum basis of $60,000. To the extent an estate acquired assets from a decedent which have a basis of less than $60,000, the basis generally will be increased to that amount.

The Congress also recognized that a decedent transmitting property to his heirs under a carryover basis system was transmitting with that property a contingent income tax liability on the post-1976 appreciation which had accrued at the date of his death. When the heir sold the inherited property he would have to pay the income tax attributable not only to the appreciation from the date of his own acquisition but also on the appreciation from the date of original acquisition from the decedent or, in the case of property held on December 31, 1976, from that date. Since it would be appropriate under a system which imposed income tax at the date of a decedent's death to make the income tax payable a deduction from the gross estate, it is appropriate, in a carryover basis system to compensate for the estate tax on an amount equal to the contingent income tax liability. The compensation for the putative overpayment of estate tax is accomplished by adding to the basis of the appreciated property an adjustment for the death tax attributable to that appreciation. The adjustment to basis compensates roughly by reducing the income tax at the time of the sale of the transferred property by an amount equal to the increase in the estate tax over the amount that would have been paid had the accrued gains at the time of testamentary disposition by the decedent been subject to income tax.

Since the enactment of the carryover basis provisions, the bar, accountants, the staff of the Joint Committee on Taxation and the Treasury have been reviewing the practical operations of carryover basis. Treasury has concluded that Congress by and large did a pretty good job of enacting carryover basis, although we concur with Senators Byrd and Dole that there are some significant improvements which can be made, to make it operate more equitably and simply. We were very pleased to see the provisions of S. 2228, because we believe they represent a reasonable and constructive approach to the practical problems of carryover basis. While there are a number of details in S. 2228, which we think require modification, we are in accord with the three major concepts of S. 2228, namely, liberalization of the minimum basis requirement, combination of the separate death tax adjustments into one and application of the new single death tax adjustment at marginal rather than average rates.

We believe that the bill introduced by Senators Byrd and Dole, if modified by suggestions made by our staff and by expert practitioners with whom we have consulted, takes care of all of the significant problems anyone may have with carryover basis.

The bill introduced by Senators Byrd and Dole provides a minimum basis that corresponds to the exemption equivalent of the increasing estate tax credit, rising to $175,000 by 1981. This will be a major simplification. It eliminates all estates which are not required to file Federal estate tax returns from the carryover basis provisions. Thus, 98 percent of the population, or more accurately the ex-population, will not be affected by carryover basis. At the most, only 2 percent of all decedent's estates will be concerned with carryover basis. In point of fact, it is likely that many of the 2 percent will not have the problem because those estates will be composed largely of liquid nonappreciated assets.

We also believe that rolling the Federal and state tax adjustments into a single computation, to be applied after the minimum basis adjustment, will result in great simplification. Moreover, we concur that the application of the adjustment at marginal estate tax rates is the correct solution, since the income tax deduction which would have been applicable had the property been sold immediately before death, or had an income tax been imposed upon the transfer at death, would have been a deduction at the marginal estate tax rate.

We also favor relief in one case beyond that encompassed by the Byrd-Dole bill. We suggest a special minimum basis of the first $75,000 of the fair market value at date of death for a home occupied by a decedent at the time of his death as his principal residence. The comments we have received and the testimony we have heard indicate a personal residence is one of the areas where taxpayers have experienced difficulty in calculating basis and determining holding period. It is not usually difficult to know what price a decedent paid for or when he originally acquired his residence, and it may even be ascertainable from public records. On the other hand, many persons do not keep track of improvements made after original acquisition. To relieve those persons from difficulty in ascertaining basis where the value of their residence is such that they are not likely to be able to afford professional advice in reconstructing their basis, we propose a minimum basis for a principal residence. This is similar to the $10,000 exclusion applicable to personal and household effects. We point out also that a minimum "fresh start" basis for tangible personal property will be determined by a formula under the Technical Corrections Act which we discussed before this Subcommittee yesterday. Enactment of these changes will eliminate most of the difficulties low and middle income taxpayers will have in establishing basis for their property. The minimum basis for residences and tangible personal property would, of course, be a first charge under the liberalized minimum basis Senators Byrd and Dole propose and which we endorse.

Let me know review S. 2228 section by section to suggest the modifications we believe would make it a workable and acceptable improvement over present law. Again, let me point out that, for the reasons I have already stated, we are opposed to both S. 1954, the repeal of carryover basis, and S. 2227, the postponement of the effective date. Senators Byrd and Dole have demonstrated that it is possible to make relatively straightforward amendments to carryover basis which make both the repeal and the postponement unnecessary and undesirable. Enactment of the Byrd-Dole amendments, as modified by our suggestions, will not signal an end to our efforts to make the administration of the carryover basis provisions as simple and equitable as possible. We at the Treasury, as well I am sure as the staff of the Joint Committee on Taxation, will continue to work with bar, the accounting profession and professional fiduciaries to see where further improvements can be made to ease administration of the law. We are confident, however, if S. 2228 is modified as we propose, we will have a truly workable carryover basis provision that will affect only that part of the population which is able to manage any problems it might cause.

The first substantive provision of S. 2228 is section 3(a), which repeals the fresh start adjustment and eliminates from the applicability of carryover basis all assets held by a decedent on December 31, 1976. As I indicated earlier, we strongly oppose this provision. While it may be appropriate through the fresh start adjustment to permit the escape from taxation of appreciation which arose through December 31, 1976, there is surely no reason to permit the escape from income taxation of appreciation which arises after that time. To grandfather all pre-1977 assets would increase the undesirable "lock-in" and create great inequity between similarly situated taxpayers with respect to their continuing post-1976 appreciation. Moreover, enactment of a grandfather clause applicable to all assets held on December 31, 1976 would be subject to great abuse. Let me give you an illustration. Suppose a taxpayer has a closely held corporation, the stock of which he acquired just before December 31, 1976. There is nothing to prevent him from having his corporation acquire assets after December 31, 1976 and thereby completely escape the carryover basis provisions with respect to property acquired after 1976. The stock of that corporation, and presumably all of the value which it represents, would under the bill be exempt from the carryover basis provisions. Furthermore, the benefits of estate tax reductions were given to those assets which we in the hands of the decedent on December 31, 1976. If those asests are exempted from the carryover basis provisions, they should also be excluded from the estate tax reductions which became applicable following 1976. The Byrd-Dole bill in its other provisions simplifies carryover basis so much that we do not believe the grandfather provision is necessary or appropriate.

Section 3(b) of the Byrd-Dole bill increases the minimum basis along with the corresponding increase in the estate tax exemption equivalent. As I have indicated, we approve so long as the minimum basis is reduced not only by the basis of all carryover basis property, but also by the proceeds of life insurance included in the estate. The Byrd-Dole bill accomplishes its purpose of eliminating small estates from the operation of the carryover basis provisions. However, to avoid abuse of the new provision, account must be taken of assets which are included in the estate but are not carryover basis property. The only significant one of these is life insurance proceeds and therefore the minimum basis should be reduced by life insurance proceeds included in the estate. To do otherwise would be to give a minimum basis to other assets of a taxpayer who might have $1 million of insurance on his life and whose estate would be very large. Of course, the Subcommittee is aware that generally any gain realized from the proceeds of life insurance is free of income tax under existing law and that exemption for life insurance proceeds would continue.

Section 3(c) of the bill provides for a single adjustment for Federal and state estate and succession taxes at the marginal rate. The bill provides that this adjustment should follow the minimum basis adjustment and should be allocated to all appreciated property including marital deduction property and property contributed to charity.

We endorse the general concept of a single adjustment for Federal and state taxes at the marginal rate and an adjustment which follows in order the minimum basis. We have serious problems, however, and practitioners with whom we have discussed the matter concur, with extending the adjustment to property used to fund the marital deduction, a charitable deduction, or the orphan's exclusion. Inasmuch as property which funds the marital or charitable deduction or the orphan's exclusion does not bear any death tax it is inappropriate to give it a basis adjustment.

We suggest that the tax adjustment be computed as follows. We would first calculate the Federal estate tax attributable to appreciation. We do this by computing the gross Federal estate tax on the actual taxable estate, before any allowance for a credit for state taxes, and then we would subtract a hypothetical tax on a taxable estate reduced—not below zero—by the net appreciation—combining post-1976 carryover gains and losses. The difference is the Federal estate tax attributable to the appreciation. One could compute state taxes in a similar way, but we believe it would be unduly complicated because of variations in the base to which state taxes apply. We, therefore, suggest that the proportion of state taxes (in excess of the Federal credit) attributable to the appreciation be the same as the proportion of Federal estate tax that is attributable to the appreciation. We would then combine the dollar amount of Federal and state taxes applicable to the appreciation and divide that dollar amount by the gross appreciation in the estate or if less, the taxable estate. We then apply the rate resulting from such division to the appreciation in each item of carryover basis property included in the taxable estate. When any item of carryover basis property is actually used to fund a deductible marital, charitable or orphan's bequest the adjustment for taxes, which is the last adjustment added, would not apply. The reason for precluding a tax adjustment with respect to property which does not bear any tax is to avoid a doubling up of benefits for that property.

Where there is no Federal tax on the estate at all, we propose two rules for state taxes. If the estate is not required to file a Federal estate tax return, i.e., if it is under $175,000 when the new credit is fully effective, we would give no adjustment for state taxes. In this case, the minimum basis adjustment will take the whole estate out of the system. If the estate is required to file a Federal return but there is no Federal tax, the state taxes will be pro rated in the ratio that net post 1976 appreciation bears to the total estate.

As I indicated before, we agree with section 3(d) of the bill which provides that the minimum basis adjustment is to be made before the adjustment for death taxes attributable to appreciation.

Section 3(f) provides for capital asset treatment for objects of art, literary assets and the like, which in the 1976 Act lost capital asset status in the hands of an heir. We agree that such assets should not lose capital asset status solely because they have become carryover basis property. Of course, if they would be non-capital assets in the hands of the heir without regard to the decedent, they should retain that characterization on the basis of the circumstances of the heir.

Section 3(f) would also treat crops and livestock which are carryover basis property, as capital assets. We do not believe it is appropriate to make crops and livestock, which are almost invariably inventory property, capital assets in the hands of one engaged in the farming business. In the case where the crop or livestock would be a capital asset under the circumstances of the heir, it would have capital asset status. We would, however, be willing to accept a complete exemption from the carryover basis provisions of livestock and poultry held by the decedent on December 31, 1976. This presents a different issue from the general grandfathering provision because it will phase out very quickly. Most livestock and poultry held on December 31, 1976 will be disposed of within a very few years after 1976 and therefore it is desirable to avoid the complication of calculating a fresh start adjustment with respect to that property.

Section 4 of the bill deals with a simplification of the contemplation of death provision of the 1976 Act and was the subject of our testimony yesterday. Under section 4 of the bill, the gross estate would include gift taxes paid and life insurance contracts transferred within three years of death, as well as the value of any property which would have been included in the decedent's gross estate under section 2036 and 2038 by virtue of a retained estate or power if the decedent relinquished that estate or power within three years of death. All other transfers within three years of death would not be included in the gross estate. We agree that this is an appropriate amendment if there is also included in the transferor's gross estate the value of the property which would have been included under section 2037 where a reversionary interest is relinquished within three years of the transferor's death. The reason for this is that the new unified rate schedule operates well in the case of outright gifts, but operates only imperfectly in the case of split interest gifts. It is therefore necessary to bring those transfers, along with life insurance, back into the estate.

We also indicated yesterday that it would be necessary to include in the transferor's gross estate cash and the basis of other property transferred within three years of death for purposes of the new Byrd-Dole minimum basis adjustment. Otherwise, there would be a strong incentive for a decedent to make death bed transfers of cash and other high basis assets to manipulate the minimum basis adjustment to his advantage. For similar reasons we recommend that for purposes of special relief sections 303, 2032A, 6166 and 6166A only, the percentage qualification requirements should be calculated by including in the gross estate the gift tax value of any property transferred within three years of death. For example, in determining whether closely held stock constitutes a sufficient portion of a decedent's estate to qualify it for the special redemption provisions of section 303, the percentages should be calculated with reference to the estate inclusive of transfers within three years of death. This would prevent transferring assets out of the estate to qualify in a situation where the illiquid property is really a minimal portion of the decedent's predeath assets.

Section 5 of the Byrd-Dole bill provides that eligibility for estate tax special use valuation for farms and closely held business real property is not to be lost on account of the material participation requirements under certain circumstances where because of age, status as a minor, or other handicaps, it is necessary for the farm to be leased or operated by a manager. We do not object to this change since it is consistent with the concept of special use valuation.

Section 6 of the bill provides that the estate shall succeed to the decedent's unused net operating or capital loss carryover. We oppose the extension of net operating loss carryovers to the estate. Such extension has little to do with carryover basis and is inappropriate. The effect could very well be to allow artificial losses generated through tax shelter investments to continue beyond the decedent to his estate.

On the other hand, there is logic to allowing the capital loss carryover to go forward into the estate where it can be used to offset gains which may be realized by the estate on carryover basis property. We would therefore not object to extending the capital loss carryover of a decedent to his estate. It would, however, be inappropriate to allow the decedent's capital loss carryover to flow from the estate into the hands of the heirs, where it could be used to offset the gain on property of the heirs which was not carryover basis property of the decedent.

Section 7 of S. 2228 would liberalize the amount of stock which would be redeemed under section 303 at capital gains rates rather than being treated as a dividend. As we indicated in our testimony yesterday, this amendment is inappropriate on the merits. The purpose of Code section 303 was to permit a limited bail out of earnings, which would normally be taxed as a dividend, to the extent of death taxes and funeral and administration expenses. In my experience practicing in this field since 1949, and in the experience of other practitioners with whom I have spoken, we have found that section 303 is used primarily as a one time opportunity to bail out corporate earnings and profits without regard to real liquidity needs. The 1976 Act introduced liberalized and generous installment and postponement of payment provisions. Therefore the extension of section 303 is unnecessary and unwarranted.

Section 8 provides that the definition of a closely held business is to be the same for purposes of section 6166 and 6166A, which relate to extensions of time for payment of estate tax attributable to a closely held business. We do not object to the change in this section.

We would also like to call to your attention one other problem that has arisen as a result of carryover basis in the practical world of estate planning for stockholders of closely held corporations. It may be illustrated by the not infrequent situation of a corporation, the stock of which is owned by two stockholders. It is normal practice to provide that upon the death of one of them the corporation will redeem his stock leaving the other stockholder in sole control. In that way the heirs of the stockholder who dies first have a market to liquidate their investment. At the same time strangers to the survivor are not introduced into the management of the business. It is usual to fund these arrangements by life insurance purchased by the corporation. An alternative arrangement to a redemption by the corporation is a cross purchase agreement, whereby each of the two stockholders insures the life of the other and agrees to use the proceeds of insurance to buy the stock of the other. With the enactment of carryover basis, in many cases it becomes more advantageous to use the cross purchase arrangement because the surviving stockholder will then receive as the basis of his newly acquired stock the purchase price, which is represented by the proceeds of the insurance. If the stock were redeemed by the corporation, any basis represented by cost of the purchase would simply be lost. The advantage to the survivor in obtaining the higher basis is greater in a carryover basis world, since after he too dies, a higher basis would be available to his heirs.

In order to change pre-existing funding arrangements it may be necessary to transfer existing insurance policies owned by the corporation to each stockholder. Under section 101 of the Internal Revenue Code, the transfer of insurance for a valuable consideration results in a loss of the income tax exclusion of the life insurance proceeds when received by the beneficiary unless the transferee is within certain enumerated categories. These categories include the insured himself, a corporation of which the insured is a shareholder or officer or a partnership of which the insured is a partner, but they do not include a shareholder of a corporation of which the insured is a shareholder. It is appropriate to permit rearrangement of these affairs by allowing the transfer of an insurance policy by a corporation to a shareholder if the insured is a co-shareholder of that corporation. We recommend legislation to that effect.

To summarize, we are very pleased that Senators Byrd and Dole have introduced constructive legislation to make carryover basis an administrable and equitable part of the income tax law. With the modifications we have suggested today with respect to the new minimum basis provisions and the provisions for tax adjustments, we believe that Senators Byrd and Dole will have performed a real service to taxpayers and practitioners. The bill as modified will preserve the equitable aspects of carryover basis but eliminate from its impact the 98 percent of the estate tax population as to which the amount of appreciation is insignificant, and as to which therefore the necessity for making the calculations involved also is unnecessary.

I shall be very pleased to respond to any questions which you may have.

Senator BYRD. This committee will stand in recess until 9 a.m. tomorrow.

[Thereupon, at 10:50 a.m. the subcommittee recessed to reconvene at 9 a.m. on Friday, October 28, 1977.]

TECHNICAL CORRECTIONS ACT OF 1977

(Including Carryover Basis Provisions)

FRIDAY, OCTOBER 28, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room S. 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senator Byrd.

Senator BYRD. The committee will come to order.

Today, the Subcommittee on Taxation and Debt Management Generally continues consideration of H.R. 6715, the technical corrections bill of 1977 and bills relating to the carryover basis provisions of the 1976 Tax Reform Act.

I am pleased that the subcommittee has received a large public response to these issues. I believe that it is vitally important to hear the views of practitioners and knowledgeable persons who are affected by tax proposals. Otherwise, we can be legislating in the dark, as was done in the enactment of the carryover basis provisions of the 1976 law.

In addition to the witnesses who have submitted requests to testify, I have also received several letters from groups interested in various provisions of the Technical Corrections Act. This includes a letter from Merrill, Lynch & Co., and a letter from PGB industries.

I would like to have these and other letters of a similar nature in the record of the hearings; and, without objection, these will be so included.*

We have so many witnesses that we cannot hear them all today. We will have some 8 or 10 today and probably next Tuesday we will hear other witnesses who may wish to testify.

The first witnesses today will be a panel consisting of: Warren W. Lebeck, president, Chicago Board of Trade; Lee Berendt, president, Commodity Exchange, Inc.; and John W. Clagett, president, Futures Industry Association, Inc.

You gentlemen may take the witness stand and proceed as you wish. Welcome.

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*See app. A.

STATEMENT OF WARREN W. LEBECK, PRESIDENT, CHICAGO BOARD OF TRADE

Mr. LEBECK. Good morning, Mr. Chairman. I am Warren Lebeck, president, Chicago Board of Trade. First, let me thank you and your subcommittee for allowing me this opportunity to appear before you today. My remarks will be directed toward the provision in the Technical Corrections Act which would change the present law that allows a special 6-month capital gain holding period for all commodity futures contracts. The House-passed change would limit the application of the 6-month holding period to "agricultural" futures contracts only. The Board of Trade is very much opposed to this change for reasons which I will discuss.

Before proceeding to the proposed change relating to futures contracts, it may be helpful to briefly describe the Chicago Board of Trade. It was founded in 1848 and has grown to be the largest commodity futures exchange in the free world. More than 50 percent of all futures contracts traded in this country are traded on the floor of the Chicago Board of Trade. Last year, over $396 billion in futures contracts were traded on the floor, more dollar volume than was traded on all of the Nation's stock exchanges. And this year, the volume is even higher.

The exchange trades both agricultural and nonagricultural commodities.

If you were to look in the Wall Street Journal today, you will see that the futures contracts listed there for all exchanges have a relatively short life. With very few exceptions, the contracts will expire by the end of next year.

Because of the limited life of a futures contract, when Congress changed the capital gain holding period for capital assets from 6 to 9 months in 1977 and to 12 months thereafter, they retained the 6-month holding period for futures contracts. Otherwise, there would be very little incentive or opportunity for investors to choose the commodity futures market if they were interested in long-term capital gains.

Unfortunately, some question arose over the intention of the amendment providing for the special 6-month holding period for futures contracts when it was offered in the Ways and Means Committee. The proposed amendment in the Technical Corrections Act would restrict the special 6-month holding period to only "agricultural" contracts.

In theory and in practice, there is no difference between agricultural and nonagricultural futures contracts in the manner they perform their economic functions and the inevitability of short-term expiration.

The intent of the present law is simple and logical. Futures markets to be successful depend upon participation by those willing to assume economic risks. Those willing to assume such risks take very much into consideration the tax effects of the various investment mediums that are available. Thus, because futures contracts have a limited life, Congress made the correct judgment that retention of the 6-month holding period would permit futures contracts to compete fairly for risk capital.

Differentiating between types of contracts would only have the effect of artificially creating a significant difference between contracts.

The history of capital gains treatment of futures contracts is one of uniformity and that is as it should be. Any device which classifies contracts differently for tax purposes will almost certainly cause serious dislocations of capital.

I might add that our concern is shared by the Chairman of the Commodity Futures Trading Commission, who expressed his views in a recent letter to Senator Talmadge, chairman of the Senate Committee on Agriculture and Nutrition.

Therefore, Mr. Chairman, we urge the Senate to reject the House amendment limiting the 6-month holding period to "agricultural" futures contracts only. All futures contracts should be accorded a 6-month holding period.

If for some reason the committee does not reject the House provision, we respectfully submit that there are certain important changes which should be made to the provision. First, the effective date should be changed to make it apply only to contracts purchased or acquired after the date of enactment. The provision as now drafted would apply to sales or liquidations occurring after 1977, even though acquired prior to any announced change in the law.

Second, the term "agricultural" should be defined, either in the statute or in the committee report. It should be broadly defined to include raw agricultural commodities, processed agricultural commodities, timber and timber products. If it is not defined, the marketplace will be left in a state of confusion for a long period of time while the IRS develops its own definition. Even then, it could result in lengthy litigation. In this regard, we will be most pleased to submit to the committee staff specific language on a definition of "agricultural."

Mr. Chairman, this concludes my remarks. Thank you for your time, and again, thank you for allowing me to express our views before this subcommittee.

Senator BYRD. Thank you very much.

Mr. Clagett?

STATEMENT OF JOHN W. CLAGETT, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, INC.

Mr. CLAGETT. Mr. Chairman and members of the Senate Finance Committee, I wish to thank you for the opportunity to appear before you to make a statement with respect to H.R. 6715.

I am John W. Clagett, president of the Futures Industry Association, Inc. (FIA) New York, N.Y.

I would like to furnish a little background about the Futures Industry Association so that you can better understand our interest in the bill which is before your committee.

The membership of the FIA is comprised of large and small firms in the cash and futures commodity business. The primary functions of the FIA are to (1) prepare and disseminate educational material and statistical data; (2) raise the ethical and financial standards of the futures trading industry and (3) to give greater protection to the public, as well as individuals and firms that use or are affected by the futures market.

Since I have only 5 minutes, this is only a brief summary statement of our thoughts on this matter.

It is our belief that this committee should reject any amendment to section 1402(d) of the Tax Reform Act of 1976, which provides for a

6-month holding period for long-term capital gain or loss on all commodity futures transactions. To have a holding period of 6 months for agricultural commodities and a 9-month period in 1977 and a year period in 1978 for all other commodities will be disruptive to the futures markets and could well create a real hardship on individuals and firms that look to the futures markets for price insurance—through hedges—for commodities they produce, use, process, store or finance.

Two basic economic purposes of futures trading are (1) price discovery and (2) price insurance (hedges) against major adverse price fluctuation. Both of these important economic tools will be badly damaged if the public is discouraged or prevented from trading in the futures market because of a change in the holding period.

Futures contracts, whether they be agricultural or nonagricultural, have certain distinct differences from other capital holdings. The most significant difference is that while an ordinary capital item, such as a security or real estate, has an infinite life, a futures contract has a finite and relatively short life period.

We also believe that provision (s) of H.R. 6715, as passed by the House of Representatives should be rejected by your committee for the following reasons:

One, the amendment is substantive not technical.

Two, no hearing or debate was held by the House of Representatives on this aspect of H.R. 6715.

Three, all futures transactions whether for agricultural or nonagricultural commodities should be treated the same.

Four, public participation in the market will be diminished and will adversely affect futures trading and will in turn: (a) reduce volume of trading; which in turn will (b) reduce liquidity; and thus (c) reduce the benefit of competition to get an accurate price disclosure of the commodities traded.

Five, probably cause a significant number of commercial traders to use foreign markets to hedge copper, silver, gold, and other nonagricultural commodities. This probably will, in turn, reduce our balance of payments.

The volume of trading in nonagricultural commodities in 1976 was 8,892,389 futures contracts. It appears that the volume of trading in nonagricultural commodities will be greater in 1977.

If the amendment to H.R. 6715 is passed, it could have a very significant effect on the volume of trading in nonagricultural commodities by the investing public.

I thank you, sir.

Senator BYRD. Thank you, sir.

The next witness will be Lee H. Berendt

STATEMENT OF LEE H. BERENDT, PRESIDENT, COMMODITY EXCHANGE, INC., NEW YORK, N.Y.

Mr. BERENDT. Senator Byrd, members of the subcommittee, I am Lee H. Berendt, president of the Commodity Exchange, Inc., generally known as Comex. In terms of trading activity, Comex is the largest metals futures market in the world and the third largest futures market in this country.

I certainly appreciate this opportunity to appear before you today to speak in opposition to section 2(u) and discuss what I consider its very serious impact on our industry. This amendment proposes to limit the 6-months holding period exceptions for commodity futures contracts to "agricultural" contracts.

Mr. Chairman. I fully appreciate the time constraints which your committee faces in attempting to move H.R. 6715 through the legislative process as a necessary adjunct to the successful implementation of the Tax Reform Act of 1976. However, I must point out that this particular section of the bill really is not technical in nature. Rather, it is extremely substantive in its impact on our country's futures markets.

For this reason, I was particularly distressed by Mr. Lubick's testimony before your committee on Wednesday on behalf of the Treasury Department which suggested that the bill, as passed by the House of Representatives, encompasses only "essential technical clarifications of the underlying policy decisions embodied in the 1976 act." We must take issue with this judgment that totally disregards the factual situation, at least as it affects this particular section of the bill.

I would like to add that my views in this regard are also shared by the Commodity Futures Trading Commission, the Federal agency charged by Congress with the responsibility of overseeing futures markets.

Mr. Chairman, with your consent, I would like to submit, at this time, for the record a copy of a letter dated October 21, 1977, from Chairman William Bagley of the Commodity Futures Trading Commission to Senator Talmadge in his capacity as chairman of the Senate Committee on Agriculture, Nutrition, and Forestry, which committee has primary jurisdiction over these markets.

Senator BYRD. The letter will be included in the record.

[The material referred to follows:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., October 21, 1977.

Re H.R. 6715.

Hon. HERMAN E. TALMADGE,
Chairman, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The above measure, as you know, is before you in Senate Finance and would make technical and clerical adjustments to the Tax Reform Act of 1976. Also as you know, section 2(u) of H.R. 6715 would apply different capital gains holding periods for "agricultural" and nonagricultural commodity futures contracts.

While I am not concerned about the actual tax aspects of H.R. 6715, I am concerned about any tax distinction between different commodity futures which would falsely affect one market or another. I personally can see no rational reason for such a distinction but can see a skewing of liquidity and dislocation of capital disfavoring one large segment of commodity trading. Tax neutrality—i.e., no distinction—would appear to be the best policy.

Since your Agriculture Committee has general jurisdiction over all commodity futures traded and all CFTC regulated markets, it would seem logical for the Committee to study the impact of this proposal change. No committee of Congress has done so to date.

I pass along this suggestion personally as someone who now knows a little something about Commodity markets but also as a former chairman of a legislative Taxation committee who has dealt with the issue of "tax neutrality" over the years.

Sincerely,

WILLIAM T. BAGLEY.

Mr. BERENDT. At this time, Mr. Chairman, I would like to review what I consider to be the rather unusual history of this amendment and the fact that it is not technical but highly substantive and controversial; creates, for the first time in our history, a distinction in capital gains treatment which would be unfairly discriminatory and detrimental to certain contract markets; and is based on faulty reasoning. Let me explain.

The holding period for long-term capital gains treatment of futures contracts has always been uniform. Under pre-1976 law, futures contracts were subject to a 6-month holding period. The Tax Reform Act of 1976 increased the holding period generally for long-term capital gains treatment, but provided that "futures transactions in any commodity" would continue to be eligible for the 6 months holding period.

However, the report of the Ways and Means Committee on that legislation incorrectly described the exception as providing that "gains on agricultural commodity futures contracts are exempted from the increase in the holding period."

As a result of the confusion that resulted from the discrepancy between the report language and the language of the statute itself, an internal revenue ruling was issued. The ruling supported the clear language of the statute and continued a uniform tax treatment for all futures contracts.

The purpose of H.R. 6715 was to correct certain technical aspects of the Tax Reform Act of 1976. Comex supports that concept. However, section 2(u), by limiting the 6 months holding period exception to "agricultural" futures contracts would, for the first time, draw a distinction for tax purposes between different types of futures contracts.

H.R. 6715 passed the House under suspension on October 17, 1977. It is now pending before the Senate Committee on Finance.

Comex is deeply concerned that the consequences of such a discriminatory distinction were not fully considered, but passed as a technical amendment. The measure was not subject to hearings in the House or to any meaningful deliberation. It is like saying that different tax treatment should be afforded to investors in IBM stock as compared to investors in Xerox stock.

Comex believes that the subject amendment is far from being merely technical. It has enormous substantive significance. Discriminatory and unfavorable tax treatment may severely limit, and eventually might eliminate, the ability of those who produce, process, use, market, and finance metals to effectively hedge their transactions in these commodities in the United States.

The result could be the destruction of Comex as a viable institution, as well as impairment of the performance and capability of all other nonagricultural futures contracts. Contract markets—commodity exchanges perform a vital and extremely sophisticated role in the economy of the United States. My formal statement discusses this in detail.

In order for commodity exchanges to effectively perform their functions, it is essential that trading include substantial public participation. A futures market without public participation is unable to generate the trading volume that provides necessary breadth and liquidity.

If the amendment passed by the House becomes law, public investors will shift their interest from those commodity futures with a longer holding period and will tend to trade in those futures contracts that offer the possibility of a long-term capital gain after 6 months.

It should be noted that the bulk of trading volume in all commodity futures is in contracts having a maturity of less than 12 months. In addition, such longer term participation would not add liquidity to the market.

Hedgers generally are invoved in near- to mid-term maturities which would gain little benefit from public interest in trading maturities greater than 12 months. Eventually, hedgers would start to leave the market for more liquid competitive markets, and public traders would find less reason to remain. As further liquidity is siphoned from the market, commercial hedgers will tend to use the market still less.

This potential decline is even more of a reality to Comex since foreign hedge markets that actively compete for the same business will attract hedgers. The vicious cycle would continue, in that, even if the public disregarded tax treatment, it would go to the now more liquid foreign markets.

Comex believes that the underlying logic for distinguishing between agricultural and nonagricultural futures contracts is faulty. It has been suggested that because agricultural commodities have a growing season of less than 1 year, it would be impossible for hedgers to obtain long-term capital gains if the holding period was 1 year.

The flaw in this analysis is that hedgers realize ordinary income or loss as the result of futures transactions no matter what the holding period or the commodity.

Another justification for special tax treatment for agricultural futures contracts is that such commodities are perishable. This is a specious argument, since it is the futures contract which is traded and not the agricultural commodity itself.

Critically, the amendment does not contain any definition of what constitutes an "agricultural futures contract." There are a number of futures contracts in processed commodities such as those in frozen concentrated orange juice, soybean oil, and meal, lumber and plywood. These are nonseasonable, nonperishable products. What about futures contracts for cocoa and coffee which have no significant domestic crop, and animal products such as cattle, hogs, and frozen pork bellies?

The lack of definition is critical because it expands the potential impact to a broad group of futures contracts which combined with readily defined nonagricultural commodities, account for more than 50 percent of the total annual futures volume.

In conclusion, it is clear that section 2(u) represents a significant departure from present tax policy. The amendment is not technical but highly substantive, and will destroy the historically uniform, fair, and equal tax treatment afforded all futures transactions.

If Congress, in its wisdom, determines that such a change in fundamental tax policy is desirable, Comex thinks it should not be accomplished under the guise of a technical amendments bill passed in the waning hours of this session of Congress. Instead, such critical action should be the subject of separate legislation afforded full deliberation and study.

Thank you again, Mr. Chairman, for this opportunity to appear before you today. If you have any questions, I will try to answer them.

Senator BYRD. Thank you, gentlemen.

I might say, at this point, that the committee has received a letter from Senator Javits of New York, taking the same position that the panel has taken, and I will put that letter in the record at this point.

[The material to be furnished follows:]

U.S. SENATE,
Washington, D.C., October 27, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Senate Committee on Finance, Russell Senate Office Building, Washington, D.C.

DEAR HARRY: I am concerned about a particular section of H.R. 6715 which is presently before your sub-committee for consideration.

As you are aware, H.R. 6715, the Technical Corrections Act of 1977, was meant to make only technical and clerical adjustments to the Tax Reform Act of 1976 (Public Law 94–455). My concern relates to Section 2(u) of H.R. 6715 which is, for the first time, making a distinction in the tax treatment of the capital gains holding period between agricultural and nonagricultural commodity futures contracts. I believe that to make such a distinction would have a fundamental adverse impact on the liquidity and stability of the entire futures contracts market.

Such a distinction in the treatment of the capital gains holding period undoubtedly will cause a flight of capital from the nonagricultural commodity markets in this nation and would consequently cause an artificial and inflationary rise in the pricing mechanisms of the agricultural commodity markets. Conversely, it should be noted that to make no distinction in the treatment of agricultural and nonagricultural capital gains holding period would have no adverse impact on the agricultural commodity markets themselves.

In addition, such a distinction would be highly discriminatory towards New York City, where a vast majority of nonagricultural commodity futures contracts are traded, thereby creating a further flight of capital from New York. I understand that representatives of some of the New York commodity exchanges will be testifying before your sub-committee later this week.

I welcome your subcommittee's providing the opportunity this week for the issue to be aired on its merits (the first opportunity, I might note, in either the consideration of this measure or last year's Tax Reform Act for a discussion on the merits). In connection with the hearings, I would ask you to consult with the Government National Mortgage Association and the Commodity Futures Trading Commission in addition to the Treasury Department for their views of this issue.

As this is a substantive change in the law, not a technical one, I would urge you, Mr. Chairman, to seek deferral of action on this particular section until such time as its impact may be considered by the additional committees in both Houses of Congress with jurisdiction over the commodity futures markets and the Government National Mortgage Association. The Technical Corrections Act is not, I believe, the appropriate measure to be used for a change in the law that will have such a fundamental and widespread impact on the liquidity of our commodity markets.

I will appreciate your consideration of this request.

With best wishes.

Sincerely,

JACOB K. JAVITS.

Senator BYRD. Let me ask you this. When did it come to your attention that there was a proposed change in the law in regard to the tax treatment of commodity futures contracts?

Mr. BERENDT. Comex first learned of the intent to make this technical correction September 23. That was the date.

Senator BYRD. Did you have an opportunity to present your case to the House?

Mr. BERENDT. No, sir.

Senator BYRD. Does the panel as a group favor continuing the law as it is now?

Mr. BERENDT. Yes.

Senator BYRD. What groups favor the limitation only to agricultural commodities?

Mr. CLAGETT. I do not know of any.

Senator BYRD. Do any of you know how this limitation got in the House bill?

Mr. CLAGETT. No, sir.

Mr. LEBECK. The answer to that is we wish we did.

Senator BYRD. I agree with the panel that this is not, in my judgment, a technical correction. It is a very substantial change in the tax law.

Whether it should be made or should not be made is one aspect of it, but the other aspect is that it is not a technical correction. That being the case I, as one member of the committee, would favor eliminating this from the technical corrections bill and if those that favor the proposal that is currently in the technical corrections bill want to make a case for it at some future date, I will listen to it with an open mind.

But, at this moment, I do not think it is an appropriate proposal for a so-called technical corrections bill.

Thank you, gentlemen, for your testimony.

[At the request of Mr. Berendt the following communication was made a part of the record:]

E. F. HUTTON & Co., INC.,
NATIONAL COMMODITY DEPARTMENT,
New York, N.Y., October 26, 1977.

Mr. LEE H. BERENDT,
President, Commodity Exchange, Inc.,
New York, N.Y.

GENTLEMEN: We understand that you intend to testify before the Senate Finance Committee concerning the section of Bill No. HR 6715 concerning the tax treatment of capital transactions in commodity futures contracts whereby "agricultural" commodities would retain a holding period of six months for long term capital gains, whereas other commodity futures transactions would be treated in the same manner as other capital transactions.

Accordingly, as one of the leading commodity futures brokers on your Exchange and other Exchanges, we would like you to have our views on this subject:

The commodities futures markets are a very important mechanism in the movement of basic commodities from producer to consumer. This mechanism allows the producer, dealer, processor and user to shift price risks to others. The speculator pays for the privilege of accepting price risks that commercial users wish to avoid. Substantial speculative activity is needed in every market to provide the liquidity, as well as the risk capital, to enable commercial users to obtain good executions on sizable orders, which is necessary if futures markets are to serve the function for which they were created at the least possible cost to the commercial user.

The nature of commodity price moves does not normally encompass trends of more than 6 to 9 months and moves of such a length of time occur infrequently. If the holding period were extended to 12 months, it is likely that considerably less speculative capital would be made available to the commodities futures markets from individuals in high tax brackets.

Trading records show that the total volume of trading on commodities exchanges has gone from a value of $42. billion in 1960 to $820. billion in 1976. Further, governmental statistics show clearly that of the total volume, commercial users have increased their percentage to a substantial extent in recent years, while speculative activity as a portion of the total has dropped sharply. The commodities future markets need more speculative capital if they are to continue to perform their functions in the superb manner that has been exhibited in the past four years of violent price movement.

Accordingly, we believe it is vital that the holding period be kept at 6 months for all markets.

Furthermore, a review of the volume of trading, outstanding contracts, etc. clearly shows that the bulk of commercial positions are placed in delivery months that mature within 6 to 9 months and that very little commercial participation as a percentage of the total is in delivery months more than a year from the current date.

Anything that causes speculators to initiate positions in the most distant months diffuses the effect of the speculative capital, and could tend to make nearer months, where the bulk of commercial trading takes place, less fluid and less liquid than would otherwise be the case.

In any event, we strongly believe that all commodities futures transactions should have the same tax treatment. To give speculators the incentive to place funds in one group of markets as opposed to others is not fair treatment to the producers and users of non-agricultural commodities. Any severe loss of liquidity in such markets could result in increased costs of moving the commodity from producer to user. Furthermore, commodity futures markets do exist in other countries. Reduced liquidity in U.S. markets, for whatever reason, can lead to a shift in trading from U.S. commodities exchanges to exchanges in foreign countries.

While we have never seen figures on U.S. markets, recent statistics released in the U.K. show that the U.K. invisible earnings amounted to pound 247. million from commodity exchange operations in 1976.

Liquid commodities futures markets are important to the economy of the U.S., to the producers, handlers, processors and consumers of the United States, and we hope that the proposed legislation will be amended accordingly so that they may continue to provide the facilities which have enabled them to become the most efficient markets in the world and to insure that such facilities remain in the U.S.

Yours sincerely,

DAVID T. JOHNSTON,
Director and Senior Vice President.

[The prepared statement of Mr. Berendt follows:]

STATEMENT OF COMMODITY EXCHANGE, INC., NEW YORK, N.Y., PRESENTED BY LEE H. BERENDT, PRESIDENT

SUMMARY OF PRINCIPAL POINTS

Commodity Exchange, Inc. (Comex) opposes § 2(u) of H.R. 6715, which proposes to amend the Tax Reform Act to grant special tax treatment only to agricultural commodities.

The holding period for long term capital gains treatment of futures contracts has always been uniform. This uniformity was sustained in the Tax Reform Act of 1976, which allowed an exception for all futures transactions.

The amendment was passed without hearings or deliberation as a technical amendment. The amendment is, in fact, substantive and will result in discriminatory treatment.

(a) Unfavorable tax treatment will result in an inability of metals futures to perform their proper economic function as a hedging vehicle.

(b) Necessary public participation will shift to futures contracts offering more favorable tax treatment and adversely affect all non-agricultural futures contracts.

(c) Underlying logic for distinguishing between agricultural and non-agricultural futures contracts is not valid.

The amendment does not define the term "agricultural" which will lead to further confusion, ambiguity and questioning of the provision.

The distinction will cause a decline in trading activity in non-agricultural commodity futures and would have critical adverse impact on Comex, its members, the general financial community, New York City and State, and the consuming public.

Commodity Exchange, Inc. (Comex) is a designated contract market for futures trading in copper, gold and silver. In addition, the Commodity Futures Trading Commission, the Federal agency charged by Congress with overseeing the futures industry, recently approved the exchange's application for trading in zinc futures. In terms of trading activity, Comex is the largest metal futures market in the world and the third largest futures market in this country. During the twelve months ended June 30, 1977, 6,013,871 futures contracts were traded on Comex, accounting for 14.5% of the total volume of futures traded in the United States.

As the leading metals futures market, Comex respectfully submits this statement in opposition to § 2(u) of H.R. 6715 which proposes an amendment to Section 1402(d) of the Tax Reform Act of 1976 relating to the capital gains treatment of futures contracts. Comex intends to bring pertinent facts to the attention of the Committee that will clearly demonstrate:

That the amendment is not technical but highly substantive and controversial;

That a distinction in capital gains treatment resulting from the amendment would be unfairly detrimental to certain contract markets;

That the rationale for such a distinction is based upon faulty reasoning.

The holding period for long term capital gains treatment of futures contracts has always been uniform. Under pre-1976 law, futures contracts were subject to a six month holding period. The Tax Reform Act of 1976 increased the holding period generally for long term capital gains treatment, but provided an exception for "futures transactions in any commodity", which continued to be eligible for the six month holding period on a uniform basis. However, the report of the Ways and Means Committee on that legislation described the exception as providing that "gains on agricultural commodity futures contracts are exempted from the increase in the holding period". As a result of the confusion which resulted from the discrepancy between the report language and the language of the statute itself, an Internal Revenue Ruling was issued. The ruling supported the clear language of the statute, and continued a uniform tax treatment for all futures contracts.

As we understand it, the purpose of H.R. 6715 is to correct certain technical aspects of the Tax Reform Act of 1976. An amendment (§ 2(u) of the bill) offered in the Ways and Means Committee by Mr. Rostenkowski, would propose to alter the uniform tax treatment for futures contracts by limiting the holding period exception to "agricultural" futures contracts. This would, for the first time, draw a distinction for tax purposes between different types of futures contracts. H.R. 6715 passed the House, under suspension, on October 17, 1977, and is now pending before the Senate Committee on Finance.

Comex is deeply concerned that the consequences of such a discriminatory distinction were not fully considered but passed as a technical amendment. The measure was not subject to hearings in the House or to any meaningful deliberation. There is no reason or apparent logic for the creation of different tax treatment for absolutely like transactions. It is like saying that different tax treatment should be afforded to investors in IBM stock as compared to investors in Xerox stock.

Obviously, the authors of the Tax Reform Act of 1976 took into account that there were significant differences between the finite life of a futures contract and the longer term life of other investment vehicles. Futures contracts, whether agricultural or non-agricultural, have certain distinct differences from other capital holdings. The most significant difference is that an ordinary capital item, such as a security or real estate, has an infinite life, while a futures contract has a finite life that ranges from twelve months to a maximum of twenty-four months.

Nothing has developed during the intervening period to alter this conclusion. Certainly no record has been developed in this, or the last, Congress to support such a dramatic change in the law. Similarly, there has been no redefinition of futures contracts that would set apart a trade in an agricultural commodity and one in a non-agricultural commodity. Therefore, it would appear that the exception granted to all futures transactions is still valid.

Comex believes that the subject amendment is far from being merely technical; it has enormous substantive significance. Discriminatory and unfavorable tax treatment may severely limit and, eventually, might eliminate the ability of those who produce, process, use, market and finance metals to effectively hedge their transactions in these commodities in the United States. The result could be the debilitation of Comex as a viable institution, as well as impairing the performance and capability of all other non-agricultural futures contracts.

Contract markets (commodity exchanges) perform a vital and extremely sophisticated role in the economy of the United States. For the purposes of this statement, two highly important functions result. Through the mechanism of hedging, the market enables commercial interests to obtain low cost protection against adverse price fluctuations in the commodities in which they deal. In addition, the market provides price discovery, that is, a means by which commercial interests and the public can determine what the future value of a commodity will be through the interaction of market forces. While we have expressed these highly critical functions in basic terms, they are the result of highly complex and technical market forces that can be easily imbalanced, particularly by ill-conceived governmental action.

In order for commodity exchanges to effectively perform these functions, it is essential that trading include substantial public participation. A futures market without public participation is unable to generate the trading volume that provides necessary breadth and liquidity. Lacking these ingredients, hedgers cannot readily enter and leave the market without creating price distortions and thereby increasing the cost of hedging. Concommitantly, a futures market without public participation and hedger liquidity becomes a poor barometer of prices.

The history of futures markets indicates that there is frequent and strong correlated movement of most major commodity groups, when broad based trends develop in response to economic influences. If the amendment passed by the House becomes law, public investors will shift their interest from those commodity futures with a longer holding period and will tend to trade in those futures contracts that offer the possibility of a long term capital gain after six months. It should be noted that the bulk of trading volume in all commodity futures is in contracts having a maturity of less than twelve months.

If the expectancy of reward between an agricultural or a non-agricultural futures contract is similar, certainly it follows that the public trader will enter the market offering the potential of more favorable tax treatment.

At best, public participation in a futures market receiving longer term capital gains treatment would manifest itself in trading of contracts with a maturity of twelve months or more. To attract such participation, the prospect of a major long term trend would have to be apparent. Problematically, commodity prices rarely trend uninterruptedly, so that the sustenance of public interest would be difficult to maintain. In addition, such longer term participation would not add liquidity to the market. Hedgers generally are involved in near to mid-term maturities which would gain little benefit from public interest in trading maturities greater than twelve months. Eventually, hedgers would start to leave the market for more liquid competitive markets and public traders would find less reason to remain. As further liquidity is siphoned from the market, commercial hedgers will tend to use the market still less.

This potential decline is even more a reality to Comex since foreign hedge markets, which actively compete for the same business, will attract hedgers. The vicious cycle would continue, in that, even if the public disregarded tax treatment, it would go to the now more liquid foreign market.

While Comex certainly views these potential developments as having almost destructive impact on its metals contracts, the spillover into other markets must be noted. Other non-agricultural futures contracts would suffer the same consequences, although somewhat ameliorated by lack of direct competition from foreign markets. Moreover, since investment capital will flow to futures contracts afforded the most favorable tax treatment, a dislocation and disruption could occur in agricultural as well as non-agricultural markets.

Comex believes that the underlying logic for distinguishing between agricultural and non-agricultural futures contracts is unclear. It has been suggested that because agricultural commodities have a growing season of less than one year, that it would be impossible for hedgers to obtain long term capital gains if the holding period was one year. The flaw in this analysis is that hedgers realize ordinary income or loss as the result of futures transactions, no matter what the holding period or the commodity.[1]

Another justification for special tax treatment for agricultural futures contracts is that such commodities are perishable. This is a specious argument, since it is the futures contracts which are traded and not the actual commodities. Hedg-

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[1] *Corn Products Refining Co.* v. *Commissioner,* 215 F.2d 512 (2nd Cir. 1954). *See, also,* § 1233(g) IRC and Regulation §1.1233–1(6).

ing activities generally take place well in advance of crop harvest. Furthermore, it is frequently stated that a relatively small percentage of futures contracts are fulfilled by actual delivery of the commodity. The delivery figure most often quoted is some three percent of all futures contracts traded.

Critically, the amendment does not contain any definition of what constitutes an agricultural futures contract. This can only lead to market confusion and ambiguity in interpretation. There are a number of futures contracts in processed commodities such as frozen concentrated orange juice, soybean oil and meal, lumber and plywood. These are non-seasonal and non-perishable products. Substantial questions would be certain to arise as to the tax treatment of these contracts. Similar questions may arise regarding treatment of contracts for cocoa and coffee, which have no significant domestic crop, and animal products such as cattle, hogs and frozen pork bellies. The lack of definition is critical because it expands the potential impact to a broad group of futures contracts, which combined with readily defined non-agricultural commodities, account for more than 50 percent of total annual futures volume.

Of course, there are other factors that critically affect Comex and, to some degree, other markets dealing in non-agricultural futures contracts. The ramifications are extensive and would require more complete study. In brief, Comex would be faced with a decline in membership and revenue. The loss of income to remaining members and the general financial community will be significant as trading diminishes and business goes abroad. Obviously, another sector of unemployment would result.

These factors stretch beyond Comex and impact on New York City and State in terms of loss of jobs and tax revenues.

It is also likely that the consuming public would be faced with higher costs as hedging capabilities are impaired and costs rise for industry.

In conclusion, it is clear that § 2(u) of H.R. 6175 represents a significant departure from present tax policy. The amendment is not technical but highly substantive, and will destroy the historically uniform, fair and equal tax treatment afforded all futures transactions. If Congress, in its wisdom, determines that such a change in fundamental tax policy is desirable, then Comex submits that it should not be accomplished under the guise of a technical amendments bill passed in the waning hours of this Congress. Instead, such critical action should be the subject of separate legislation, afforded full deliberation and study.

For all of these reasons, Comex urges the committee to reject § 2(u) of H.R. 6715.

ADDENDUM TO STATEMENT OF COMMODITY EXCHANGE, INC.

While Comex opposes § 2(u) of H.R. 6715 in its entirety, it feels compelled to point out that, if the committee does retain this section, it unfairly is made retroactive in its application.

Subsection 2 of § 2(u) provides "the amendment made by paragraph (1) shall apply to sales or exchanges after December 31, 1977."

Since the subsection speaks of "sales or exchanges," it would apply to futures contracts previously established in 1977 and sold after year-end.

For example, under the amendment, an investor who, in July 1977, purchased a nonagricultural (sic) futures contract in the belief that after 6 months he would be entitled to a long term capital gain, would suddenly discover that he now must hold that contract for 12 motnhs [3] in order to receive a long term capital gain. However, it was not until September 23, 1977 that the public first nad nouce that Congress was ever contemplating such an amendment.

Comex cannot believe the House intended that § 2(u) have such retroactive impact. For these reasons, Comex urges that subsection 2 of § 2(u) be modified so that section will apply only to "gain or loss on futures transactions initiated after the date of enactment."

Senator BYRD. The next witness is Mr. Joseph Kartiganer of New York who is well known to this committee who has testified before and we are glad to have you again today.

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[3] See p. 49, House report No. 95–700.

STATEMENT OF JOSEPH KARTIGANER, PRIVATE CITIZEN

Mr. KARTIGANER. Thank you, Senator Byrd. It is a pleasure to be here.

As you indicated, I previously appeared before this subcommittee to talk generally about the estate and gift tax provisions of the 1976 act. That was on July 25 of this year when I was a part of the panel composed of Miss Blazek of Washington, D.C., Mr. Costello of your State of Virginia, and Mr. Eubank of Texas. As a panel, we discussed problems which we, as practitioners, had encountered with the 1976 act.

Senator BYRD. May I say at this point that your panel, the four of you, were most helpful to this committee and I want to express the appreciation of the committee for the tremendous amount of work that you have done on this problem.

Mr. KARTIGANER. Thank you, sir. We have considered ourselves a panel and we have had continuing discussions as proposals have come through the House of Representatives and bills have been introduced here in the Senate, and we have arrived at various consensuses for various bills.

I want to emphasize at this time that, as before, we are speaking as individuals. We have no authority to speak for any group of which we are members or committees which we chair, but we do believe we are representative of practitioners, and experienced practitioners particularly, throughout the country.

In the last panel discussion, we found that we spent almost 80 percent of our time talking about carryover basis. When you talk about the estate and gift tax provisions of the 1976 act, everything pales in comparison to carryover. We believe that carryover is a technical and administrative nightmare. It is confiscatory in nature; it is counterproductive in terms of venture capital, the retention of small businesses and farms and perhaps the capital markets generally; and it certainly runs counter to the trend throughout the country for the simplification of the probate process.

We believe, and we are unanimous in this recommendation, that carryover basis is unnecessary and regressive and we advocate repeal. We support Senator Curtis' bill, S. 1954.

However, we recognize that we are lawyers and cannot influence except in terms of technical comment the political process, so we have considered two of the bills that have been introduced, S. 2227 and S. 2228, both introduced by you and Senator Dole. Again, we cannot choose between them because we think the choice is essentially political, but we do believe that if carryover basis is retained, it is vitally important that it be fixed up.

You cannot leave taxpayers in limbo and cannot leave the situation as it is today, where nobody in the country knows what to do or how to do it. And if you are going to fix up carryover basis, we believe S. 2228 is a marvelous job. There are some flaws that we see but, by and large, it does as good a job as we think possible in fixing up the problems in carryover.

I would like to discuss S. 2228, not section by section but concept by concept.

I think the first important concept, one vital to the success of that bill, is the concept of grandfathering pre-1977 assets.

Grandfathering is important because it is practical. On of the major problems with carryover is the burden it imposes in terms of searching records to find out what actual basis was for assets acquired during a period when nobody thought that records had to be kept.

Grandfathering is fair. It eliminates the reverse indexing action of the current law which says that, if a person has an asset that remains relatively flat in value and is not a marketable security, the longer he lives, the more he loses. It is fair because it keeps the rules of the game intact. It says that people who acquired assets under the old law are not being told in the middle of the ballgame, "we are changing the rules." It says to people who require assets in the future, "you know what you are doing; play it by the new rules." And finally, contrary to Mr. Lubick's statement yesterday, I do not believe that I ever heard a complaint by a taxpayer about the unfairness of the old system. Theoreticians thought that there was unfairness and they may be right, but I believe that Mr. Lubick's approach in opposing grandfathering is to say that we are going to replace the theoretical, old unfairness with a very real, current unfairness of greater magnitude.

Perhaps most importantly, grandfathering is equitable and even-handed in its application. You have no need for special exceptions for special assets. For example, Mr. Lubick in his testimony yesterday spent quite a bit of time talking about an insurance bail-out to change entity purchase agreements to cross-purchase agreements. He does not talk at all about the problems of renegotiating those agreements, and there must be thousands, perhaps millions of them, throughout the country. Every one of them will have to be renegotiated and bargaining positions may well have changed.

Senator Hathaway's bill gives special grandfathering provision for preferred stock. I do not understand why he singles out preferred stock. Perhaps it is to save it from dividend or capital gains treatment when it is redeemed to pay taxes. But only some redemption agreements refer to preferred stocks. The majority of them refer to common stock. Are you going to have a special exception for common stock subject to redemption agreements? Grandfathering eliminates all of those problems because it treats all aspects equally.

Mr. Lubick also talked about two other objections to grandfathering. The first was that it creates an undesirable lock-in effect. I think that it is undeniable that there will be some increase of lock-in through grandfathering, but I do not think the lock-in increase will be significant. It will affect primarily the elderly. The young will still make investment decisions the way people have always made investment decisions and the elderly are locked in anyway because they want to keep their fresh-start adjustment. So the increase, if it exists, will not be of great magnitude.

The other problem Mr. Lubick addressed was the problem of the so-called aging of assets, taking new assets and turning them into protected assets by adding them to old corporations. I believe S. 2228 solves that problem by a specific grant of regulatory authority to the Treasury to prevent any significant addition to an existing asset in order to grandfather that addition.

The next major aspect of S. 2228, which we approve and are enthusiastic about, is the minimum basis provision which increases the minimum basis from the current $60,000 to $175,000. I gather from the comments that this has received unanimous approval; perhaps I should not spend too much time on it.

Treasury has come forward with what I think is a desirable improvement—I must say an unexpected one—in adding the $75,000 minimum for the family residence.

On the other hand, they propose reducing the $175,000 by the amount of the insurance owned by the decedent. The desirability of this proposal involves a policy decision rather than a technical one. The question is what you are trying to accomplish by the bill. Are you trying to impose carryover only on those estates which you consider large, in which case the Treasury proposal makes sense; or are you trying to eliminate recordkeeping for those estates which are too small to worry about, in which case the Treasury proposal is counterproductive.

The next major improvement that S. 2228 suggests is making the adjustment for estate taxes at marginal rather than average rates.

Again, I sense unanimous approval of that; Treasury supported it yesterday. I am reluctantly inclined to agree with Treasury that you have to resurrect the old concept of "property not subject to tax." Although the S. 2228 system has the benefit of simplicity, it works a material injustice and significantly increases the liquidity problems of estates.

We would suggest that the adjustment for basis and the so-called 691 adjustment be rolled together and that the 691 adjustments include State death taxes as well as Federal.

We approve the carry forward of losses provision. That is another improvement in carryover basis.

We suggest for the consideration of the committee concepts which are not in S. 2228.

One is an elective averaging of basis, elective on the part of the fiduciary and perhaps limited to assets which are being distributed to the beneficiaries (to eliminate the possibility of using it to minimize the taxes when you raise cash requirements). It is important in terms of eliminating discriminatory effects of the selection of assets to pass out to one beneficiary or another.

In terms of the prospective operation of carryover, we would like to see some provision which would except what we consider noninvestment assets. Everybody, when he starts out in life, thinks he is going to die a millionaire. That means that if he is going to cooperate with the provisions of carryover, he must keep records of everything he purchases. I think it is reasonable to ask him to do that with regard to investment assets. I am not sure it is reasonable, in fact I think it is unreasonable, to ask him to do it with respect to other assets.

We address also the problem of liquidity, which we think S. 2228 solves very well. We are very pleased with the position taken there.

Mr. Lubick takes a position with regard to the income tax provisions in the Senate bill, which indicates a fundamental hostility to the entire concept of section 303. In our experience, we have not found that section 303 is subject to any unusual abuse. All taxpayer relief provisions, to some extent, are taken advantage of. We do not think this is an unusual one.

By and large, we think most taxpayers do not want to take advantage of the deferral provisions. They want to pay their tax, and they will do it if they can raise the cash. Section 303 allows them to. But because carryover now imposes an income tax liability on that method of raising cash, we believe that 303 should include income taxes as a redeemable amount. In fact, we believe that the bill should be expanded to take into account the not insubstantial burden of State income taxes.

I do not want to take any time of the committee to talk at length about less substantial matters. I do, however, want to call to the attention of the committee that there are at least two areas which either have not been considered by the Senate bills or in H.R. 6715 or, if they are in the latter, are not adequately handled.

In the formal submission, we discuss the problems of disclaimers and transitional rules for generation-skipping purposes. We believe both of these items are important and deserve the attention of this committee.

Thank you, Senator. If there are any questions, I would be glad to respond.

Senator BYRD. Thank you, sir.

I gather from your testimony that you feel that the grandfathering of pre-1977 assets is a basic and extremely important part of S. 2228.

Mr. KARTIGANER. In the real world, Senator, the most serious problem for the clients—forget the lawyers—is the fact that they do not have records and there is no way of establishing what went on before. And to use a system of reverse indexing, such as used in H.R. 6715 and in the Tax Reform Act, I think is unfair. And the other inequities are important.

They are important to a substantial portion of the population, primarily the small businessman and the farmer.

Senator BYRD. What I am getting at is that if the grandfathering of the assets were eliminated from the pending bill, S. 2228, would it then be a satisfactory piece of legislation?

Mr. KARTIGANER. Removed entirely is your question?

Senator BYRD. Yes.

Mr. KARTIGANER. The answer to that, for me as an individual, would have to be no because it would leave problems of such magnitude, and would make administration of carryover basis so difficult, that I would rather stake my whole case on repeal.

Senator BYRD. Other than grandfathering pre-1977 assets, how could the fresh-start adjustment be made workable so that it does not discriminate against nonmarketable securities in real estate?

Mr. KARTIGANER. I am not sure that there is a way. I have thought about it.

One thing that would obviously have to be done is eliminate the fact that you get an adjustment for only gain purposes and not for loss purposes. I think that is relatively noncontroversial. That has been agreed to by everybody who talks about it.

Absent saying that you can go out and appraise everything as of December 31, 1976, which is worse than carryover to begin with, I do not know of any system, and the imagination of the people I have spoken with has not been able to come up with any system, which works with fairness and does not involve the so-called reverse indexing, which is the worst part of the fresh start; the longer you live, the more money you lose.

Senator BYRD. The longer you live, the more money you lose?

Mr. KARTIGANER. Yes.

Senator BYRD. That is the philosophy?

Mr. KARTIGANER. That is the philosophy of fresh start as applied to nonmarketable securities and nonmarketable assets, because it depends on the ratio of the pre-1977 and post-1976 time. The longer you stretch the post-1976 time, the lower the basis is, as a percentage of date-of-death value. You are on a treadmill just to stay even. If the value of the asset stays level, you are losing money. You are not increasing its value, and you are decreasing your basis.

Senator BYRD. In the testimony against the grandfathering of assets, Treasury uses as one of its arguments that this part of the bill could lead to possible abuses and could lead to complexities in drafting regulations. Your feeling, I gather from your testimony, is that it is not subject to abuse in any greater degree than any tax legislation would be subject to?

Mr. KARTIGANER. Senator, this problem has always existed. It is not new. When the Tax Reform Act of 1976 came out, this question of abuse was already there with regard to old assets and adding new assets to them. Lecturers throughout the country were talking about this great idea. We will age the assets.

That is a problem, whatever approach you take, a fresh-start approach or a grandfathering approach. There must be a grant of regulatory authority to the Treasury to take care of those relatively few situations which require complicated treatment.

I do not believe it need be statutory. The bill takes the right approach. It is a short, simple statement which says Treasury can look at it and decide where the areas of abuse are, and stop it. And I do not think it is reasonable to subject the great masses of the population to an inequitable bill because there may be some complications in drafting regulations to stop a very few who are abusing it.

Senator BYRD. Thank you very much.

Mr. KARTIGANER. Thank you, sir.

[The prepared statement of Mr. Kartiganer follows:]

STATEMENT OF JOSEPH KARTIGANER

Mr. Chairman and members of the subcommittee, on July 25 of this year, I, together with Ms. Blazek and Messrs. Costello and Eubank, appeared before this subcommittee to speak in general terms about problems which have arisen in the planning and administration of estates and trusts because of provisions in the Tax Reform Act of 1976. The four of us considered ourselves a panel and, since that hearing, we have continued to discuss the issues raised before and by your subcommittee and issues raised in connection with H.R. 6715, the technical corrections bill of 1977.

Upon being notified that your subcommittee would hold hearings on H.R. 6715, S. 1954 (introduced by Senator Curtis), S. 2227 and S. 2228 (both introduced by Sentors Byrd and Dole), and S. 2238 (introduced by Senator Hathaway), the panel decided that there were certain problem areas in the estate and gift tax field which are of such significance that there was need for the designation of a spokesman for the panel to appear again before your subcommittee and to recommend certain steps which we believe to be of overriding importance.

This submission, and my testimony, is our joint effort to record our recommendations.

As was the case in my prior testimony, I appear before you as an individual; I do not have, and indeed I did not seek, authority to speak either for the New York law firm of which I am a partner or for any committee or organization (other than the panel) which I chair or of which I am a working member. To the extent this submission or my testimony reflects and represents the views of the other panel members, this same disclaimer applies to them.

CARRYOVER BASIS AND RELATED PROBLEMS

Obviously, the most important problems in the new tax law originate from the concept of carryover basis. The provisions relating to carryover basis are extraordinarily complex; the resulting tax is regressive (it imposes a tax burden on small estates which never had an estate tax liability ever before the Tax Reform Act and substitutes a capital gains tax liability in "larger" estates which Congress hoped would be relieved of tax burdens); the tax discriminates against small and closely-held businesses and increases the likelihood that these businesses will be merged into larger, publicly-held companies; and the tax reduces and perhaps negates entirely the relief which Congress attempted to give to the small and closely-held businesses through other provisions. We are unanimous in our recommendtion that the simplest, most effective method of curing the problem of carryover basis is outright repeal. We support S. 1954.

As between the approach taken by S. 2227 and S. 2228, we as a panel were unable to secure unanimity. In attempting to choose between the approaches of these two bills, we are forced to assume that immediate repeal of carryover is not a practical possibility. S. 2227 offers the advantages of time to make a careful study of carryover basis (avoiding the rush and lack of consideration which were the hallmarks of the 1976 legislative process) and further opportunity to demonstrate that carryover basis (and its alternatives, AET and capital gains at death) are all unwise reactions to a problem which was magnified in the press and in some political quarters beyond all rational bounds. On the other hand, S. 2228 represents such significant improvements to the current rules of carryover basis that it is difficult to conclude that we should forego the opportunity for such improvement at this time in the hope of better things in the future; and the elimination of uncertainty (which would continue if S. 2227 were enacted) is in and of itself a desirable goal.

We are unanimous that, with regard to carryover basis, both S. 2227 and S. 2228 are preferable to H.R. 6715.

Putting aside the question of priority, we have made a preliminary review of the provisions of S. 2228 and comment on those provisions of the bill relating to carryover basis.

Grandfathering

We believe that the bill approach of "grandfathering" pre–1977 assets is a highly significant contribution to the solution of major problems in carryover basis. It solves the record search problem created by the 1976 Act; it eliminates the unfairness of attaching a new tax liability to previously structured arrangements and investment decisions; and, perhaps most important, it is equitable and evenhanded in its treatment of all taxpayers, regardless of the form of capital accumulation. We recognize that there is a possible economic effect in that it increases the "lock-in" potential, but we believe that this is a short-term problem, affecting primarily the elderly, and that it is a problem which already exists (in somewhat reduced form) under the "fresh-start" approach taken in the 1976 Act.

The need for "grandfathering" is demonstrated graphically by the convolutions the opponents of grandfathering must go through to do equity in the situations called to their attention (and, presumably, will go through in the future for situations they have not yet thought of). Thus, in his testimony before this Subcommittee, Mr. Lubick spent much time on the need to permit special treatment for life insurance when "entity" stock purchase agreements are changed to "cross-purchase" agreements; he does not, however, address the problems which will be inherent in any attempt to negotiate any single agreement between owners whose interests are now competing, let alone the untold numbers of such plans throughout the country. Similarly, Senator Hathaway, in S. 2238, provides a special rule for "fresh start" for preferred stock, presumably to avoid dividend or capital gains tax problems upon redemption; he does not, however, indicate why preferred stock should be singled out for special treatment over common stock which might be, and often is, subject to the same liquidity pressures and pre-existing purchase agreements. We reiterate: "Grandfathering" is practical, it is fair, and it is evenhanded—it should be adopted.

Minimum Basis

The provisions increasing the minimum basis adjustment to coincide with the amounts required for the filing of an estate tax return and causing this adjustment to be made before the estate tax adjustment are also significant improvements offered by the bill. The "small" estate, the estate which Congress intended to benefit by the 1976 Act provision relating to the estate tax, would be relieved of most, and perhaps all, the incredible complications introduced by carryover basis. Although complications would continue to exist for the larger estate, at least they would be limited to those estates better able to afford the professional help required.

Marginal Rate Adjustment

We commend the decision to make the adjustment for death duties at marginal rates rather than at average rates. Since it is the increase in the value of the asset which increases the estate tax, it should be the increase in the estate tax which measures the adjustment.

We note that several policy decisions were made with regard to this adjustment which may create technical difficulties and perhaps unfairness. For example, no account is taken of the differences between Federal and state taxing approaches; property not subject to tax may receive a basis adjustment; and the related "691 deduction" provisions take no account of state death duties paid by an entity other than the estate and, perhaps more importantly, require a two-step computation (first eliminating the estate taxes attributable to appreciation and then computing the estate tax attributable to the 691 income). We believe that other approaches, which may be simpler and would probably be more equitable, are available and should be considered. For example, the "property not subject to tax" concept of current Section 1023(f)(4) might be retained; and the basis adjustment and 691 deduction could be rolled into a single computation. However, because of the absence of time, we are unable to make a final recommendation on these points.

Carry-forward of Losses

The bill provision authorizing the estate to make use of unused loss carryovers is a provision which satisfies the requirements of elemental fairness and is highly desirable.

Again, we note some possible technical problems. For example, the exception provisions are too narrow (they are limited to losses attributable to property "held" by the decedent and should probably extend to any loss attributable to any property, whether or not held by the decedent, which reflects adjusted basis on December 31, 1976) and there should be a provision which eliminates the possibility of utilizing the loss carry-forward twice (once by the estate and once by a surviving spouse on the return for year of death).

Mr. Lubick, in his testimony yesterday, stated that Treasury opposes "allow-[ing] the decedent's capital loss carryover to flow from the estate into the hands of the heirs . . .", perhaps to be used against other gains. We believe this position to be lacking in merit. The heirs receive carryover basis property with built-in income tax liabilities and equity demands they receive the benefit of the losses; if they use the losses against other property, they will have lost an offset to the gain built into the inherited property (a position no different from that of any other taxpayer).

Carryover Basis Problems Not Addressed by the Bill

Two problems in the area of carryover basis not addressed by the bill relate to allocation of property among beneficiaries and the need for record searches in the future. As to the former, we urge that consideration be given to a provision which would authorize an election by a fiduciary to average cost basis among various assets so that the assets can be distributed to the decedent's beneficiaries without the inequities caused by differing cost bases. As to the latter, we urge consideration of a provision which would exempt from carryover basis "non-investment assets" (*e.g.*, the house, furnishings, cars, hobby items such as stamps and books, and the like) to eliminate the prospective problems of record-keeping and record searches. A grant of regulatory authority and, perhaps, a dollar ceiling, would prevent this approach from creating new "tax shelters."

We feel strongly that "grandfathering" of pre-1977 assets is the proper approach. However, if it is rejected, we believe that "fresh-start" should apply for gain and loss purposes (for reasons of equity and simplicity) and, in all basis adjustment provisions, references to "without regard to section 2032" should be deleted.

LIQUIDITY PROBLEMS

Closely related to, but analytically different from, the problems of carryover basis, are the problems relating to liquidity. Here, we are unanimous that S. 2228 repersents a significant improvement over the 1976 Act provisions and the provisions of H.R. 6715.

The approach taken by S. 2228 to Setcion 303, although not as generous as we would have liked, is a significant improvement over current law. We believe that the old Section 303 worked well andl we are not aware of abuses. S. 2228 resurrects the old percentages, 35 percent and 50 percent, but, as to the latter, applies it to a different amount. Under the old law, the 50 percent was applied to the taxable estate, the estate after deduction for marital and charitable transfers. The bill applies the 50 percent to the gross estate after deduction for debts and administration expenses, a significantly higher net figure, which makes it more difficult to qualify under Section 303.

Mr. Lubick, in his testimony yesterday, took a position hostile to the very concept of Section 303, labeling it a device used primarily for one-time bailouts of earnings and profits. From that viewpoint, his position on income taxes as a qualifying redemption amount is understandable. However, we dispute the accuracy of his perception. As stated, we have not, in our experience, seen Section 303 abused any more frequently than any other taxpayer relief provision and, in most cases, it provides the only method for securing needed liquidity. (As we testified in July, most taxpayers would rather not resort to the deferral provisions and would prefer to pay the taxes quickly if the funds are available.) The government, through carryover basis, imposed a tax liability in utilization of this relief, and we believe that it is equitable to allow redemptions to pay for this liability.

In fact, we note that the S. 2228 amendment to Section 303 refers only to Federal income taxes. We believe that it should refer to state income taxes as well.

With regard to the provisions relating to the extension of time within which to pay estate taxes, we commend the decision to make the definition of closely-held business in Section 6166A to conform to the definition in Section 6166. However, we urge that consideration be given to additional changes in these two deferral sections which would authorize the substitution of collateral for lien purposes and the tax-free exchange of properties: for the farmer and small businessman, such provisions would recognize the economic realities which must be faced by a decedent's family in attempting to continue the operation as a family enterprise.

Finally, we believe that the qualification tests in Section 2032A (special valuation for farms) and Section 6166 (15-year deferral for closely-held businesses) should be amended to change the qualification test to 50 percent of the gross estate or 65 percent of the taxable estate (as opposed to the current 65 percent of the gross estate).

MISCELLANEOUS PROBLEMS

Several other significant problems exist as a result of the 1976 Act which are addressed to some extent in H.R. 6715 and S. 2228. Other problems exist which are addressed in neither bill. This Subcommittee will hear testimony on many of these areas relating to both policy and technical considerations. I, as spokesman for the panel, would like to limit my comments to what we consider the more important areas.

Contemplation of Death

We are chastened to find that it is sometimes easier to make recommendations than to attempt to establish the technique for carrying them out. An example of this is the question of transfers in contemplation of death.

The panel had recommended that the whole approach to contemplation of death be changed in view of unification of gift and estate tax rates and that the three-year rule be eliminated except for the purposes of bringing back into the estate gift taxes paid with respect to transfers made within the three-year period, life insurance transferred within the three-year period, and retained life interests released within the three-year period. § 2228 adopts this approach.

However, upon reflection, we are concerned that the bill's approach, in its search for simplicity, overlooks complications and creates significant loopholes. For example, the relief provisions of Sections 303, 3032A, 6166 and 6166A all relate to the size of the gross estate. If the approach of S. 2228 is adopted, there would be a great incentive to make deathbed transfers of property not involved in the closely-held business in order to allow the interest in the closely-held business to qualify. We do not believe that this would be in accord with congressional intent.

A similar problem arises because of the possibility of a tax-free transfer to a spouse. If a deathbed transfer of $100,000 is made, the total amount which can pass to the surviving spouse free of tax is increased by $50,000. This may or may not be in accordance with congressional intent.

Finally, there appear to be technical problems with Sections 2037 and 2038 which must be addressed, and consideration must be given to whether the Section 2036 reference should be to interests released, rather than to interests held, within the three-year period.

If the approach of S. 2228 is not adopted, we disagree with the approach taken in H.R. 6715. That bill, because it makes includibility depend upon whether or not total transfers to a given individual in a single year would require the filing of a gift tax return, creates too much of an incentive to argue about valuation and to argue about what constitutes a gift. For example, should a Christmas gift of a necktie be added to transfers made to an adult son to bring the total amount of donative transfers from $3,000 to $3,010, thereby bringing the entire amount back into the estate? However, we do commend H.R. 6715 in its recognition of the problems created by "split gifts" made within three years of death, and urge that Section 3(h) of H.R. 6715 be adopted in that event.

Disclaimers

S. 2228 does not address the question of disclaimers at all: H.R. 6715 addresses them only in terms of a very limited problem, namely a disclaimer by a surviving spouse which results in the interest of the surviving spouse passing to a trust of which the surviving spouse is also a beneficiary. We commend the relief offered by H.R. 6715 to this limited problem. However, we believe that there is a more significant problem created by Section 2518, namely the questions relating to the disclaimer of powers of appointment and fiduciary powers.

Section 2518 defines a power as an interest and requires that, for a disclaimer to be effective, the disclaimed interest must "pass" to another person. Since, in the usual case, a disclaimed power "disappears" rather than "passes," we urge amendment to section 2518 to eliminate the "passing requirement" with regard to powers. We know of no policy reason why Congress should make the disclaimer of a power difficult, and perhaps impossible.

Transitional Rules for Generation-skipping Trusts

Neither H.R. 6715 nor S. 2228 addresses the unfairness in the 1976 Act's transitional rules relating to generation-skipping trusts. Separate hearings were held on this question by the House Ways and Means Committee and this Subcommittee will undoubtedly hear comments on this question during today's hearings. We will not belabor the obvious unfairness of applying retroactive effective dates nor will we belabor the unfairness of penalizing normal activities of individual taxpayers without giving them sufficient time within which the individuals and their advisers can learn the new rules. However, we urge this Subcommittee to give consideration to additional transitional rule relief which would take into account the uncountable numbers of individuals who, in ignorance of the provisions of the new law and without tax avoidance motives, executed new wills, codicils to old wills, new trust agreements or amendments to old trust agreements before the provisions of the 1976 Act were widely known.

Obviously, these are not all of the matters about which we testified in July or about which we are currently concerned. However, they do represent matters which we, as a panel, believe are of immediate and urgent importance to taxpayers, to practitioners and to fiduciaries.

Thank you very much for the opportunity to appear before this subcommittee.

Senator BYRD. The next witness is Mr. David Hardee, chairman, Committee on Carryover Basis, American Bar Association, Section of Taxation; accompanied by Mr. George Hauptfuhrer, immediate past chairman of American Bar Association, Section of Real Property, Probate and Trust Law.

First, I want to welcome each of you: and second, since I note that you are chairman, Mr. Hardee, of the Committee on Carryover Basis, it just occurred to me that it may be well for you, in beginning your testimony, to first define for the record so we will have it here in the committee hearing, define for the record carryover basis.

STATEMENTS OF DAVID HARDEE, CHAIRMAN, COMMITTEE ON CARRYOVER BASIS, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, AND GEORGE HAUPTFUHRER, IMMEDIATE PAST CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, ACCOMPANIED BY LIPMAN REDMAN, CHAIRMAN-ELECT, SECTION OF TAXATION, AND DORIS BLAZEK

Mr. REDMAN. Mr. Chairman, before we proceed, if I might, since my name does not appear on the printed program, let me be very brief and identify myself and identify also my role.

I am Lipman Redman, of Washington, D.C., chairman-elect of the Section of Taxation of the American Bar Association. My presence here is to make a few preliminary points and to express the regrets of the chairman of our section, Mr. John Pennell, of Chicago, who is participating in a tax institute elsewhere in the country and, because of the short notice of these hearings, was unable to extricate himself from that commitment. My presence is designed to underscore the interest of these two sections of the American Bar Association in the subject matter of carryover basis. Because we speak for two sections of the ABA, which sections represent 48,000 members, I would make the point that we operate within certain restrictions in the area of our testimony and written statement.

We have to follow various ABA procedures in order to be able to speak for these sections and, in these circumstances today, we speak only for these two sections and not for the American Bar Association generally.

Mr. Hauptfuhrer and Mr. Hardee, whom you have identified, will divide between them—and I really accompany them, rather than their accompanying me, because they are the primary experts in the area—they will divide the area for discussion purposes. With Miss Doris Blazek, a member of the committee, perhaps we can field whichever questions the chairman may have.

In view of your request, if you would defer your request, Mr. Hauptfuhrer will proceed, followed by Mr. Hardee.

Mr. HAUPTFUHRER. My name is George Hauptfuhrer. I am the immediate past chairman of the American Bar Association, section of real property, probate, and trust law. As Mr. Redman just indicated, I am here to comment on the very strong views of our 22,000 members who regard themselves as the men in the trenches, the men who are dealing with families at the time of death.

The technical aspects are in our paper; Mr. Hardee will get to those. I would like to comment on the broader issues, as our section sees them almost with total unanimity.

So many of the comments which have been made and which we have read from the tax experts seem to view taxes as in a vacuum, without any regard to the human aspects involved at the time of death.

We think these comments cannot see the forest for the trees. At the time of death, a family is under unusual stress, unusual burdens, unusual economic burdens. Not only do you have the costs, which are usually substantial, of the last illness and the funeral and the administration's expenses, but you have a tremendous income loss, usually, in the primary wage earner. This, in itself, is a traumatic event in almost every family.

We have been concerned about this for years, Mr. Chairman. What our section has done to reduce the time and costs at death is to promote the Uniform Probate Code. We also have a statement of principles to cut down expenses, including lawyers' fees, particularly in modest estates, those just getting into the Federal estate tax level. We labored hard with the stock exchange so that transfers of securities could be made easier and simpler and less costly, and we are now working with the National Center for State Courts so that the accounting process can be made easier.

We view these things as major steps forward.

In that context and in the greater context of the law, we view carryover basis as a giant step backward. On a scale of 1 to 10, when we look at all of the problem areas in the tax reform measures in 1976, carryover is at the top. It is No. 10. There is not another problem we have that would rise above the level of No. 3. Carryover is the main problem that the people have today in settling estates.

Why? You have heard many of the reasons. I would just like to hit the highlights from the perspective of our people who are probating estates. We think it is unfair to change the rules. No one said it better than former Solicitor General Griswold. I believe you read his letter to you into the record.

Next, you have unreasonable administration expenses, and Mr. Eubank and Mr. Costello testified to that at the earlier hearing. You have unreasonable delay. You do not know what the tax values are for basis until you complete the estate tax audit. The administrative burden is retrogressive.

Our strongest feelings are in two areas. People just have not kept the records to comply, No. 1. That goes to the past. And No. 2, it is unreasonable to expect them to keep those kinds of records for the future when you are talking about all aspects of one's life.

As Mr. Kartiganer said, everybody hopes to get into the Federal estate tax brackets. I wonder if you, or other members of the committee, or other people here in the audience live their lives so that all of their records are spread out in a bookkeeping fashion from day one, and that includes wedding presents, birthday gifts, grandfather presents, et cetera, et cetera.

It is unrealistic to impose that kind of a recordkeeping burden on the people of this country.

We think that when the carryover basis concept was introduced there were representations made of unwarranted discrimination. We believe that, in the totality of the law, that is an unfair and inaccurate representation.

We also believe that the representations with regard to what that tax law did to businessmen and farmers, in light of carryover, that representation was for closely held businessmen and farmers totally inaccurate. Mr. Costello in his earlier testimony before the committee emphasized that point. Basically it boils down to, if we have friends like that, one does not need enemies.

In short, Senator, we beg—and I say that word deliberately—we beg for repeal of carryover basis. We think that the whole system of self-assessment of taxation, and its survival, depends on repeal of carryover basis. We think that the whole system of self-assessment of taxation, and its survival, depends on repeal of carryover. We think that the bookkeeping problems run through almost every alternative that has been suggested, and we urge that, because this area is so complex, when a bill is prepared that we have an opportunity to comment on the actual language of the bill. We just do not think that 6 days is enough, because of the complexities.

Thank you very much.

Mr. HARDEE. Mr. Chairman, I am David Hardee from Charlotte, N.C. I am chairman of the carryover basis committee on the section of taxation.

Before I answer your question directly, I think it is good to put carryover basis in the right perspective. Oftentimes we get so bogged down in the detail that we forget to see the forest for the trees.

The most important thing for us to do initially is to define the problem. The problem, presumably, is we have unrealized appreciation that under former law was getting a tax step-up in basis. Presumably that is the problem. The problem is defined in terms of lost revenues from assets with unrealized appreciation which are, in the broad scope of things, carryover basis property.

Then we need to define that carryover basis property and how much lost revenue is going through the old step-up in basis.

There is no current analysis of how much unrealized appreciation is going untaxed each year. It is almost elemental that we know how much this revenue, this lost revenue, is before we can define the problem. And then, after we define the problem, come up with a cure.

If we define the problem, then, as lost revenues, we have to apply to that problem all of the policy considerations that might mitigate that, such as the desire to keep farms in the families rather than ending up in agribusiness, and keeping closely held businesses in the community rather than having them merged into national corporations.

In addition, there is the problem of inflation: a great deal of unrealized appreciation these days is attributable to inflation. In the past 10 years, inflation has exceeded well over 50 percent and yet the stock market is down 200 points.

This is a real problem that we, today, do not have a handle on. It is more important for us to define the size of this problem; then we can develop a handle on it.

Once we put a dollar value on this problem we can look at the supposed cures, one of which is carryover basis, another of which may be capital gains at death or some other appreciation estate tax concept.

Then we can see if the cost of the cure is worth the gain, and I submit to you that the cost, in terms of administrative flexibility and what it does to our self-assessment tax system, is not worth the candle.

Even if carryover basis can be corrected by the Byrd bill and there are no technical flaws in the Byrd bill, we have some fundamental problems remaining with carryover basis. The first and foremost is that the Treasury yesterday said that carryover basis applies only to 2 percent of the taxpayers. That is true at death, but I have a client who comes in to me and he says, do I have to keep records of everything I do all my life? And I say, it depends on whether you have an estate of $175,000 or not. If you have it over that, yes, you do. If you do not, then there is no need to under the Byrd bill.

The fact and the point I am trying to make is that we do not know then, and it is an unconscionable burden to impose on 40, 50, 60 percent of the population to go through the problems of keeping up with the cost basis of his storm windows that he puts on his house on Saturdays so that these records may be available at death (if, indeed, he does have an estate tax problem), only to tax this 2 percent of the population at death.

Further, you have other people. I recall an instance I had in an estate of $250,000, a farm family, a 150-acre farm. Normally you do not think of those people as being wealthy, but, nonetheless, they had a death tax problem. They had all of the problems of carryover basis.

And I was counseling the wife on these problems and she looked at me and said, we have never had an income of greater than $15,000 a year. She could not understand that. She had no idea that their little 150-acre farm was now worth $250,000.

The point I am trying to make is that many people unsuspectingly will not keep these records even if you do it prospectively. It is for these reasons that the section of taxation has concluded that outright repeal is very appropriate and absolutely essential. But because we do not have a dollar figure on the lost revenues, I understand the joint committee staff is reprograming their computer and updating their figures; but their figures are not ready. So we take the position that a 2-year moratorium will first, allow us to define the problem of this unrealized appreciation; and second, to examine the solution, whether it be carryover basis, modified carryover basis, or some other alternative, not in the pressure-cooker atmosphere that we got carryover basis in the first instance, but rather in a proper legislative process that gives us plenty of time to comment and critique the problems of grandfathering assets, the pro ration rule, and all of the other fundamental problems. We have four bills now that we are trying to juggle around on 8 days' notice and come up with a solution that will be a long-term, viable solution.

We cannot do it at this time. We need this moratorium.

We will be glad to entertain your questions.

Senator BYRD. Thank you.

Treasury yesterday said that S. 2228, if enacted with some modifications which Treasury recommends, would solve most of the carryover basis problems, but I assume that this panel does not agree with that assertion?

Mr. REDMAN. Mr. Chairman, the panel might have some individual comments with regard to various aspects of S. 2228, but as spokesmen for the Section on Taxation and Real Estate, Probate, and Trust Law, we are not authorized to speak to that point.

However, either Mr. Hauptfuhrer or Mr. Hardee may wish to express their views, which would clearly only be their individual views, to the extent they can in the framework of the severe time limitations.

Mr. HAUPTFUHRER. My view on that point is the recordkeeping aspect of it is the tremendous problem. People will just not comply with the law.

When a person is alive he can remember on such and such a day he went down to Sears-Roebuck and bought a couple of hundred dollars of insulation to improve his house and he signs the tax return himself, and to a certain extent he has a capacity for recall.

But after he dies, it is almost impossible for an executor to reconstruct that person's life and I think most of those suggestions fall because of their dependency on accurate recordkeeping.

Mr. HARDEE. I think the proration rule we now have is totally unworkable. Everyone acknowledges that we need some kind of step-up for pre-1977 assets, but the proration rule that depends upon the date of acquisition and the cost basis of pre-1977 assets back when the taxpayers were not required to keep these records is totally unworkable.

It is very clear in the tax law if you cannot establish your date of acquisition and your cost basis it is then zero, so the proration rule basis is zero for these people.

Grandfathering is a solution to this problem, but as Treasury pointed out yesterday, there are a lot of problems with grandfathering and it would take a complex statute or a complex system of regulation to prevent its abuse.

The only alternative for pre-1977 assets that I find at all satisfactory—and once you go through all of these mental gymnastics you say, is the game really worth the candle—is taking the date-of-death value of the assets and backing it down—this being on nonmarketable assets—on a cost-of-living increase, back to December 31, 1976, so that you do not have to establish your date of acquisition and your cost basis in pre-1977 assets.

This has a lot of economic weaknesses because it does not assure that the appreciation that occurred post-1976 occurred ratably or had any relationship at all to the cost of living, but it does prevent you from getting that zero cost basis.

Senator BYRD. Let me ask you this. Assuming S. 2228 is enacted, would it be better to have the grandfathering of the pre-1976 assets as a part of it or not?

Mr. HARDEE. Personally I think it is absolutely essential that you have grandfathering or another strong cure for the present proration rule in order to make carryover basis work.

Senator BYRD. In other words, if I gather accurately from your testimony, you are doubtful as to whether S. 2228 should be enacted at this session, but if it is enacted, it most certainly should include the grandfathering of assets, or something similar to grandfathering?

Mr. HARDEE. Absolutely.

Mr. HAUPTFUHRER. I would concur with that. As Mr. Redman said, these are personal. But I would also encourage carve out for investment of business assets.

Senator BYRD. What do you mean?

Mr. HAUPTFUHRER. If you are talking about the future in regards to carryover, after the original grandfathering that is going to give you a step up; but for future carryovers, after the first group goes out, then if you would limit future carryovers to those business assets where people do keep records because they have income tax consequences, that would be realistic and people could live with it.

Mr. HARDEE. Let me make one observation. I think that we are in a situation where if we had a 2-year moratorium, a 2-year period of time to first define the problem and then analyze the solution that we are very fortunate in that it costs nothing in terms of lost tax revenues.

The joint committee staff's report that went along with the 1976 Reform Act indicated that carryover basis does not produce or generate any revenues in its first 2 years. We have nothing to lose by a 2-year postponement.

Senator BYRD. I think that that is a very good point. Treasury, in that connection, made the point, however, that carryover basis was part of the package, that the taxpayers are getting some advantage from the other part of the package and that Treasury feels that they should get the disadvantage of carryover basis.

Mr. HARDEE. My response to that, Senator, is that replacing the unified rate schedule with two former gift rates and the estate tax rates and doing away with the exemption, replacing it with a credit, was, in itself, its own independent exchange, and it should not go on and be extended to carryover basis. I think you have got to separate those two.

We have integration and credit exchange for the loss of the exemption.

Mr. REDMAN. I would like to add also, Mr. Chairman, that no matter how you might define the so-called package, I gather your hearings are establishing a fair degree of unanimity that carryover basis is a horror and it costs little or no revenue dollars to provide time to restudy such a complicated subject. It therefore behooves the Senate and the Congress, and is in the benefit of the public interest, to provide for that time, so that this complicated subject can be adequately studied; and certainly through these two sections of the American Bar Association, perhaps with the authority to speak for the American Bar Association as a whole during the course of such study, we could provide adequate, and hopefully very helpful input to the committee and its staff for purposes of coming up with a workable rule.

Senator BYRD. No. 1, your first preference is to repeal carryover basis.

Mr. HARDEE. Yes, sir.

Senator BYRD. No. 2, in lieu of repeal, to defer its application for 2 years.

Mr. HARDEE. That is correct.

Senator BYRD. Is your No. 3—I am not clear on your No. 3 choice, whether you feel if neither one of those can be accomplished, and I personally favor both of them, then is 2228 the best alternative or is it better to leave it as it is until January?

Mr. HAUPTFUHRER. Here we get into the limitations of our authority one again. Our authority really only goes to the first two propositions because neither of our groups have had an opportunity to take a position on any other bill.

Senator BYRD. Maybe as individuals you would have some thoughts.

Mr. HAUPTFUHRER. I would concur with that statement with the modifications that were suggested by Mr. Kartiganer in this morning's testimony.

Mr. HARDEE. The decision is almost a political one and it is difficult to weigh whether we are better to suffer under the unconscionable burden of the current carryover basis for 6 months if we think we can get a very sound bill that makes either carryover workable or replaces it in its lost revenues with adjustment in the death tax rate, or some other compensating factor.

As a personal preference, I do not like legislation that is adopted in a pressure-cooker atmosphere of 1 week. I do not think we can foresee all of the problems and provide for a long-term, viable solution.

Senator BYRD. The testimony of each of you has been very helpful this morning and the committee appreciates your being here.

[The prepared statement of the Section of Real Property, Probate and Trust Law, American Bar Association follows:]

STATEMENT OF THE SECTION OF TAXATION AND THE SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, AMERICAN BAR ASSOCIATION

Our written statement is being presented on behalf of both the Section of Taxation and the Section of Real Property, Probate and Trust Law of the American Bar Association which are concerned with the problems created by Carryover Basis. A letter dated September 9, 1977, from Frederick S. Lane, the Chairman of the Section of Real Property, Probate and Trust Law to the Honorable Russell Long expressing that Section's concerns with Carryover Basis is attached to this statement. This statement, prepared by the Section of Taxation, is in accord with the views of and is endorsed by the Section of Real Property, Probate and Trust Law. These are two of the largest Sections of the American Bar Association together totalling over 48,000 members.

These views are being presented only on behalf of these two Sections and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association, and should not be construed as representing the position of the ABA.

We very much appreciate the opportunity of appearing before the Committee to express our concerns with respect to the Carryover Basis concept.

Our statement which follows deals in some detail with the many technical and administrative problems that have resulted and will continue to result from the Carryover Basis Legislation. Important as are those technical and administrative difficulties, we believe that there is one overriding concern with respect to Carryover Basis that demands its repeal. This concern is that in practical effect the application of the Carryover Basis rules will have their greatest impact where the effect can least be absorbed. This impact will be on the middle bracket taxpayer, the small businessman, the farmer and others who pass on to their heirs a medium sized estate leaving their heirs with virtually an insoluble problem of determining basis with respect to the assets received. The wealthy and those with large estates, either are sophisticated in the area of taxes and have, as a result, maintained or have had mintained for them, the necessary records to establish basis. They are in a position to employ those who can establish those records and the cost of that activity will be minimal in its impact on them. However, the middle and small bracket taxpayers, those with moderate sized, but nonetheless, taxable estates will be in the worst position to establish the basis of assets which they pass to heirs. They will not have maintained the meticulous records necessary to establish Carryover Basis. They will not be able to afford the technical assistance to establish that basis, if, indeed, it can be established at all. It is this level of taxpayer that is of material concern to the Section of Taxation.

We are concerned that there is a growing sentiment among many taxpayers that they have been dealt with unfairly by their government. We believe there is a growing feeling among this group that they believe the rules have been changed in the middle of the ballgame. They have proceeded in the conduct of their activities on the understanding that a precise record affecting the basis of their property was unnecessary if they planned to leave that property to their heirs because the property would receive a new basis in the hands of their heirs equal to date of death or comparable value. Now they find that their reliance on that belief has been ill-founded. They have discovered that the rug has been pulled out from under them and that what they have been led to believe to be a fact no longer is operative and that they should have been keeping these records all along. It is no answer to them to admonish them that they should have kept the records. They have not and they have not because they believed it was unnecessary.

Statistics compiled by the Commissioner of Internal Revenue Service clearly indicate that there is a steady decline in compliance with the Internal Revenue Code in the income tax area. We fear that, if the attitude being engendered in taxpayers by the Carryover Basis concept continues to grow because nothing is done about the Carryover Basis, there will be a growing tendency toward noncompliance in the estate tax area as well. If the taxpayers of this country lose confidence in the fairness by which they are treated through the taxing system, our voluntary self-assessment system will no longer be viable.

From a practical standpoint, Carryover Basis is unworkable. But, aside from the problems of administering Carryover Basis, the costs involved, the difficulties that are being and will continue to be encountered, the Section of Taxation believes that the overriding concern of this Committee should be with the attitude developing among taxpayers by reason of this growing feeling of unfairness.

We urge the Committee to consider whether the perceived problem is, in fact, so great as to warrant the massive change brought about by Carryover Basis. It may well be that the game is not worth the candle; that the problem sought to be cured is less harmful than the cure itself. We urge the Committee to pass Senator Curtis' bill, S1954, to repeal Carryover Basis and return to the status that existed prior to the enactment of the Tax Reform Act of 1976. At the very least, we urge the Committee to defer the effective date of Carryover Basis to December 31, 1978, by pasing S2227, which will permit a thorough and detailed study of this provision in all of its aspects.

A number of alternatives have been suggested to Carryover Basis. Our statement considers some of those alternatives and points out the deficiencies that exist in them. Although the problems have been studied now for over a year since the enactment of the Tax Reform Act of 1976, we submit that meaningful solutions and alternatives to current Carryover Basis cannot be adequately considered in hearings called on seven days' notice. This is a problem that needs intensive study, and substitutes for or amendments to Carryover Basis, generated in a pressure cooker atmosphere similar to that which produced Carryover Basis in the first instance will not prove to be a long term solution.

At the very least, we urge the Committee to adopt S2227, deferring the effective date of Carryover Basis until December 31, 1978, to permit thoughtful and careful study of the importance of the goal to be sought and of possible methods of reaching it.

There follows a detailed analysis for a number of the technical problems created by the Carryover Basis.

I. BACKGROUND

Since the Senate Finance Committee did not hold hearings on the Carryover Basis provisions and they were grafted on the 1976 Tax Reform Bill by way of conference report, it is difficult to perceive the intended Congressional purposes in adopting Carryover Basis. However, the House Ways and Means Committee Report (H. Rept. No. 94–1380, 94th Congress, 2d Sess., August 2, 1976) presented these reasons for making the changes imposed by the new Carryover Basis provisions, as follows:

"Present law results in an unwarranted discrimination against those persons who sell their property prior to death as compared with those whose property is not sold until after death. Where a person sells appreciated property before death, the resulting gain is subject to the income tax. However, if the sale of the property can be postponed until after the owner's death, all of the appreciation occurring before death will not be subject to the income tax.

"This discrimination against sales occurring before death creates a substantial 'lock-in' effect. Persons in their later years who might otherwise sell property are effectively prevented from doing so because they realize that the appreciation in that asset will be taxed as income if they sell before death, but will not be subject to income tax if they hold the asset until their death. The effect of this 'lock-in' effect is often to distort allocation of capital between competing sources.

"In order to eliminate these problems, your Committee believes that the basis of property acquired from or passing from a decedent should have the same basis in the hands of the recipient as it had in the hands of the decedent, i.e., a 'carryover basis.' This will have the effect of eliminating the unwarranted difference in treatment between lifetime and death time transfers."

At first blush, it would appear that Carryover Basis does treat the estate of the deceased in the same tax manner as a living taxpayer. However, closer examination reveals that this is a myopic view. For instance, the Carryover Basis provisions now perpetuate the "lock-in" effect of the unrealized appreciation in assets. While, under former law, assets would receive a tax free step-up in basis freeing these assets from this "lock-in" effect, now this is no longer true. The Carryover Basis provisions run counter to the stated economic goal of allowing the free interchange of capital among competing sources, with the tax law having as neutral effect on the allocation of capital as is possible.

Secondly, it is essential that in applying the principle of equity (i.e., achieving the same tax treatment for taxpayers of similar economic circumstances) that the full impact of *both* death taxes and income taxes generated by the sale of assets to pay these death taxes be considered.

II. CONFISCATORY NATURE OF CARRYOVER BASIS

After the fresh start adjustments are phrased out or if an estate cannot prove its cost basis and the date of acquisition, the cumulative effect of the Federal estate tax, state death taxes, and Federal and state income taxes imposed upon an estate will consume much of it. The following simple fact situations graphically illustrate this result.

For simplicity, assume that taxpayer dies with a $1,000,000 taxable estate, all in closely held stock. Either because his cost basis in the stock is negligible or his estate or his beneficiaries are unable to prove it, also assume that it is zero. The approximate Federal death taxes after application of the 1981 credit leaves his estate with approximately a $300,000 Federal death tax bill. Further, assume that the deceased is a resident of a typical state that has a death tax equal to 30% of the Federal death tax, adding $90,000 to his death taxes. Since his estate is eligible for a § 303 redemption for the payment of these death taxes, $390,000 in stock is redeemed and death taxes are paid. However, the estate is then faced with the payment of a tremendous capital gain tax. Since the law provides for adjustments for death taxes paid on the unrealized appreciation, this $390,000 becomes part of the cost basis in the stock. The § 303 redemption redeems stock with an adjusted cost basis of $152,000, producing a capital gain of $238,000. The capital gain tax, plus the minimum tax, will produce a total tax in excess of $100,000. In order to pay the Federal and state income taxes on this gain, additional stock must be redeemed. However, this subsequent redemption does not meet the requirements of § 303, or probably of § 302, so that the extra amount will be ordinary income to the estate under § 301, producing an additional tax of up to 70 percent, leading to subsequent redemptions to pay these continuing taxes.

After the payment of all income and estate taxes, the net estate may be diminished by as much as 70 percent to 80 percent. The deferral provisions of § 6166 and § 6166A only defer this tax and do not greatly diminish it, so the fundamental problem remains the same. Furthermore, § 2032A does not provide any relief from these income taxes.

The above fact situation is aggravated even more if the estate contains only § 306 stock. If it does, and § 3(a)(1) of the Technical Corrections Act of 1977 (H.R. 6715) is adopted, then § 303 will be unavailable, resulting in ordinary income treatment on all redemptions. The $1,000,000 estate will then be reduced to almost nothing, due to combined effects of death and income taxes.

In another example, assume that the $1,000,000 is invested in real estate (perhaps a farm of 640 acres at $1,600 per acre) and that the estate has $200,000 of recapture property. A sale of part of this real estate to pay the $39,000 death taxes will first produce ordinary income to the extent of this recapture, perhaps a total of $200,000. The remaining $190,000 will be subject to several basen adjustments for death taxes paid but, at the same time, will still produce a substantial capital gain tax. This tax must then be paid, so additional property must be sold, producing additional tax, triggering an additional sale of property.

In a fourth example, assume that the $1,000,000 estate consists of works of art or literary works which are not now considered capital assets in the estate. The sale of these assets to raise the $390,000 in death taxes produces ordinary income of $390,000, requiring the additional sale of property, which results in additional income taxes. When this cycle is complete, most of the assets of the estate would be consumed by the combined death taxes and income taxes.

The above examples illustrate the devastating tax effects of a not unusual estate of a self-made business man or a farmer. The replacement of the $60,000 estate tax exemption by the unified credit creates a maximum estate tax savings in a $175,000 estate of $25,000. Yet, this sum is quickly recaptured in income taxes on the sale of the family residence and other assets which may have substantial appreciation.

The foregoing examples indicate one of the most serious problems of the current Carryover Basis law—the extremely harsh tax result that flows from selling assets to raise the money to pay the death taxes. The equity theory of treating assets in the hands of the taxpayer's estate the same as if they had been sold during his lifetime must be extended at least through the payment of the income taxes which if generated before death would have reduced the taxable estate. Failure to do this creates an extremely harsh total tax that then becomes inequitable in other extreme.

III. PROVING BASIS

Perhaps the major problem in taxing unrealized appreciation is one of proving the initial cost basis and date of acquisition of Carryover Basis assets. Established tax law is very clear: the burden is one the taxpayer to prove his basis; if he fails, then he has no cost basis in the assets. This cost basis is established by traditional rules of evidence that have univeral applicability. These rules of evidence have been developed over numerous years and have evolved such exceptions as are necessary to fairly establish facts and preserve the integrity of our judicial system.

In tax matters, with few exceptions, the duty is placed upon the taxpayer to establish the facts needed to support his position. Thus, he has the burden of proof to show by preponderance of the evidence the facts upon which his determination of basis rests. If the taxpayer fails to establish the cost basis of the asset, then § 1023(g)(3) may apply. This section provides as follows:

"If the facts necessary to determine the basis at the hands of the donor or the last preceding owner are unknown, to the donee, the Secretary or his delegate, if possible, shall obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obain, such property was acquired by such donor or last preceding owner."

This statute, in effect, would establish an alternate cost basis if the taxpayer can establish an acquisition date and if the taxpayer can establish the fair market value when it was acquired by the donor or the last preceding owner. These are two big "ifs" and greatly restrict the ultimate use of this section. Almost by definition, the evidence that will be available in situations arising under this section will be hearsay. The decedent or the decedent's donor (who is also likely to be dead) will normally be the only persons who have direct knowledge of the basis and the date of acquisition in the Carryover Basis property.

The Federal Rules of Evidence would be applicable in Tax Court and in Federal District Court. Rule 803 of the Federal Rules of Evidence provides for exclusion of relevant evidence if its probative value is outweighed by other facts, such as prejudice or misleading the jury, even where the declarant is available as a witness. Rule 804 provides for exceptions where the declarant is not available as a witness.

One of the most frequent exceptions under Rule 803 that will be invoked by taxpayers to establish the basis of Carryover Basis property will be Exception No. 16, Statements in Ancient Documents. The Rule provides for the admissibility of "statements in a document in existence 20 years or more, the authenticity of which is established." The exception evolved because in the case of documents of such age, there is usually a great need for the evidence and because of the usual dearth of other evidence. See *Weinstein's Evidence* (Matthew Bender, 1975), ¶803(16(01)).

This rule is founded on the premise that since the document came into existence long before the litigation at issue and without its anticipation, the motive to misrepresent would normally not exist. However, when faced with the problem of establishing a cost basis and acquistion date, it is highly likely that decedents will go to great lengths to make self-serving statements and to attempt to establish other admissible evidence of a cost basis, without regard to facts that are no longer knowable or accurate. Hence, the area is fraught with problems of fraud and the admissibility test for ancient documents is probably insufficient to prevent these statements from being used as evidence. Furthermore, the Service will not have available any evidence to impeach this evidence and, thus, its credibility. It is simply impossible to develop the traditional judicial restraints on admissibility of evidence of this nature in such a fashion as to permit admission of authentic documents that are not self-serving or fraudulently prepared, and allow their veracity and probative value to remain virtually unchallenged by the Internal Revenue Service.

An additional problem is raised as to whether the executor should rely upon this evidence. The executor is forced to play the role of a judge and decide on the admissibility of the evidence and, if admissible, its probative value. Further, the beneficiary receiving the Carryover Basis property has to go through the same process of weighing the evidence, its admissibility and probative value. If predictability, ease of administration, and simplicity are hallmarks of good legislation, then it is hard to imagine a worse law to implement than the current Carryover Basis provisions.

Another exception is provided both in Rule 803 and in Rule 804 providing for exceptions where the declarant is not available:

"A statement not specifically covered by any of the foregoing exceptions but having equivalent circumstantial guarantees of trustworthiness, if the Court determines that (A) the statement is offered as evidence of a material fact; (B) the statement is more probative on the point for which it is offered than any other evidence which the proponent can procure through reasonable efforts; and (C) the general purposes of these rules and the interests of justice will best be served by admission of the statement into evidence. However, a statement may not be admitted under this exception unless the proponent of it makes known to the adverse party sufficiently in advance of the trial or hearing to provide the adverse party with a fair opportunity to prepare to meet it, his intention to offer the statement and the particulars of it, including the name and address of the declarant."

Statements from the decedent's acquaintances, business associates, etc., as to what they understood his basis in the property to be will come within this rule. This exception to the hearsay rule in conjunction with Rule 803 affords the trial court discretion to admit or exclude on the basis of the peculiar strength or weakness of the particular evidence offered. This exception will frequently be employed in cases arising under Section 1023, but, again, it will be extremely difficult to predict in advance whether a particular piece of evidence will ultimately be admitted at trial. This makes it difficult to know whether to rely upon the evidence in determining basis or whether to disregard the evidence and conclude that the basis is unknown. And, again, the question arises as to whether the beneficiary should accept the § 6039A statement at face value or make his own determination.

The foregoing indicates that establishing the cost basis from date of acquisition, even under Section 1023(g)(3), is an extremely difficult task. It is made much more difficult in view of applying the law retroactively. If the date of acquisition and the cost basis (or fair market value) cannot be readily established, then the fresh start rule § 1023(h)(2) is of absolutely no value and taxpayers will be denied a fresh start step-up in basis.

For instance, how would a taxpayer begin to establish the cost basis and holding period of gifted property, assets received in an involuntary conversion, like-kind exchange, tax free § 351 transfers, or tax free reorganizations, to name a few possibilities? Furthermore, the § 6039A notice required to be given to beneficiaries has no evidenciary value. (Its numerous other shortcomings will be discussed in detail later.)

IV. PROBLEMS WITH INTEGRATING CARRYOVER BASIS WITH PROVISIONS OF THE CODE

The current Carryover Basis statute provides for too few exceptions from its application and is not properly integrated with the other sections of the Internal Revenue Code. The following areas are some of the more blatant shortcomings of current law:

A. *Personal Residence.*—There is no specific exclusion or exemption from Carryover Basis on any amount of gain recognized on the sale of a personal residence. Congress has long indicated its desire to defer the payment of tax on the gain recognized on a personal residence (§ 1034), with special tax considerations given to people over age 65 (§ 121). It is incomprehensible that Congress would now take away these tax considerations through Carryover Basis, creating an even heavier tax burden on the ultimate disposal of a personal residence without a specific exemption of some amount.

B. *Property which has an Indebtedness in Excess of its Basis.*—Borrowing against property has never before been treated as a taxable event. However, when a taxpayer disposes of property which has an indebtedness in excess of its basis, he is treated as having received income to the extent the debt exceeds basis, even if it is a gift: see *Malone* v. *U.S.*, 325 F. Supp. (ND Miss. 1971), *aff'd. per curiam* 455 F. 2d 502 (5th Cir., 1972), and *Johnson* v. *Comr.* 495 F. 2d 1079 (6th Cir., 1974); or a charitable contribution, Rev. Rule 75–194, 1975–1 C.B. 80.

Under the foregoing rationale, the deceased, or his estate or heirs, would also have income. It is doubtful that Congress intended to tax a surviving spouse on the transfer of the family residence, merely because it had a mortgage on it in excess of its tax basis. Due to the non-recognition treatment of the sales of principal residences, or the refinancing of a home for educational or medical costs, this could become a common occurrence. The fact that the estate is still liable for the debt makes no difference to the Internal Revenue Service.

C. *Section 303 Redemptions.*—Section 303 permits a family corporation, by redemption, to distribute funds sufficient to pay death taxes and administration expenses without the distribution being taxed as a dividend. Indeed, prior to the 1976 Act, a § 303 redemption gave rise to no taxable income at all, because the decedent's estate obtained a stepped up basis for the stock redeemed under § 1014.

Under the 1976 Act, an estate will take a Carryover Basis for the stock redeemed. Thus, a § 303 redemption will now generate capital gain tax in most cases. In the family corporation context, the tax so generated could be quite substantial, since shareholders in such corporations frequently have a very low basis in a business they originated.

The purpose of § 303 is to permit the estate of a large shareholder of a family corporation to obtain cash from the corporation with which to pay the taxes and expenses caused by the shareholder's death. Congress recognized that if the money for death taxes and expenses could not be obtained from the corporation without a dividend tax, family corporations would be forced to sell out at the founder's death, thus contributing to the concentration of industry in large, publicly held companies. The same policy considerations that justify affording relief in the payment of estate and inheritance taxes occasioned by death apply with equal vigor to income taxes generated by the Carryover Basis provisions to raise funds to pay those death taxes.

Section 303 currently offers inadequate relief to estates of closely held companies and will result in the forced sale of many family corporations. For example, if the 100% shareholder's estate is able to withdraw $200,000 from the corporation with which to pay estate and inheritance taxes and administrative expenses, the only way available to raise the approximately $60,000 to $75,000 of income taxes payable on the § 303 redemption is by a further redemption. However, this redemption does not qualify for § 303 and probably will not qualify for capital gain treatment under § 302. This will result in the withdrawal being fully taxed as a dividend under § 301, resulting in additional income taxes at the higher ordinary income rate.

D. *Section 1221(3) Assets.*—A literary work, work of art, or other such property is not considered to be a capital asset in the hands of the person who created it. However, under § 1221(3)(C), the estate of the creator (or his beneficiaries) could treat such works as capital assets. The Carryover Basis provisions change this result because their basis is determined by reference to the basis of the creator. Although this may be proper in theory, there is legitimate concern that a part of these assets sufficient to pay death taxes and income taxes should be eligible for capital gain treatment.

E. *Recapture Properties.*—The general explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation makes the following statement:

"It is also intended that where property passes to an estate which has unrealized appreciation which would have been subject to recapture (under section 1245 or section 1250) if it had been sold by the decedent prior to his death, the potential depreciation recapture is to be passed through to the beneficiary who receives the property."

The first question that arises is whether the unrealized appreciation subject to recapture under §§ 1248, 1251, 1252, and 1254 is also to be passed through to the beneficiary who receives the property, or was it intended to simply carve out §§ 1245 and 1250 for special treatment. Another question is whether it was intended that the "fresh start" adjustment for appreciation prior to 1977 was intentionally made not applicable to §§ 1245 and 1250 property.

Potential recapture carries with it an accrued tax liability that is not reflected in estate tax values. To the extent that this deferral continues, this is justified. However, this tax liability should properly be reflected if the estate is forced to sell these assets to pay death taxes.

F. *Net Operating Loss Carryforward.*—Net operating loss carryforwards currently expire upon the death of a decedent. Since his assets now carry forward their pre-death characteristics, it is equitable to also permit this carryforward.

G. *Capital Loss Carryforward.*—Also, under current law, capital losses expire upon the death of a decedent. Since basis is carried over, these losses should also be carried forward.

H. *Minimum Tax and Maximum Tax.*—The untaxed portion of capital gains is currently treated as a tax preference item, subject to the minimum tax, and reduces the availability of the maximum tax. The combined effect of these taxes increases the marginal rate of capital gains tax to almost 50 percent. The policy considerations that led to the adoption of the minimum and maximum taxes with respect to capital gains do not necessarily apply to the sale of capital assets to raise funds for the payment of death taxes.

I. *Comprehensive Tax Reform Proposals of the Administration.*—Within two weeks, the Administration is going to announce its Tax Reform Proposals for overhauling our tax system. In various memoranda of the Treasury Department on these proposals, there is indication that substantive revisions will be proposed in capital gains, capital losses, real estate depreciation, ordinary income rates, indexing of basis, and integration of corporate income taxes. Since changes in these areas dramatically affect Carryover Basis, it is absolutely essential that these provisions properly mesh with the treatment of unrealized appreciation at death. The only proper method of achieving this result is a reconsideration of the Carryover Basis concept, not only in light of its many shortcomings, but also in light of major tax revision that is about to begin.

V. TECHNICAL AND PRACTICAL PROBLEMS OF IMPLEMENTATION OF CARRYOVER BASIS

The general explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation stated, in Section I, Paragraph F, that two of the major purposes of the Estate and Gift Tax portion of this Act were (i) to relieve the pressure on the estates and families of farmers and small businessmen to sell or partition the assets of the estate in order to pay the Federal estate taxes, and (ii) to raise the level of estates that may escape the imposition of the Federal estate tax. The greatest practical problem with implementing the current Carryover Basis provisions is that there is no exclusion of assets from these requirements. All estates, regardless of size, are required to make basis adjustments, file notices, and comply with a myriad of other complex and needless details. The following section will set forth the broader practical problems inherent with implementing these Carryover Basis provisions. Only a few of the overwhelming number of problems have been addressed by the Technical Corrections Act of 1977. Many are inherent in the concept of Carryover Basis; others are present in the current law, but can be changed only by substantive policy decisions.

A. *Personal Property Exclusion.*—The term "Carryover Basis property" is defined as any property which is acquired from or passed from a decedent and which is not specifically excluded from such definition. Among the limited types of property excluded (such as income in respect of a decedent, proceeds of life insurance, etc.) are "personal or household effects" in the hands of the decedent and with respect to which the executor makes an election to exclude from the application of the Carryover Basis rules. The personal and household effects selected for exclusion by the executor may not exceed in value $10,000.

This provision was intended to provide relief from the burden of tracing and proving decedent's basis in personal and household effects, unless he is wealthy. However, a taxpayer with two average cars already exceeds the $10,000 worth of personal and household effects exemption, so it is of limited value to many middle class families.

The first decision an executor is faced with is what assets are personal or household effects for these purposes. Is there any reason to distinguish between clothing, cars, televisions, etc., and works of art, coin collections, stamp collections, etc., based on the investment aspect of the latter group? Neither the statute nor the Committee reports provide any guidance.

Since the Carryover Basis of personal or household effects cannot exceed the estate tax value for purposes of determining a loss, the executor is further faced with a decision as to what personal or household effects to elect to exclude from the Carryover Basis provisions. This assumes that the executor will be able to determine the basis of the property—which is the overwhelming problem that the exclusion of personal and household effects attempted to solve. Thus, the executor must still determine the basis of every asset so as to make the further determination as to which ones to exclude.

The Technical Corrections Act of 1977 attempts to solve this problem by providing that in calculating the basis adjustment under § 1023(h)(2), an arbitrary 8 percent annual discount back to December 31, 1976, is to be applied to the Federal estate tax valuation of "tangible personal property," thereby removing the need to establish the basis of such assets. Although this amendment eliminates the need to establish the basis of tangible personal property acquired prior to 1977, it still has formidable problems. For instance, the law is further complicated by a new term "tangible personal property," presumably different from "personal and household effects," but lacking any definition. The arbitrary 8 percent annual discount bears no relationship to time economic changes and is of no value to assets acquired after 1976.

Another area which will cause serious problems to an executor is the acquisition by a decedent over a period of time of a large number of similar assets having small individual value, such as a coin or stamp collection or silver service. It is impossible to determine the basis of each item acquired over the years, but there is no provision allowing for an averaging of basis for ease of administration. (A similar problem exists with dividend and mutual fund reinvestment plans.) To require an accounting of the cost basis and acquisition date of every reinvestment or every acquisition of a part of a collection is an absurd burden on executors and an impossible enforcement problem for the Internal Revenue Service.

Still another practical problem is who is to make the election if there is no formal administration of the estate, due to the small size of the probate estate. In such a situation, § 2203 provides that the person in possession of the property is the "executor." If there are several surviving joint owners of property held with the decedent, there will be competing interests as to which assets are excluded from Carryover Basis. And even if there is a formal administration of the estate, the executor will likely be faced with competing interests as to the assets selected if there are two or more beneficiaries of personal property. Still further problems may arise if the estate tax valuation of such personal and household effects is raised on audit. Does the executor then file a new election? If assets are sold during administration, may others be substituted? May the executor modify or revoke a prior election?

B. *Adjustments in Computing Carryover Basis.*—The adjustments to basis of Carryover Basis assets are nothing short of horrendous. Perhaps the greatest injustice of these awful adjustments is that they apply to virtually every decedent who has appreciated Carryover Basis assets, without exception. It is farcical to think that every taxpayer who qualifies as executor in its all-encompassing tax definition is going to make these adjustments, and file the required § 6039A notice, thus striking at the integrity of our self-assessment tax system.

The law provides for four adjustments to basis, each of the last three turning on calculations made in the preceding adjustments. The following is a description of some of the more onerous adjustments:

(1) *Item-by-Item Adjustment.*—Each asset must be adjusted individually. There is no provision for grouping like or similar assets. For example, fractional shares of a dividend reinvestment program must each be adjusted separately. Assets not subject to tax do not qualify for some of the adjustments, so the same assets may have a different basis, depending upon whether it was allocated to the marital deduction or to the residue.

(2) *Multiple Bases for the Same Asset.*—The "fresh start' adjustments apply only for purposes of determining gain, but not for the purpose of determining loss. Further, most states still allow a step-up in value of assets to their fair market value on the date of death. These results mean there may be as many as five possible bases for a single asset.

(3) *Suspended Basis Problem.*—Section 1023(c) provides that the basis of appreciated Carryover Basis property shall be increased by an amount which bears the same ratio to the Federal and state estate taxes as the net appreciation in value of such property bears to the fair market value of all property subject to the estate tax. However, the amount of the Federal and state estate taxes will be uncertain until these taxes are finally determined, thereby "suspending" the basis adjustment provided in § 1023(c). The same may be true with respect to the basis adjustment provided in § 1023(e) providing for an adjustment for state succession taxes paid by a recipient of appreciated Carryover Basis property. If such property is sold prior to the final determination of the Federal and state estate, death, and succession taxes, it will be impossible to determine the amount of gain or loss resulting from such a sale because of the suspended basis of the asset sold. As a result, it will also be impossible for the seller to accurately report his gain or loss for income tax purposes. If the reported taxes are relied upon by the seller, and the final determination is different from the reported taxes, then claims for refund and amended returns will have to be filed. Since the statute of limitations may well run on the income tax returns where Carryover Basis asset sales are reported prior to the finalization of death taxes, the filing of protective claims for refund and protective assessment of taxes will become necessary. The burden of these tasks is in defiance of sound tax administration and an unmanageable burden on both the taxpayers and the Internal Revenue Service.

(4) *Recalculation of Carryover Basis.*—Any time the value of any property includable in the decedent's adjusted gross estate is changed upon audit, the basis of each Carryover Basis asset must then be re-determined because of the reliance upon the ratio of net appreciation in value of property to the value of the estate in determining Carryover Basis adjustments.

Further adjustments are required in the basis of each Carryover Basis asset if a different "fresh start" adjustment is made. For instance, if the holding period of a nonmarketable asset changes, even slightly, then there is a change in the total net appreciation of assets subject to adjustments and recalculation of basis of every asset must be made.

(5) *$60,000 Minimum Basis.*—Section 1023(d) provides for a "minimum basis" adjustment up to $60,000 after the "fresh start" adjustment and the § 1023(c) death tax adjustment. It is the intention of this adjustment to eliminate many small estates from the subsequent capital gains tax inherent in Carryover Basis properties by allowing a minimum basis of $60,000. However, this provision is inadequate, since many modest-sized estates will have to pay much more in income taxes than they saved in estate taxes by introduction of the credit. Further, the average family residence now sells for the amount of these adjustments, leaving other assets of a modest estate with possible substantial income taxes to be paid.

(6) *Fresh Start Adjustment.*—The first of the complex series of adjustments to basis is a step-up to December 31, 1976, value. This adjustment is made solely for purposes of determining gain, so the executor must determine a basis with the adjustment and another without the adjustment. Marketable bonds and securities are given a step-up in basis to their value on December 31, 1976, if the

fair market value on that date exceeds their adjusted basis on such date. The term "marketable bond or security" is loosely defined as any security for which there was a market on the stock exchange, in an over-the-counter market, or otherwise, as of December, 1976. Neither the Conference report nor the Committee report assists in defining what the term "otherwise" means. Furthermore, in the only regulations issued under Carryover Basis, T.D. 7500 on marketable bond or securities do not lend much light on defining the term "or otherwise." It does not discuss in depth what constitutes a marketable bond or security. For instance, what is the status of stock in a personal holding company which owns marketable bonds and securities? What is the status of restricted stock of a publicly held company? What is the status of commodity futures contracts which are normally traded on a public market? In addition, of alarm and serious concern is the fact that the International Revenue Service waived both notice and hearing requirements when adopting these temporary regulations, thus denying any public input into their content.

If an eligible "fresh start" asset is not a marketable bond or security, then a proration of the appreciation is to be made as between the holding period of the asset prior to January 1, 1977, and the holding period of the asset from December 31, 1976, to the date of death. To the extent that personal property is not excluded under the $10,000 exclusion for personal and household effects, the basis and holding period for each personal property asset must still be determined. The taxpayer is required to establish the basis and holding of each asset which was acquired prior to December 31, 1976.

The calculations necessary to compute the "fresh start" adjustment to basis can become highly complex, even in what would be considered normal situations. For instance, suppose a decedent owns real estate that she acquired upon the death of her husband many years ago. If no Federal or state estate or inheritance tax returns had to be filed at that time, and no appraisal was made, it would be an exceedingly difficult task to go back and "appraise" the value of the real estate as of the death of the husband. Another problem occurs if the decedent owned several residences over a period of years and, making matters even worse, made substantial improvements to each of the properties before selling. If no records are available as to the purchase price or basis of the first residence, then it will be difficult to make all of the adjustments necessary upon the sales and purchases of subsequent residences. In addition, taxpayers very often keep poor records as to substantial improvements they make to their properties. Such substantial improvements are treated separately for purposes of the "fresh start" rules and without sufficient records, it will be impossible to make the required calculations.

In many cases where a decedent has inherited properties over a period of years and has received substantial gifts over a period of years, there will be absolutely no record of where the items came from, of when they were acquired, nor of the basis of such items. The time spent by the executor in researching the basis of such items would be excessive.

The enormous problems of proof have already been discussed in detail. Suffice it to say that these problems are even more serious, since the proration rule is applied retroactively when taxpayers had no notice and now have no means of establishing the facts required to establish cost basis and acquisition date acquired many years ago.

The step-up in basis provided by the "fresh start" rule also contributes to the "lock-in" effect, since holders of highly appreciated property will attempt to hold such property until death to avail their estates of this step-up.

(7) *Foreign Tax Adjustment.*—Currently, no basis adjustment for unrealized appreciation in Carryover Basis property is allowed for foreign death taxes, even though they are actually paid and are credited against the Federal estate tax (as are state death taxes).

(8) *Special Use Valuation Election's Effect on Basis Adjustments.*—In the event of recapture, there is no current means to effect basis adjustments with respect to special use valuation property (§ 2032A), as though the election had not been made. This is a prime deterrent for electing special use valuation.

(9) *Miscellaneous.*—Certain aspects of the basis adjustments for Federal and state taxes on pre-1977 appreciation encourage taxpayers to make large sales and to reduce indebtedness immediately prior to death. Because the Federal and state estate tax adjustment are computed at the average rate of such taxes, if a highly appreciated asset is sold and a capital gains liability incurred immediately prior to death, the estate taxes are reduced at the highest marginal rate, therefore producing an overall tax advantage. Additionally, the deductions

under § 2053 are not included with the marital and charitable deductions allowed in determining the gross estate for purposes of the basis adjustment under § 1023(c). Therefore, basis may be further increased by satisfying indebtedness immediately prior to death.

VI. INCREASED BURDEN ON EXECUTORS

Executors have the responsibility to carry out Carryover Basis in the face of the multitude of problems previously described. Many of the professional executors, such as banks and trust departments, will refuse to serve except in very large estates. This shifts the burden of Carryover Basis to people with modest-sized estates and they are least able to afford professional assistance absolutely required to comply with this hydra-headed monster. In addition, executors now have more pronounced fiduciary duties to the estate and its beneficiaries, which cause justified concern.

A. *Fiduciary Responsibility of Executors.*—As previously mentioned, in determining the basis adjustments under subsections (c) and (e) of § 1023, providing for basis adjustments for Federal and state estate and death taxes, property qualified for the marital and charitable deductions are to be treated as not subject to tax and will not be entitled to these adjustments. Therefore, the executor must decide which assets to allocate to a marital or a charitable portion and which assets to allocate to the taxable portion of the estate. The difference is significant where certain assets have greatly appreciated and other assets have not greatly appreciated. If the greatly appreciated asset is allocated to the taxable portion of the estate, then the Federal and state estate and succession taxes paid with respect to such property may be added to the basis under subsections (c) and (e) of § 1023. This will have the effect of maximizing the basis increase and minimizing the gain realized upon subsequent sale. However, the gain that would have been realized upon the sale of the high basis-low appreciation asset still might be less, so the executor must determine how likely it is that a sale may occur in the taxable portion of the estate and what gains would be realized respecting the various assets in the estate if they were sold. Naturally, the executor will also have to consider the effect on the surviving spouse and to her beneficiaries upon her later death of allocating high-basis or low-basis assets to the marital portion.

The Carryover Basis provisions raise what appear to be unresolvable issues relating to the real value of assets in an estate. Under former law, when an executor was told to distribute, for instance, $150,000 to a beneficiary, no problem was presented.

Under the Carryover Basis provisions, that same executor is now confronted with the problem of how to satisfy such an instruction. For example, given two assets to work with, both worth $150,000, but one of which has a cost basis of $140,000 and one a cost basis of $10,000, which asset should the executor choose to deliver the designated beneficiary? Is that to be a fair market value at death, the value of any potential income tax liability in an asset, or some compromised value in between? This whole new world of questions relating to the true value of estate assets incredibly complicates the job of an executor distributing estate assets from an estate, forcing him to balance two variables where only one existed before, and exposing him in the course of this balancing act to increasing claims and liabilities from disgruntled beneficiaries.

B. *Section 6039A Notice.*—New § 6039A provides that every executor, as defined in § 2203, is required to furnish the Internal Revenue Service and the recipient of the decedent's property certain information with respect to Carryover Basis property. New § 6694A provides for substantial penalties for executors who do not furnish the information required under § 6039A.

A similar problem with the definition of "executor" appears with respect to § 6039A as appeared with respect to the election to exclude up to $10,000 worth of personal and household effects. In other words, where there is a small estate with respect to which formal administration is unnecessary, or where administration is not actually necessary because most of the property is jointly held or in the hands of an independent trustee or there are similar assets not passing through an executor's hands, there may be confusion as to who is responsible for filing the notices required under § 6039A. As previously indicated, § 2203 provides that the term "executor" means the executor or administrator of the decedent or, if none, then the person who is in actual or constructive possession of the property of the decedent. Therefore, where there is no formal administration of the estate, but there are several beneficiaries, it would be difficult to point to any one beneficiary and say he or she is responsible for filing the § 6039A notice.

Presumably, the original intent of the statute was to require the executors to file a § 6039A notice with both the Internal Revenue Service and the beneficiaries in order to aid in the determination and calculation of basis of Carryover Basis property. When referring to the House Ways and Means Committee Report on 1976 Bill, pages 45 and 46 state that the purpose of these two provisions is to provide the Internal Revenue Service and the recipients of property from the decedent knowledge of the Carryover Basis of the property and the adjustment provided for death taxes and the minimum basis adjustment. However, Congress did not give this notice any specific evidentiary value. In fact, the beneficiary is not bound by the contents of the notice and will have to make an independent verification of the facts contained in it. Courts of law and the Internal Revenue Service will also have to judge the credibility of the facts contained therein and the extent of their admissibility in a court of law.

Generally, it is fair to impose the responsibility upon the executor of calculating the adjustments to Carryover Basis, since he is in possession of the facts necessary for making these calculations. However, it is burdensome to place this responsibility on virtually every person who may be considered an executor within the framework of § 2203, regardless of his responsibility to file death tax returns, make the payment of taxes thereon, or, in fact, have the ability to ascertain the necessary facts to be contained in a § 6039A notice.

The problem is equally serious for the Internal Revenue Service, since it is not interested in receiving literally millions of documents that may have little relevance to its revenue raising function.

With respect to the penalties provided in § 6694A for "each failure" to supply information to the Internal Revenue Service or to the beneficiaries, a "failure" is not defined. Does it mean each item of property, or each beneficiary not notified? Does it include incorrect notification? Incorrect information? Furthermore, the penalty may be imposed even for negligent disregard for these complex rules on unsuspecting "executors."

VII. ALTERNATIVES TO CARRYOVER BASIS

When reviewing alternatives to carryover basis, three concepts must continually be kept in focus. They are simplicity, equity, and the total tax revenues to be raised from gratuitous transfers of wealth. Simplicity and equity are often competing, with compromise being reached on the amount of revenue needed to be collected and the administrative cost in doing so. Further, the burden on the small taxpayers must carefully be analyzed for it is these people upon whom the integrity of our self-assessment tax system depends.

A. *Outright Repeal.*—As has previously been discussed, without looking at the total effect of both death and income taxes, the carryover basis may appear more equitable than a step-up in basis at depth. However, if one extends this analysis of equity to encompass the income taxes and burden on small taxpayers, then one readily concludes that the simplest type of wealth tax is a full step-up in basis on the date of death. Previous Congresses have long realized that this compromise between equity and simplicity was properly handled this way and no doubt set death tax rates accordingly.

In order to compensate for the loss of revenue, two choices are available; rates could be raised to the level under former law or the unified credit could be reduced. In keeping with the spirit of the gift and estate tax reform, the former is preferable since it does not lower the threshold for filing Federal death tax returns in modest sized estates. Thus the larger estate, better able to afford a modest rate adjustment, bears this loss in revenue.

B. *Delay in Effective Date of Carryover Basis.*—The problems of carryover basis described herein are so overwhelming that its effective date should be postponed at least until December 31, 1978. This would allow a detailed examination of the current carryover basis provisions, as well as the carryover basis concept, and other alternatives available. This consideration is even more important in light of the substantive income tax reform proposals to be introduced by the Administration. Tax on gratuitous property transfers should complement the income tax law.

A continuing concern of Congress in any tax matter is the revenue impact. The Joint Committee of Taxation's Revenue Effect Projections for Carryover Basis (page 21 of its report on the Tax Reform Act of 1976, Table 2, Part II) demonstrate that no additional revenue will be produced for fiscal year 1977. The projected tax revenue to be derived from carryover basis in fiscal year 1978 is a mere $36 million. Very rarely has Congress been placed in the position of being able to postpone the effective date of such a significant law with so little revenue loss.

C. *Taxation of Unrealized Capital Gains at Death.*—Another method of replacing the lost revenue which has received considerable discussion and study is taxation of unrealized gains at death. Two principal methods of achieving this result have been proposed.

The first is a graduated tax which would be deductible in computing the estate tax. This method, which has been described as an Appreciation Tax, was proposed in H.R. 13966, and was offered as an election in lieu of carryover basis.

The other method is an Appropriation Estate Tax (commonly referred to as AET) which would be a flat rate tax not deductible in computing the estate tax. A form of statute designed to accomplish this result has been prepared by counsel for the American Bankers Association.

Two basic objections have been voiced to taxation of gains at death. The first is that it does not eliminate the problem of determining the decedent's basis in assets, a difficulty which is also inherent in carryover basis. The other objection to taxation of gains at death is that it eliminates the option afforded by carryover basis to determine the time when gain is to be realized, and consequently when gains taxes must be paid. By requiring payment at the time of death, the liquidity problems of estates would be greatly enhanced. This would be particularly evident in the case of estates comprised of closely held businesses or farms. Perhaps this objection is partially countered by the expanded use of the deferment provisions of §§ 6166 or 6166A.

(1) Appreciation Tax

The Appreciation Tax proposed in H.R. 13966 provided a graduated tax on the net appreciation in a decedent's gross estate at rates between 5 and 20 percent after an initial $50,000 exemption. The tax payable would be a deduction in the computation of the estate tax.

The imposition of a tax, whether flat or graduated, which is deductible from the Federal estate tax has the effect of imposing a relatively higher tax on smaller estates than on larger ones. Assuming a 35-percent capital gains tax rate, appreciation would be subject to a net tax of 10.5 percent if the estate is in a 70-percent estate tax bracket, but 23.8 percent if the estate is in a 32-percent bracket. Such a result would seem to be both socially and politically undesirable. The graduated alternative tax rates provided in H.R. 13966 appear to be an effort to alleviate this difficulty but cannot be expected to provide an equitable solution in every case.

Were it not for the fact that the tax would be deductible from the gross estate, however, the total tax on some highly appreciated, low basis assets, when the preference tax is taken into consideration as well, could exceed 110 percent of the value of the asset.

Whether the preference tax should be applicable to a graduated tax on capital gains at death is a policy question, but consideration must be given to the total effect which the imposition of this additional tax would have on the total taxes payable.

Another matter to which attention should be directed is the proper manner of treating any capital loss carryover of the decedent in applying the capital gains tax at death. It would seem consistent with the total scheme to permit the use of the carryover in computing the total tax due.

In any estate with substantial unrealized appreciation at the time of the decedent's death, the total tax payable under an Appreciation Tax, coupled with the estate tax could well exceed the rates of tax under prior law.

(2) Appreciation Estate Tax

The AET, by imposing a flat rate nondeductible tax on unrealized appreciation would not discriminate in favor of large estates the way a deductible tax would. Its proponents acknowledge that a flat rate estate tax would constitute a double tax on the appreciation in the estate, because it would already have been taxed at regular Federal estate tax rates. It is probably for that reason that the American Bankers Association has suggested that the flat rate is fixed at 7 percent, which would bring the maximum rate of tax with respect to appreciation up to 77 percent, the maximum rate under prior law.

The imposition of an AET would also avoid the problem of the preference tax which is generated under prior law.

The imposition of an AET would also avoid the problem of the preference tax which is generated under the Appreciation Tax proposal.

Again, equity would require that any capital loss carryover or net operating loss of the decedent be netted against the appreciation subject to the AET.

(3) Possible Exemptions From The Tax

Proposals with respect to taxation of capital gains at death, whether by an Appreciation Tax or an AET, have usually included suggestions of various exemptions from the tax. In the case of the exemptions, carryover basis might apply. The principal exemptions suggested are for property qualifying for the marital, charitable and orphans deductions as well as property qualifying for extension of time for payment of the estate tax under Sections 6166 or 6166A or for the special use valuation for real property under Section 2032A.

It is generally conceded by proponents of these schemes that property qualifying for the charitable deduction should be exempt from taxation of gains at death. Problems occur, however, with respect to the treatment of split interest trusts, where both charitable and non-charitable interests are involved.

In the case of the marital deduction, suggestions have ranged from one extreme of applying carryover basis to such assets through offering an option to the executor as to whether to apply carryover basis or pay the tax, to the other extreme of no exemption from the payment of the tax. Simplicity under the tax laws would seem to favor subjecting property passing to the marital trust to immediate tax. Offering the alternative to the executor to select immediate payment or carryover basis subjects the executor to a potential surcharge action for having made the wrong selection and would also raise the problem of selection of assets for allocation to the marital trust which was discussed in an earlier part in this paper.

Proposals for exemption of property qualifying for extension of time for payment of taxes or for special valuation under Section 2032A stem from the fact that the need for those sections is based largely on a presumed lack of liquidity in the estate. Funds for the payment of the gains tax at the time of death would therefore presumably not be available. Again, in the interest of simplicity under the tax laws, it may be suggested that no exemption should be allowed but that the tax payable be made subject to deferment under Sections 6166 and 6166A. The same argument would apply with respect to Section 2032A property because of the availability of one or both of the sections permitting extension of time for payment of taxes.

(4) Dollar Amount Exemption

Various suggestions have been made in connection with taxation of capital gains at death with respect to exemptions based on the size of the estate or the amount of appreciation involved. H.R. 13966, for example, provided for an exemption from tax on the first $50,000 of unrealized appreciation. The American Bankers Association's AET proposal would grant an exemption in the amount of $60,000. Other suggestions have been to the effect that the tax should be payable only in estates with respect to which a Federal estate tax return must be filed.

Tangible personal property and personal residences have also been suggested as items to be excluded from the tax, at least up to some figure.

Because these matters are strictly a matter of tax policy we deem it inappropriate for the American Bar Association to take a position on these questions. We do believe, however, that consideration should be given to some sort of dollar exemption in general, and perhaps also with respect to tangible personal property and residences.

(5) Fresh Start Adjustment

Because taxation of gains at death involves the same problem which caused Congress to add paragraph (h) to Section 1023, providing for a fresh start adjustment, it would be proper that any provision for taxing capital gains at death also provide such an adjustment.

The problems inherent in the fresh start provisions of paragraph (h) of Section 1023, as previously discussed, should be solved so that the adjustment will be both equitable and workable, irrespective of whether carryover basis is retained or capital gains become taxable at death.

(6) Additional Considerations

With the unification of estate and gift taxes, consideration should be given to treating transfers inter vivos and transfers at death in the same manner from the point of view of unrealized appreciation. If transfers at death are to be subject to tax on the unrealized gain, should inter vivos gifts of appreciated property be subject to a comparable tax, rather than being subject to carry-over basis as is the current rule?

VIII. ADVANTAGES OF TAXATION OF GAINS AT DEATH OVER CARRYOVER BASIS

The primary advantage which taxation of gains at death has over carryover basis is that the old rules providing for a step up in basis of assets will be restored. Administration of estates under these rules would be subject to all the law which has been developed over the years in this regard. Reversion to traditional rules of estate administration would lend a measure of certainty to that process which will never be achieved under carryover basis.

Of even more importance is the fact that the duties of estate administrators would be greatly simplified by the elimination of the problems inherent in allocating assets with differing capital gains liabilities among beneficiaries with differing interests. Ths particularly enures to the benefit of small and modest sized estates, which do not have available professional assistance at reasonable cost.

A matter of importance both to administrators of estates and to the Internal Revenue Service is the fact that the suspended basis problems previously discussed would be eliminated. Income tax returns for estates and trusts could be filed without the necessity of a subsequent amendment when the adjusted basis of assets had finally been determined. Similarly, the lock-in effect of owning carryover basis property would be eliminated. In addition, tax considerations would no longer dominate investment decisions. The complexities of having several bases for assets (i.e., a basis for gains, a basis for loss, a basis for state tax purposes) would be eliminated.

Finally, taxation of gains at death has the additional advantage from the point of view of the Treasury of realizing immediate revenue rather than postponing the realization of that revenue until some date in the future when assets with a carryover basis would be sold; however, this should be reflected in a substantially lower tax rate, due to this earlier payment.

IX. DISADVANTAGES OF TAXATION OF GAINS AT DEATH OVER CARRYOVER BASIS

One of the major objections to carryover basis is the problem of establishing the date of acquisition and the cost basis of assets held by the decedent. Taxation of capital gains at death does not provide any solution to that problem. Taxation of gains at death, with concurrent step up of basis does, however, ameliorate the problem insofar as succeeding estates are concerned. A basis will be established at the time of the decedent's death and there will be no need to maintain carryover basis records over several generations.

The primary disadvantage of taxation of gains at death, however, is that the decedent's estate is forced to pay the taxes immediately. There is no opportunity to select the time for realizing the gain. Under carryover basis, realization of the gain can be postponed for many years and even for several generations. The liquidity problems so frequently present in decedents' estates are thereby substantially increased under a taxation of gains at death procedure.

The adoption of a statutory scheme which would tax capital gains at death, giving a step up in basis to assets in the decedent's estate, has some few advantages over carryover basis in terms of simplicity and certainty. It does not, however, eliminate one of the major problems under carryover basis—the establishment of the base from which appreciation is to be calculated. Finally, it has the disadvantage of increasing the liquidity problems in most estates.

CONCLUSION

Again, it is our strong recommendation and urging that the Committee act to adopt S1954 to repeal Carryover Basis and return to the prior law providing step-up in basis at death with revenue loss, if it is significant, being recouped in another way. At the very least we recommend the immediate adoption of S2227 to extend the effective date of Carryover Basis until December 31, 1978, to permit adequate time for study of the multitude of problems and formulation of a workable solution.

AMERICAN BAR ASSOCIATION,
Boston, Mass., September 9, 1977.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: When the appropriate time comes (and we hope that it will be very soon) to evaluate and reconsider some of the basic changes made by the Tax Reform Act of 1976 to the previous income tax laws, we hope that the following views will be considered very carefully and weighed very heavily.

The Section of Real Property, Probate and Trust Law is the next-to-largest Section of the American Bar Association, with a membership of approximately 22,000 lawyers. It is the continuing concern of the Section that fairness, equity and common sense characterize the law, and its application, in the fields of estate and tax planning and administration. The purpose is to protect the general public—the consumer of the services performed by the Section's members.

In the field of estates, as in other areas of the law, the overwhelming demand of the consumer is for simplification, expedition and cost saving. The public has complained long and vociferously about probate expense and delay and about the high cost of dying, and we share the public's concern. Over the past decade our members have participated in extensive efforts in all parts of the country to reform state law by reducing court involvement in the probate process. A number of states have adopted the Uniform Probate Code, which is based upon the principle of independent administration of estates. Other states have introduced into their own probate systems parts of the Uniform Probate Code or ideas taken from it. These developments serve consumerist purposes of simplification and economy.

Tax reform of all kinds should serve comparable consumerist purposes. Unless the legislation meets the test of simplification, and in the modest-to-medium-size situation, the test of cost-saving, it is not responsive to the demands or needs of the public. At this time we will not attempt to apply these tests to the full range of estate, gift and related income tax changes that fall under the umbrella of the Tax Reform Act of 1976. We wish to focus our attention on the "carryover basis" provisions of the Act. We believe that this part of the legislation is a public disaster. The carryover basis provisions have created an administrative nightmare of increased complexity, delay and expense in processing estates.

To begin with, determining the decedent's basis will be a major problem, to the extent that the carryover basis provisions apply to assets held before passage of the Tax Reform Act of 1976. It may be difficult or impossible for elderly individuals to document the cost basis of long-term assets, particularly inherited assets, tangible personal property and residential property that includes capital improvements made over many years. After the property owner dies the difficulty or impossibility of determining basis will be the more certain. Under the best of circumstances, it will be burdensome and expensive to determine the cost basis of stock of a single corporation purchased in several lots, each of which the Act treats as a separate asset for basis purposes. Stock splits and stock dividends compound the difficulty. Imagine the detailed and complex calculations—and the cost of accounting and support services—required to determine the carryover basis of a mutual fund holding with dividend reinvestment and/or a periodic withdrawal program.

But determining basis is only the beginning. The Act provides for four possible adjustments to basis, each of the last three turning on calculations made in the preceding adjustment. The adjustments are accomplished by a series of incredibly complicated calculations, which probably can be handled efficiently and effectively only by computer. The adjustments must be made with respect to each asset, and even a modest estate will have many assets. Moreover, there may be several bases for a single asset, since the adjustment to December 31, 1976, values is made for the purpose of determining gain, but not for the purpose of determining loss. Since only assets subject to tax qualify for some of the adjustments, assets will have a different basis if allocated to a marital deduction share for the spouse than if allocated to the residue. Basis will be suspended during the period of administration until that allocation is made. There may be as many as four possible bases for a single asset.

The adjustments to basis will have to be made to comply with the reporting requirements that accompany the carryover basis provisions. But it is not a matter of doing the calculations just once with respect to each asset. Preliminary basis calculations will be needed after the estate is opened to determine which assets to sell to raise funds; if the basis report is due with the federal estate tax return, the calculations will have to be made when the return is prepared; and they will be done again when audit of the federal estate tax return is complete.

The elements of the calculations are such that the change on audit of one dollar in value of any carryover basis asset subject to tax will change the adjusted basis of every such carryover basis asset in the estate. Doing the laborious calculations will consume large amounts of professional time and will correspondingly increase the costs of administering an estate. Computer services may become available to expedite the procedure, but it may be difficult for accountants and lawyers in general practice to avail themselves of such services and the estate will in all events incur significant additional expense. Experienced accountants, attorneys and banks are still wondering, nearly a year after the Tax Reform Act passed, how they will cope with these calculations. Again, the costs of compliance are likely to exceed substantially the amount of tax at issue.

The Tax Reform Act requires every "executor" to furnish an information report on carryover basis property to the Internal Revenue Service and to the person acquiring the property, and it imposes a maximum penalty of $7,500 for failure to comply. "Executor" is defined for this purpose as the recipient of any property of the decedent. This definition covers the surviving spouse who receives $500 in joint carryover basis property from her deceased spouse. If there is no asset to be probated, the survivor may not be advised of the reporting requirement. Although there is clearly no federal estate tax return due, the spouse will face a penalty for her failure to report to the Internal Revenue Service the basis of this asset.

The reporting requirements and penalties may make banks and others reluctant to serve as executor. Often the decision of whether to serve must be made before full financial information can be developed. Rather than risk not being able to comply with the reporting requirements, or being able to do so only after great expenditure of time, named executors may simply refuse to serve. This result will most likely occur in the case of small and middle size estates, where fees do not compensate for the added burden and risk.

Since the basic of no carryover basis asset in an estate can be finally determined until conclusion of the federal estate tax audit, estate administration will be prolonged. Amended fiduciary income tax returns and refund claims will become the rule rather than the exception. Protective refund claims may have to be filed out of concern for the statute of limitations. Beneficiaries already complain about delays in closing estates, and the delays will now be more widespread and of longer duration.

The economic impact of carryover basis will be felt by estates of all sizes with appreciated assets. Almost all estates that include residential property fall in this category. The Tax Reform Act increases from $60,000 to $175,000 (in 1981) the amount that may pass free of federal estate tax. But if there is substantial gain inherent in the assets after the basis adjustments are made, selling the property and paying income tax on the capital gains will reduce or entirely eliminate the estate tax savings. As we move away from December 31, 1976, and the fresh start becomes inapplicable, we will see that small and middle size estates will pay more under the Tax Reform Act with carryover basis than under the prior law. This result is contrary to the policy implicit in the unified credit and the expanded marital deduction.

All these considerations lead us to recommend strongly the total repeal of carryover basis. Whatever equity carryover basis in theory promotes is more than offset by the practical problems that it produces in administration. The administrative burdens and the attendant costs will be felt most acutely by the modest to medium-size taxpayers that could most benefit from simplification, expedition and cost-saving.

If repeal cannot be accomplished, we urge that the carryover basis provisions be amended in major respects. Changes that would make carryover basis somewhat more workable include "grandfathering" all pre-1977 assets under the old law, with a full step-up or step-down of basis to federal estate tax value; substituting "averaging" of basis for asset-by-asset carryover; substantially increasing the $60,000 minimum basis and modifying the computation of minimum basis. These changes would provide relief from some of the worst defects of carryover basis.

Within the American Bar Association the Tax Section is the normal channel through which technical changes in the Internal Revenue Code are cleared. That Section is aware of and appreciates our Section's basic practical and administrative objections to the "carryover basis" provisions of the 1976 Tax Reform Act. In addition, the Tax Section stands ready to collaborate with our Section and Congressional staff on the drafting of amendments, if it appears that is the only politically feasible solution to this problem. At this time, however, we feel that the porvisions are a dreadful mistake and that they should be repealed. We are concerned that attempts at amendment will run the very strong risk of compounding the initial mistake rather than curing it.

We will be pleased to elaborate upon the ideas presented in this letter and we and the Tax Section stand ready to assist your Committee in its consideration of estate, gift and related income tax legislation.

Sincerely yours,

FREDERICK S. LANE, *Chairman*.

Senator BYRD. The next witness is Mr. Sheldon Cohen.

We want to welcome you, Mr. Cohen, as a former, very able Commissioner of Internal Revenue. We are always very glad to have you before this committee.

STATEMENT OF SHELDON COHEN, FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. COHEN. Thank you, sir.

I appear today, Senator, as an attorney practicing law in Washington, in my individual capacity, and not on behalf of any client or organization. I ought to say that while I am a member of the Tax Section of the American Bar Association, the previous panel does not speak for me or many other members.

Senator, I will try to summarize my testimony, rather than read what we have, asking you instead to put that in the record.

There are problems with carryover basis, but many of the opponents today and otherwise have set up strawmen and proceeded to demolish them. If we are going to deal with strawmen, we are not going to face the issue.

We have had an income tax in the United States since 1913. The income tax requires that I maintain my basis records. Therefore, every problem that the gentleman discussed in the context of the maintenance of basis records is inherent in the income tax.

We just recently settled a case in regard to theft of a very valuable coin collection. It was collected over a number of years.

The owner, of course, had recorded each coin and the approximate date he acquired it. He could establish value from various appraisal books, similar to appraisal books for automobiles, but he did not always have the exact date of acquisition and he did not always have the exact basis. Many of them he did have, and many of them he did not.

In dealing with the agents, as other attorneys have dealt with agents before, the attorney in our office was able to establish to the agent's satisfaction the basis of the coin collection.

We are dealing in the real world with real problems that arise everyday. I do not think that people do not maintain records. Most people do maintain records, because each of us goes through life knowing that we may sell an asset.

If we sell the asset during our lifetime, we must establish the day we bought it and its value.

Some of us are slobs, and some of us are careful. We are going to have to deal with that forever.

So I do not know if we can destroy a valuable concept on the basis that some people do not maintain records.

We are dealing, if the Treasury's modifications as suggested by Senator Dole and yourself are adopted, with a minimum basis adjustment, so carryover basis applies on the order to only 2 percent of the people: and those are the 2 percent who are most able to keep and maintain records.

I would like to start with that.

The problem that we face here is what is the right rule. As the Treasury people have testified, there has been a great deal of justified criticism of the old rule, the fair market value at date of death basis rule.

The old rule favors those people who do not turn over assets during a lifetime. Sometimes they are small business people; more often, they are large business people.

It also stultifies commerce. That is, there is another ingredient that enters into whether I should buy or sell an asset, the tax picture. Whether I should sell an asset should be solely an economic decision.

If you follow my testimony, Senator, you will find that I am in favor of that alternative which was mentioned a few moments ago. I personally favor fair market value at the date of death basis with full capital gains taxation. Now, I understand that there would be many problems created by that. However, none of them are insurmountable, since most problems can be handled by long-term payments and other things of that nature.

That is basically a summary. We could go item by item, but I do not think that is necessary in light of the testimony this morning.

The technical adjustments that have been suggested by you and Senator Dole are good. Treasury agrees that most of them should be made. You will find in my testimony that I agree that most of them are good. There are techniques for moderating some of the problems.

We did have a quid pro quo in the 1976 act. Two years put off is 2 years lost because, as Mr. Ullman said in hearings on the same measure, he took a package, at least, he understood that he and his committee took a package. That package was so much revenue brought in by carryover basis and by the integration of the rate structures for the gift and estate taxes, and a reduction of the rates and certain other modifications, such as an increase in the exemption equivalent of the credit.

It is difficult to ask the American taxpayer to deal with three or four different rules in the course of a relatively short period of time.

So it appears to me that I prefer, from my point of view—I practice law, and I deal with small taxpayers and large taxpayers, and I deal with my own estate and my children—that we would be better off modifying the problem areas that are recognized and having an intensive study as to whether we ought to move, as many of the experts have said, toward full realization of gain at death.

Mr. Ullman has suggested a modified tax at that time at less than the full rates. Something on that order might be a possibility.

With those comments, I would ask that the Senator read my prepared statement at his leisure, and I would be glad to answer any questions he might have.

Senator BYRD. Thank you, Mr. Cohen. We are glad to get your testimony. Thank you, sir.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF SHELDON S. COHEN

Mr. Chairman, and Members of the Committee, my name is Sheldon Cohen. I am an attorney engaged in the practice of law in Washington, D.C., and I appear before the Committee in my individual capacity, not on behalf of any client. I wish to state for the Committee's consideration my views regarding the estate tax rules applicable to unrealized appreciation.

I. STATEMENT OF THE PROBLEM

The estate tax provisions prior to the 1976 Tax Reform Act provided that property passing from a decedent would take as its basis its fair market value at the date of the decedent's death, or its value on an "alternative valuation date" six months after the decedent's death. The old rule resulted in a "stepped-up" basis for appreciated assets owned by the decedent at the time of his death. The increase in basis permitted under the old law did not affect the estate tax owed by the decedent. Rather, it eliminated the income tax which would have been paid if the property had been sold by the decedent during his life.

The 1976 Tax Reform Act changed the estate tax rules by providing that property passing from a decedent would take as its basis the decedent's basis, with certain adjustments. This "carryover basis" rule means that income tax that would have been paid by the decedent if he sold the property during his life is not eliminated, unlike the prior law. Rather, income tax on the appreciation in value is deferred until the property is sold by the decedent's estate or his heirs and distributees. The 1976 Act, however, did not adopt the carryover basis rule in its pure form. Certain adjustments to the decedent's basis are permitted, the most significant being that property owned by the decedent on December 31, 1976 and included in his estate is allowed to pass to his heirs with a basis equal to its value on that date. This rule in effect eliminated the income tax on any appreciation in value of those assets held by a decedent on December 31, 1976, which are included in his estate. Much of the complexity of the carryover basis rule results from the December 31, 1976 valuation date.

There is another alternative to the carryover basis rule of the 1976 Tax Reform Act, namely, subjecting the appreciation in value of assets to an income tax at death.

At the present time, the carryover basis rule of the 1976 Tax Reform Act is under attack. Its critics claim that the carryover basis rule is too complex and that it is administratively difficult to apply. The critics have generally recommended either a delay in the effective date of the carryover basis rule, a restriction as to the assets to which it is applicable, or a return to the stepped-up basis rule provided prior to the 1976 Tax Reform Act.

I believe the "problems" raised by the critics of the carryover basis rule have been viewed out of focus. In my opinion, the old stepped-up basis rule was poor tax policy which resulted in a substantial unjustified loss of revenue to the Treasury. In addition, the stepped-up basis rule encouraged people to hold their assets and resulted in a "lock-in" effect. Although the new carryover basis rule is not free from defects, it is an important step in the process of tax reform, and it should not be delayed or discarded. We should continue to move forward in that process. I believe that the next step in the process of tax reform should be full consideration of the merits of taxing appreciation at death, together with consideration of rules necessary to mitigate the problems raised by such a rule.

II. THE STEPPED-UP BASIS RULE WAS NOT JUSTIFIED

A. *The stepped-up basis rule was bad tax policy and resulted in a substantial unjustified loss of revenue to the Treasury.*—I believe it might help the Committee if I briefly review the tax inequities and abuses which arose under the old stepped-up basis rule.

Under the old rule, a person whose income consisted of salaries, wages, dividends, or business profits was taxed at ordinary income rates on an annual basis; and a person whose income consisted of gain from the sale of capital assets was taxed at the lower rate applicable to capital gains. In both of these cases, the estate which could be passed on to the decedent's beneficiaries at his death was accumulated after the imposition of an income tax.

On the other hand, a person who owned assets which had appreciated in value, and who could avoid selling those assets during his lifetime, could avoid income tax on the gain attributable to the appreciation. The gain attributable to the appreciation would not be subjected to income tax during his life, and upon his death, his beneficiaries would receive a fair market value basis for the assets. Therefore, no one would ever have to pay an income tax with respect to the appreciation during the decedent's life.

The result, then, under the old law, was that a person able to accumulate wealth in the form of unrealized capital gains could effectively pass on this accumulated wealth free of any income tax. The less wealthy individual, whose wealth was accumulated from ordinary income and gains which he was forced to realize by sales during his lifetime, could only transfer accumulated wealth after it had borne an income tax.

The old stepped-up basis rule ignored the fact that estate taxation is not, and was never intended to be, a substitute for income taxation. Rather, it is a separate and distinct tax with its own objectives. Whereas, the income tax is a tax on accretions to wealth, the estate tax is a tax on the right to transfer property. The old stepped-up basis rule, in effect, forgave the capital gains tax that would otherwise have been due on appreciation merely because the appreciation had to bear an unrelated estate tax burden.

If an individual sells appreciated property before his death, an income tax is incurred on the gain. Thereafter, the value of the property, less the income tax, is subject to the estate tax imposed upon the transfer of the property to the individual's beneficiaries. I do not believe that there should be a different result merely because the appreciated property is held until death.

I believe that the old stepped-up basis rule resulted in a significant unjustifiable revenue loss to the Treasury. In 1969, the Treasury Department estimated that at least $15 billion a year in capital gains fell completely outside the income tax system as a result of the stepped-up basis rule.

B. *The stepped-up basis rule resulted in an undesirable lock-in effect.*—In addition to the tax policy aspect of the rule, the old stepped-up basis rule resulted in an undesirable "lock-in" effect. Because the income tax on appreciation could be completely avoided by holding appreciated property until death, older people were encouraged by the tax law to hold such property in order to transfer it to their beneficiaries free of income tax. Thus, many investors became locked-in to their investments, and the economy was deprived of the benefits resulting from an unencumbered flow of capital into those new areas of enterprise which promised larger rewards.

III. ADOPTION OF THE CARRYOVER BASIS RULE RESULTED IN IMPORTANT TAX REFORM

The new carryover basis rule does not completely eliminate all of the above-described deficiencies, but it is certainly a step in the correct direction. No longer may the beneficiaries of a person owning appreciated assets convert those assets into cash without incurring an income tax upon the income attributable to the appreciation in value. If the beneficiaries wish to liquidate an appreciated asset, they now must pay an income tax that is similar to that which would be incurred by the beneficiaries of those decedents who had to liquidate their appreciated assets during their lifetimes.

Admittedly, the carryover basis rule does have problems. First, the lock-in effect discussed above is in some cases accentuated. Previously, an elderly person would hold an asset until his death, at which time his beneficiaries would be able to sell the asset with no income tax liability. Under the carryover basis rule, the beneficiaries may feel constrained not to sell the appreciated asset. If they sell the asset, the resultant income tax liability will reduce the value of the income producing property which remains in their hands.

However, off-setting this tendency is the fact that, under the carryover basis rule, if it is economically desirable to liquidate an appreciated asset, there is no reason to postpone the sale until after the owner's death.

Many critics of the carryover basis rule have argued that it is overly complex and entails many administrative problems. Many of the administrative problems arising under the carryover basis rule stem from the adoption of the December 31, 1976, valuation date. Some of these administrative problems would be eliminated by Section 3(c)(1) of H.R. 6715. This proposed change in the law provides for the determination of the December 31, 1976 value of property by using a formula to discount the property's value, as determined for Federal estate tax purposes, backward to December 31, 1976. The use of this formula would eliminate many of the administrative burdens on the estate which may be caused by the carryover basis rule.

The carryover basis rule also may cause administrative problems when combined with the adjustments for Federal and state estate and inheritance taxes, and the $60,000 minimum basis provision. These adjustments are the result of an attempt to make the carryover basis rule more equitable.

The purpose of the adjustment for estate and inheritance taxes is to put the beneficiaries of a decedent who holds appreciated assets in the same position as the beneficiaries of a decedent who sells his appreciated assets prior to his death. The purpose of the $60,000 minimum basis adjustment is to reduce the complexity of the carryover basis rule by making it inapplicable to the vast majority of estates. It is important to realize that many people feel that it is debatable whether these adjustments actually increase the fairness of the carryover basis rule.

If it is felt that these adjustments increase the fairness of the carryover basis rule, however, they can still be eliminated if it is concluded that the inconvenience caused by them outweighs the increased fairness which they bring about. The carryover basis rule, without these adjustments, is still preferable to the stepped-up basis rule.

Recently, S. 2227 was introduced in the Senate. This bill postpones the effective date of the carryover basis rule to December 31, 1978. I believe that such a delay is unwarranted.

The only justification for a two-year postponement in the effective date of the carryover basis rule is that more time is needed to consider the rule in order to determine whether it is an appropriate rule. As discussed above, the carryover basis rule is clearly preferable to the stepped-up basis rule. Before the carryover basis rule was enacted, Congress had heard all of the arguments at length with respect to the rule. Since 1921, the gift tax has had the carryover basis rule. No more study is needed for us to know that the carryover basis rule is better than the stepped-up basis rule.

S. 2228 was also recently introduced in the Senate. I would like to address myself to three features of the bill:

(i) Making the carryover basis rule inapplicable to property held on December 31, 1976;

(ii) Increasing the minimum basis adjustment so as to conform to the exemption equivalent of the unified estate and gift tax credit; and

(iii) Simplifying the adjustment for Federal and state estate and inheritance taxes.

I oppose making the carryover basis rule inapplicable to property held on December 31, 1976. One reason many people advance for such an exemption is that they were surprised by the new rule, and therefore, do not have the records necessary to allow them to make the required basis adjustments. Although this may present a problem, I believe it is important to realize that these people knew that if they ever were to sell the property it would be necessary under the income tax law for them to be able to prove their basis and date of acquisition. I do not believe that their lack of diligence in complying with the requirements of the income tax law should be rewarded by allowing them to permanently escape income tax on any appreciation in value of such property subsequent to December 31, 1976.

Some people are opposed to the present method of allocating appreciation of property between the holding period of the property prior to December 31, 1976, and the holding period of the property subsequent to that date on the basis of the length of each time period. They are also opposed to the use of a formula to discount the date of death value of property to December 31, 1976. They believe that both may result in undervaluing the property on December 31, 1976. I believe that it is important to recognize that these methods are to avoid a December 31, 1976, appraisal. They are in the interest of a simplicity: and as with many simplifying rules, in some cases, they may result in some injustice. However, on balance, I believe that the simplification is worthwhile.

A major problem with the exemption of property held on December 31, 1976, is the lock-in effect. If the only kind of appreciation which can completely escape income tax is appreciation in such property, there will be a tremendous incentive for people to never dispose of such property during their lifetimes.

I believe that it is important to recognize that the carryover basis rule was the quid pro quo for the Tax Reform Act of 1976's reduction in estate taxes. No one is asking for a delay in the effective date of the reductions or for a reduction therein. Unless there is such a delay or reduction, it seems inappropriate to delay the effective date of the carryover basis rule or to reduce its impact.

I believe that S. 2228's increase in the minimum basis adjustment so as to conform the adjustment to the exemption equivalent of the unified estate and gift tax credit is desirable. Such a change would be a tremendous administrative convenience to small estates, and would result in the carryover basis rule being applicable to only a small percent of all estates.

Similarly, I believe that simplification of the method of adjusting for Federal and state estate and inheritance taxes is desirable, although the method adopted in S. 2228 is not the only possible method and may not be the most effective.

IV. TAXATION OF APPRECIATED PROPERTY AT DEATH

The carryover basis rule is not the best rule possible. First, it allows unrealized appreciation to pass through successive generations without ever being subjected to an income tax if the family does not sell the appreciated assets. Thus, the carryover basis will be most advantageous to the very wealthy who can postpone the realization of such gains. Second, it has a lock-in effect. Third, as long as appreciated assets pass from one generation to the next without being subjected to an income tax, there is a loss of revenue to the Treasury. All of these deficiencies would be eliminated by subjecting all appreciation to an income tax upon death.

Although imposing an income tax upon appreciation at death is a preferred solution, and should be part of tax reform legislation to be proposed in the future by the administration, the carryover basis rule does present a significant improvement over the old stepped-up basis rule. To return to the old stepped-up basis rule, in order to eliminate some problems that are presented by the carryover basis rule, would be to take a step backwards in tax reform.

In enacting the carryover basis rule, Congress heard all of the arguments at length and decided to at least start to move forward on tax reform. It is to be congratulated for this. This positive action, taken after years of study by tax experts and careful consideration by the Congress, should not be hastily reversed.

Senator BYRD. The next witness will be Mr. Frank Berall, American College of Probate Counsel, accompanied by Mr. Arthur Peter, Jr.

STATEMENT OF FRANK S. BERALL, AMERICAN COLLEGE OF PROBATE COUNSEL, ACCOMPANIED BY ARTHUR PETER, JR.

Mr. BERALL. Mr. Chairman, I am Attorney Frank S. Berall, of Hartford, Conn., chairman of the Estate Gift Tax Reform Committee of the American College of Probate Counsel. The college is a group of nearly 2,000 probate lawyers specializing in estate planning and administration in every State and in the District of Columbia.

I am appearing on their behalf, accompanied by Attorney Arthur Peter, Jr., of Washington, D.C., who is the secretary, a regent, and also a member of the estate and gift tax reform committee of the college. We sincerely appreciate the privilege of appearing before you today to emphasize the important points in our written statement.

We advocate the outright repeal of carryover basis and a return to the former law's step-up or step-down in basis to Federal estate tax values. We believe that this should be made effective as of January 1, 1977, so that carryover basis will be retroactively expunged from the Internal Revenue Code and never have been in operation.

Carryover basis affects all estates, even those that would not have paid Federal estate tax under the old law's lower exemption. It is a giant step backward from the goal of inexpensive and expeditious probate for all estates, regardless of their size.

The expectations of small businessmen, farmers, and average Americans that the Federal estate tax would no longer be a problem for them after 1976 are being rudely dashed since that tax on them has been replaced by the far more onerous carryover basis rules, regardless of the size of their estates.

Therefore, the American College of Probate Counsel strongly supports the Curtis bill, S. 1954, which would repeal carryover basis completely and return to the pre-1976 law. However, as professionals specializing in estate and trust planning and in the administration of estates and trusts, we recognize our responsibility to comment on the alternatives to complete repeal which are before this committee.

Of the alternatives, we heartily endorse S. 2228, the Byrd-Dole bill, containing changes designed to make carryover basis less burdensome. We consider this bill to be far superior to S. 2238, the Hathaway bill.

But the enactment of the Byrd-Dole bill will still not solve the fundamental problems of carryover basis. For example, with respect to the post-1976 assets, even small- and medium-sized estates must know the cost of each one of these assets and its fair market value at the decedent's death. This is true whether or not an estate tax return is required, because the minimum basis available for such assets, whether $175,000 under the Byrd-Dole bill or a lesser amount, must be allocated among these assets in accordance with the appreciation of each asset compared with the aggregate appreciation of all carryover basis assets.

However, with the enactment of the Byrd-Dole bill, at least carryover basis will not then be totally unworkable, as we believe it to be now. The main reason why the Byrd-Dole bill will succeed in at least giving a workable or partially workable system is because the keystone of that bill is section 3(a), grandfathering all property held on December 1, 1976, so that decedents retaining such property will have the old basis rules apply to it. Thus, this particular provision makes it unnecessary to cope with the complexities and inequities of fresh start. The provision is true tax simplification.

Nevertheless, yesterday, the Treasury opposed grandfathering, on the grounds that it would increase the lock-in of assets held on December 31, 1976, and that it would also be subject to great abuse. We believe the Treasury to be wrong on both points. The present fresh start provisions encourage a lock-in of marketable securities. As Mr. Kartiganer explained a few moments ago, grandfathering will do little to increase this tendency.

On the other hand, fresh start is causing the owners of closely held businesses to sell them because of the potential future reduction in basis to their heirs, the longer these closely held business owners live. An example of this problem, Senator Byrd, is the late 1976 sale in New York City of the New York Post. Grandfathering would encourage small businessmen and farmers to retain rather than sell their assets, thus preserving family businesses and farms.

The Treasury claims that abuse of grandfathering is based on the potential for using a present loophole in the fresh start adjustment, which permits the aging of assets. It was very ably described by Mr. Kartiganer a few moments ago. We believe that section 3(a)(2) of the Byrd-Dole bill, which adds a new paragraph (4) to section 1023(b) of the Internal Revenue Code, effectively closes the existing loopholes, thus preventing grandfathering, should you enact it, from being subject to abuse. The amendment is simple and the Treasury is given wide latitude to deal with the problem through regulations.

All things considered, it is our belief that the grandfathering provision is the most important single one in the Byrd-Dole bill. Without it, fix-up will not really be workable.

If carryover basis cannot be repealed, and we believe its repeal to be your best course of action, then we urge you to enact grandfathering in lieu of fresh start.

Besides the provisions already in the Byrd-Dole bill, we suggest three additional amendments, in relation to carryover basis.

First, we think that you should increase the present $10,000 exclusion for tangible personal property to $50,000 or to such other amount that would end the substantial administrative burden on the estates of all persons other than collectors of art, stamps, et cetera.

Secondly, while the Byrd-Dole bill permits the Federal income tax paid on gains realized on a section 303 redemption to be included in the amount of the redemption, the bill does not allow redemption for the amount of State and local income taxes, such as the New York City income tax, on the gain. These State and local income taxes should be included also in that provision.

Third—and this point is not in our written statement—we would echo Mr. Kartiganer and the American Bar Association in exempting noninvestment assets from carryover basis in the future. We think that despite former Commissioner Cohen's testimony, the problem of recordkeeping does exist in the real world. We need merely to refer your committee to the letter placed in the Congressional Record on August 2, 1977, by former Solicitor General and Harvard Law School Dean Griswold, who pointed out how all his life he was collecting postage stamps and now he has no records at all with which to reconstruct his basis.

If so knowledgeable a person as Dean Griswold, a tax expert, could be falling into this trap, we certainly would expect that with the possible rare exception of a few of Mr. Cohen's clients, most people will have a serious recordkeeping problem.

Turning to another subject, we are concerned over the substantial hardships caused innocent parties as a result of their ignorance of the retroactive effective date of the generation-skipping tax in the 1976 law. We recommend that these dates be pushed back, at least to October 4, 1976, its date of the enactment, or, in the case of irrevocable trusts, to August 5, 1976, which was the date that the Senate finally set the retroactve dates.

This is in the interest of simple fairness. Furthermore, wills and revocable trusts in existence on April 30, 1976, while protected from the generation-skipping tax, cannot be amended by anything other than a codicil or a trust amendment. This causes a bad lockin for many people and a trap for others who may not be properly advised.

There is no reason for not permitting a change by a new will or a trust, so long as there is no creation of any new generation-skipping transfers or additions to old ones.

Let me now comment on some of the other provisions of the Byrd-Dole bill. We would like to endorse the changes to section 2035 that appear in section 4. These make section 2035 consistent with the unification of the estate and gift tax laws, by only including gift taxes paid on transfers made within 3 years of death and life insurance transfers within the time in the gross estate. We think that this simplifies the tax law and is far superior to section 3(f) of H.R. 6715, the Technical Corrections Act, which makes other changes to 2035. In fact, we are concerned that the House committee report to the Technical Corrections Act seems to revive the old and discredited pre-1954 code premium payments test for inclusion of life insurance without doing it by statute.

I would like to make two final comments on the estate and gift tax provisions of H.R. 6715. First of all, I want to talk about section 3(i)'s amendment to 2036. This restricts the anti-Byrum rule to ownership of closely held companies. Unfortunately, it also introduces a new trap for the unwary in the form of the ambiguous concept of indirect retention of voting rights. This will seriously impede the transfer of closely held stock, especially since the statutory language and the amendments to section 2036, as opposed to the House Ways and Means Committee report, do not define the retention of voting rights to transferred shares. This indirect retention concept should be dropped and section 2036 should confine direct retention to transferred stocks.

In any case, if you do not do this, at least you should not apply the rule retroactively to pre-April 28, 1977, transfers, when these so-called technical corrections were introduced.

My final comment has to do with the section 3(m) amendments to section 2518 of the Internal Revenue Code by the Technical Corrections Act. These are the disclaimer rules.

We believe that these rules should be made clearer, that disclaimer should be permitted by a decedent's spouse, even though the latter has a beneficial interest in the income and principal of, and a special power of appointment over, the trust into which the disclaimed property passes. Also, we believe that it should be made possible to disclaim powers of appointment and fiduciary and other nonbeneficial powers.

In closing, Senator, I would again like to urge you to repeal carryover basis. Thank you very much for your attention.

Senator BYRD. Thank you, sir.

You mentioned something about the New York Post and you used that as an example. but I am not clear as to what you were alluding to. Would you clarify this example.

Mr. BERALL. Certainly, Senator.

Under the adjustments which are made for assets other than marketable securities for fresh-start purposes, the time property is held before the fresh-start date is divided by entire time the property is held before death.

As we understand it, Mrs. Dorothy Schiff's advisors—she was the owner of the New York Post—were concerned that because there was a substantial amount of appreciation in the stock of the New York Post, the longer she held it, the lower would be her basis. This was referred to in other words by Mr. Kartiganer and the American Bar Association.

To avoid having the basis to her heirs just melt away as she lived to an advanced age, she sold the New York Post stock last fall.

Senator BYRD. In another part of your testimony, you mentioned the gift tax and the 3-year rule. Would you amplify on that?

Mr. BERALL. Yes, Senator.

Section 2035, as you know, presently has a number of provisions in it, the effect of which would be to include in the gross estate all transfers made within 3 years of death, with the exception of those transfers under $3,000.

The Technical Corrections Act makes this even more complicated and worse by excluding only transfers which do not require a gift tax return. However, we think that, in view of the unification of the estate and gift taxes, you really do not need to have in section 2035 a gross up of all the transfers at death.

What you need is to gross-up the gift tax paid on transfers made 3 years before death and, either as an amendment to 2035 or 2042, include all life insurance policies which have been transferred within 3 years of death. But, I want to distinguish between the life insurance and the premiums paid. I do not think you should change the rules with respect to premiums paid within 3 years of death. Merely let existing case law deal with just how much of the insurance proceeds are to be included in the gross estate as a result of premiums paid within 3 years of death.

Senator BYRD. What about those that go beyond the 3-year period?

Mr. BERALL. The law, for a great many years, has not grossed up or included in the gross estate transfers made more than 3 years before death unless certain other strings are retained, such as life income interests or powers to revoke.

Neither the present law, nor the Technical Corrections Act, nor any proposals of which I am aware that are before this committee, would change the rule with respect to transfers made more than 3 years before death.

Senator BYRD. Thank you very much.

[The prepared statement of Mr. Berall follows:]

STATEMENT OF FRANK S. BERALL ON BEHALF OF THE AMERICAN COLLEGE OF PROBATE COUNSEL

This Statement has been prepared by the Estate and Gift Tax Reform Committee[1] of the American College of Probate Counsel, has been reviewed by the Executive Committee[1] of the College and is submitted under the direction of its President (John E. Rogerson, Esq.).

Part I of our Statement comments on various provisions in H.R. 6715. The number preceding each comment corresponds to the number in the House Ways and Means Committee Report 95-700 on H.R. 6715 dated October 12, 1977. Part II of our Statement relates to S. 1954, and Part III of our Statement relates to S. 2228.

We compliment Senator Byrd and his Subcommittee for holding these hearings to get the views of the public on this significant legislation, and for taking the time to consider comments on problem areas in H.R. 6715.

SUMMARY OF PRINCIPAL POINTS IN STATEMENT

Part I—H.R. 6715 (The numbers correspond to the numbers used in the Ways and Means Committee Report).

1. Section 3(a)(1) of the Bill gives only limited relief from ordinary income on sale or redemption of Section 306 stock distributed before 1977, by looking to adjusted basis, including fresh start, since this relief will become less and less meaningful with the passage of time.

2. The provision in Section 3(a)(2) of the Bill, as reported by the Ways and Means Committee, whereby Section 306 stock can qualify for a Section 303 redemption, is of critical importance to the estate of the owner of a closely-held business.

3. Section 3(b) of the Bill amends Section 691(c) to provide that in the case of long-term capital gains, the adjustment for estate taxes attributable to income in respect of a decedent be changed from a separate income tax deduction to an adjustment to basis. While this may achieve the goal of ending the disparity of treatment between gains recognized by heirs for property sold before the decedent's death and gains realized by heirs upon a subsequent sale of the

[1] The membership of both of these Committees is listed on pages 38 and 39 of this Statement.

inherited property, yet it increases the disparity between sales in which gain is recognized before death (and the income tax reduces the estate at its top bracket for estate tax purposes) and sales by a decedent where the recognition of gain is deferred until after death. For this reason the policy decision is incorrect and the amendment should be deleted.

4. The option provided in Section 3(c)(1) of the Bill to determine minimum fresh start adjustment for tangible personal property by an 8% per year discount from date of death value to December 31, 1976 value, gives too much of a break to personalty acquired shortly before December 31, 1976. It would be fairer to provide an election to use a zero basis as of the date of the decedent's birth where date of acquisition and cost are unknown.

8. Section 3(c)(5) of the Bill, which amends Section 1023(c) to provide a separate computation of the adjustment for state estate taxes, is wrong in requiring the state death tax adjustment be made after the Federal estate tax adjustment, since the state death tax adjustment is thereby reduced even though imposed on the same appreciation element.

10. Section 3(c)(7) of the Bill would make the Section 1023(c), (d) and (e) adjustments to the basis of each asset for gain and then subtract the "fresh start" adjustment. This change is proposed because the minimal easing of the fiduciary's task of computing adjustments to the decedent's basis is more than offset by the reduction in the (c), (d) and (e) adjustments available for loss purposes.

15. Section 3(d)(4) of the Bill makes clear that the special use valuation under Section 2032A is to apply to community property in the same manner as property held by a decedent in his individual capacity in a common law state. This is contrary to community property concepts and "sticks" the surviving spouse with a lower cost basis if the Section 2032A election has been made rather than giving her a cost basis for her half reflecting fair market value at the date of the decedent's death. Only the decedent's half of the community property should be taken into account for Section 2032A purposes, including qualification, basis, recapture and all other characteristics. Similarly the $60,000 minimum basis under Section 1023(d) should only apply to the decedent's half of the community, and the statutory language which now refers to "*all* carryover basis property" should be changed accordingly.

16. Section 3(d)(5) of the Bill proposes to amend Section 2032A(c)(6) and (e) to provide that the special use valuation is available without personal liability for potential additional tax where the "qualified" heir furnishes a bond. This relief provision should be expanded to provide a statutory alternative to obtaining the consent of qualified heirs to the Section 2032A election by providing that the testator or settlor in disposing of Section 2032A property could authorize his fiduciary to waive the consent requirements for the Section 2032A election and thereby make all "qualified" heirs liable for the recapture tax to the extent bond is not posted.

18. Section 3(f) of the Bill amends Section 2035 to provide a new rule for the $3,000 exception to the automatic 3 year rule—only gifts made to a donee where no gift tax return is required to be filed with respect to the gift will be excluded. This proposal would only be acceptable if it is combined with present law, so that gifts in excess of $3,000 will be included in the gross estate only to the extent their value at death exceeds $3,000. At the very least, the proposal should be modified to exclude $3,000 of a split gift of up to $6,000. The Committee Report says the $3,000 exception applies to premiums paid within 3 years of death "to the extent that such payments would not have resulted in the inclusion of the proceeds of the policy in the decedent's gross estate under prior law", and thus appears to indirectly invoke the premium payment test under Section 2042 without benefit of legislation.

In any event the proposed substantive changes in Section 2035 should not apply retroactively to transfers made before April 28, 1977, the date H.R. 6715 was introduced.

19. Section 3(g)(1) amends Section 2056(c)(1)(B) to provide that where property given to a spouse is included in his gross estate under Section 2035, the reduction of the estate tax marital deduction for marital gifts of less than $200,000 will not be made. This rule should be extended to situations where the gift to the spouse is included in the donor's estate under Section 2036–2038, 2040 or 2042.

20. Section 3(h) of the Bill amends Section 2001 to provide that where a spouse consents to be treated as the donor of one-half of a gift to a third party but the

full amount of the gift is included in the donor's estate as made within 3 years of death, then in computing the estate tax for the consenting spouse, the gift is excluded in determining the amount of lifetime transfers. This is an incorrect approach for in equating common law jurisdictions with community property jurisdictions, the death of one spouse should bring only the decendent's half of the gift into his gross estate, not the entire gift, and the survivor's estate tax bracket would be increased by the amount of his or her transfer.

21. Section 3(i) is helpful in amending Section 2036 to restrict the *anti-Byrum* rule to situations where the decedent owns outright (or by Section 318 attribution), or has the power to vote, at least 20% of the otal combined voting power of all classes of stock in the controlled corporation. On the other hand, Section 3(i) introduces the very ambiguous concept of "indirect retention" of voting rights, which can be a trap for the unwary and would seriously impede the transfer of closely-held stock as an estate planning tool, particularly since the statutory language (as opposed to the Committee Report) does not confine the retention of voting rights to the transferred shares. The concept of indirect retention of voting rights should be dropped and the statute should expressly confine the direct retention of voting rights to the transferred stock. In any event, the amendment should not apply to transfers before April 28, 1977.

26. While Section 3(1) improves Section 2057 with respect to the orphan's deduction by allowing a single trust for all minor children without separate shares, yet it should be liberalized further so that the same trust could have as beneficiaries both qualified minors and older children who don't qualify.

27. Section 3(m) of the Bill amends Section 2518 to provide that a "qualified" disclaimer includes a refusal by a spouse as a result of which the disclaimed interest passes directly to such spouse. The Committee Report states that this amendment would allow the disclaiming spouse to have an income interest in the disclaimed property. This amendment should be broadened to specifically encompass in a qualified disclaimer a refusal whereby the disclaiming spouse has a beneficial interest in trust income and corpus and a special power of appointment. Further, disclaimers of powers of appointment and of fiduciary and other non-beneficial powers should be authorized.

28. Section 3(n)(1) amends Section 2613(e) to provide that an individual trustee shall not be treated as having a power in the trust which would make him a "beneficiary" if (a) he has no interest in the trust; (b) is not a related or subordinate trustee; and (c) has only limited power to alter beneficial interests. While the best solution would be to eliminate any distinction between individual and corporate trustees, various additional changes are necessary to permit an independent individual to serve as trustee without being a "beneficiary".

32. Section 3(p) of the Bill amends Section 2204 to relieve an executor from personal liability for additional Federal estate taxes attributabe to post-1976 gifts not shown on a return where the executor relied in good faith on the information supplied as to such gift tax returns by IRS pursuant to Section 6103(e)(3). There appears to be no good reason not to permit an executor to rely in good faith on gift tax returns of the decedent from whatever source supplied.

PART II—S. 1954: The American College of Probate Counsel strongly supports S. 1954, providing for outright repeal of carryover basis.

PART III—S. 2228: If outright repeal of carryover basis is not possible, The American College of Probate Counsel supports S. 2228, providing various amendments to the Code to make carryover basis more workable.

PART I. COMMENTS WITH RESPECT TO THE TECHNICAL AMENDMENTS RELATING TO ESTATE AND GIFT TAXES IN H.R. 6715

1. *Ordinary income on sale or redemption of Section 306 stock only to include amounts received in excess of adjusted basis, including fresh start adjustment.*—Section 3(a)(1) of the Bill proposes to amend Section 306 to make it clear that the amount treated as ordinary income on the sale or redemption of Section 306 stock may not exceed the amount received by a shareholder in excess of the adjusted basis of his 306 stock, including the fresh start adjustment, where he holds 306 stock distributed before 1977. This does ameliorate some of the hardship caused by the presumed effect of the carryover basis rules on Section 306 stock held by a decedent dying after December 31, 1976. Providing a fresh start adjustment for 306 stock, however, merely adjusts the carryover basis and does not substitute for it the value as of a step-up date. The fresh start adjustment to the basis of this preferred stock will, of course, decrease with the passage of

time, affording less relief in each future year. Furthermore, no relief is given with respect to Section 306 stock issued after 1976.

2. *Capital gains treatment of a Section 303 redemption made available for Section 306 stock.*—Section 3(a)(2) of the Bill, as reported by Ways and Means, reverses the provisions originally in the Bill and makes Section 306 stock eligible to qualify for a Section 303 redemption. Section 3(a)(2) in its present form is essential for the liquidity of small business in view of the common use of Section 306 stock in estate planning.

3. *Change from a separate deduction for estate taxes on capital gain realized by decedent, but recognized by heirs, to a basis adjustment.*—Section 3(b) proposes to amend Section 691(c) to provide, in the case of capital gains, that the adjustment for estate taxes attributable to income in respect of a decedent be changed from a separate deduction (which could be used against other income or against the capital gain after giving effect to the Section 1202 deduction) to an adjustment to basis. The stated objective of this change is to end the potential disparity of treatment for income tax purposes between gains recognized by heirs for property sold before death by the decedent and gains realized by the heirs upon a subsequent sale of inherited property. However, it increases the disparity between sales in which the gain is recognized prior to death (in which case the capital gains tax liability of the decedent would reduce his estate at the top bracket) and sales by a decedent in which recognition of gain is deferred until after death. We believe the policy decision is incorrect and urge that the Section be deleted.

4. *Minimum basis adjustment formula for fresh start where actual basis or date of acquisition of tangible personalty unavailable.*—Section 3(c)(1) proposes to amend Section 1023 to provide a method for determining a minimum carryover basis to reflect the fresh start adjustment for tangible personal property. Its use would be permitted instead of actual basis, regardless of whether the facts necessary to determine a decedent's basis are unknown and cannot be reasonably ascertained, where the use of the formula would produce a higher basis than the fractional adjustment in the present law (Section 1023(h)(2)(C)).

While this new proposal is helpful and will provide relief in many cases, the assumption inherent in it that post-1976 appreciation will accrue at a rate slightly higher than eight percent a year means that for deaths in the latter part of 1985, the fresh start adjustment will only be approximately half of the estate tax value of the property and thereafter even less. Unless inflation averages close to double digit rates in the future, the eight percent appreciation assumption may be too high to give much relief, particularly as more years elapse between the fresh start date and date of death. Fiduciaries will still feel obligated to try to obtain better data, despite the cost and trouble, in order to have a choice of the alternatives where they believe the decedent's adjusted basis before the fresh start adjustment was relatively high compared with the date of death value of the property and in cases where the property was held for a relatively long time. We recommend as an alternative means of relief, where cost and date of acquisition are unknown, an election to use zero cost basis as of the decedent's birth and then apply the present Section 1023(h)(2)(C) formula. This would reduce the tremendous break given by Section 3(c)(1) to personalty acquired shortly before December 31, 1976, compared to its status under existing law.

If the proposed new provision is to be retained, we suggest a modification to Section 3(c)(1) to improve it by (i) eliminating the words in new paragraph 1023(h)(3)(B)(i) "without regard to section 2032" in line 15 on page 53 so as to avoid having to also value closely held stock as of date of death when alternate valuation is elected, an unnecessary complication; and (ii) deleting the restriction of this relief to tangible personal property so that it will apply to any carryover basis property other than marketable securities.

The failure of the Bill to refer to the alternate valuation means that a separate valuation of tangibles, using date of death values, would be required solely to determine basis. If this failure is not corrected, there does not appear to be a procedure under which the I.R.S. and the estate could establish the date of death value of the tangibles.

Except as discussed, the Bill appears to carry out the purpose described in the Ways and Means Committee Report.

5. No comment.

6. No comment.

7. No comment.

8. *Adjustment to carryover basis property for state estate taxes.*—Section 3(c)(5) amends Section 1023 to provide a separate computation of the adjustment for state death duties, the adjustment being made after the adjustment for Federal estate taxes. This was designed to cure the problem which would exist if property includable for Federal estate tax purposes is not includable for state death tax purposes, or vice versa, or if values are different for purposes of the two taxing structures. Although separate adjustments are necessary, the proposed solution is inequitable since, by requiring the state death tax adjustment to be made after the adjustment for Federal estate taxes, the state death tax adjustment is reduced, even though the state death tax is imposed on the same appreciation element. Both adjustments should relate to the full appreciation element.

Furthermore, the proposal leaves untouched the difficulty which stems from the requirement in Section 1023(f)(3) that state death taxes be paid by the estate, which presumably would disqualify state death taxes apportioned, either by instrument or local law, against persons taking outside the will (*e.g.*, beneficiaries of life insurance and surviving joint tenants) or against property passing under a will substitute (*e.g.*, an *inter vivos* trust).

9. No comment.

10. *Coordination of carryover basis adjustments.*—"Fresh start" should be available for both gain and loss purposes, since "fresh start" was intended to grandfather pre-1977 changes in values. Under present law the adjustment is only available for purposes of gain. This requires (1) recording separate bases for gain and loss and (2) an extra set of multiplications to apply the (c), (d) and (e) adjustments (of which only one will generally be applicable). Section 3(c)(7) proposes to change this by making the (c), (d) and (e) adjustments to the basis of each asset for gain and then subtracting the "fresh start" adjustment. However, this does not change the fact that records must be kept of two different bases; all it does is eliminate the separate multiplications. (We do not believe that the concern expressed in the Ways and Means Committee Report is warranted.) This minimal easing of the fiduciary's task is at the cost of minimizing the (c), (d) and (e) adjustments available for loss purposes. We therefore oppose this proposed change.

11.–14. No comment.

15. *Community property under the special use valuation rule and under Section 1023(d).*—a. Where the executor of the decedent's estate elects valuation under Section 2032A to apply to the decedent's half of community property, it is unclear under present law how the basis of the survivor's half is affected. For example, for purposes of the "fresh state" computation, the Section 2032A value rather than the asset's fair market value is used in the fraction. This is perfectly appropriate for the decedent's half of the community property, but it is not appropriate for the surviving spouse's half. In other words, if the surviving spouse sells her half of the community Section 2032A property after her husband's death, her cost basis should reflect fair market value at the date of the decedent's death, rather than reflecting Section 2032A value. Unfortunately, the proposed amednment reaches the opposite result.

While the proposed language would allow the surviving spouse's half to be taken into account in determining whether or not the Section 2032A property qualifies (in terms of the percentage requirements), it also "sticks" the surviving spouse with a lower cost basis if a 2032A election has been made for the decedent's half. It is also unclear as to what happens if the surviving spouse sells her half of the 2032A property within fifteen years of the decedent's death; this should not result in a recapture tax because her half was not subject to tax at death. Does it trigger a recapture tax on the decedent's half, however, since both halves are seemingly lumped together?

Instead of the proposed amendment we recommend that it be made clear that only the decedent's half of the community property is to be taken into account for purposes of Section 2032A, including qualification, basis, recapture and all other characteristics. In other words, there would be a different cost basis for the surviving spouse's half of such property where a Section 2032A election is made on behalf of the decedent, and the surviving spouse's half would not figure in the percentage calculation in determining whether the decedent's half qualifies for the Section 2032A election.

b. Section 1023(d) states that if $60.000 exceeds the aggregate *of all carryover basis property*, then the property can be stepped up to $60,000. The $60,000 step up should only apply to the decedent's half of the community and not to the surviving spouse's half.

Section 1023(b) defines carryover basis property by reference to Section 1014 (b). Section 1014(b)(6) includes in the definition of 1014(b) property a surviving spouse's one half share of the community. For example, if the fair market value of both halves of the community at death was $120,000 but the cost basis of both halves was $30,000 (as adjusted for fresh start and death taxes attributable to appreciation), the decedent's half of the property should be stepped up to $60,000 and the surviving spouse's half should carry a basis of $15,000. It would not be fair to give both halves a step up to $30,000 each ($60,000 in the aggregate), yet that is what Section 1023(d) seems to say by referring to "*all carryover basis property.*" The surviving spouse's estate should, upon her death, be able to get a minimum basis increase to $60,000 at that time, whereas if it had been given it at the first decedent's death, there would be no additional step up available. Assuming the spouses could, immediately before death, sever their property into two equal halves of separate property each worth $60,000, this would produce the above proposed basis result. There should be no difference if they do not go through with such a severance. We believe this problem cannot be solved by regulations.

16. *Bond to relieve qualified heir of personal liability for recapture of tax where Section 2032A valuation is used.*—Section 3(d)(5) proposes to amend Section 2032(A)(c)(6) and (e) to provide that the special use valuation is available without personal liability for potential additional tax where the qualified heir furnishes a bond for the maximum amount of this additional recaptured tax which may be imposed with respect to the heir's interest in the qualified real property.

This proposal should eliminate one of the impediments to the use of Section 2032A. Unfortunately, this concept does not go far enough. Since the purpose of the agreement is to provide the Internal Revenue Service with a ready and acknowledged source of funds for the payment of the recapture tax, we suggest a statutory alternative to obtaining the consent of qualified heirs, including incompetents, to the Section 2032A election. This would be an amendment to Section 2032A(d)(2) to provide that in any will or inter vivos trust making a disposition of property that might later be eligible for Secion 2032A use valuation, the testator or settlor could authorize his fiduciary to waive the consent requirements for the Section 2032A election and thereby make all qualified heirs liable for the recapture tax to the extent of their shares of the estate unless they elected to post bond.

With respect to the bonding, the Bill language appears to be consistent with the Ways and Means Committee Report.

17. No comment.

18. *Section 2035 inclusion in the gross estate of all transfers made within three years of death required to be shown on a gift tax return, exempting those not so required unless they are life insurance.*—It should be noted at the outset that the three-year rule of Section 2035(a) appears inconsistent with the enactment into law of unification of the estate taxes. The elimination of this rule would permit dropping the exceptions in Section 2035(b), including the troublesome exclusion for gifts under $3,000. It may well be, however, that Section 2035(c), providing for the gross-up of gift taxes on transfers within three years of death, should be retained. The incidents of ownership of life insurance within three years of death could be dealt with in Section 2042.

Section 3(f) of the Bill amends Section 2035 so that instead of the present rule, providing that "the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts" (as the legislative history is interpreted by the Ways and Means Committee Report on H.R. 6715), there is a new rule that only gifts made to a donee where no gift tax return is required to be filed with respect to that gift will be excluded from the automatic three-year rule. However, no such exclusion will be permitted for a gift with respect to a life insurance policy.

The Ways and Means Committee Report notes that the legislative history of the existing law indicated that the amount of gifts included in the gross estate is limited to the excess of the estate tax value over the amount excludable with respect to these gifts. Thus, a gift of $4,000 in cash would result in only $1,000 being included in the gross estate in the event of the donor's death within three years of making the gift.

Under the new proposal, while a gift valued at $3,000 will not be included in the gross estate if the donor dies within three years even though its value at death exceeds $3,000, yet a gift valued at $3,000.01, requiring the filing of a gift tax return, will result in inclusion of the entire value of the gift at date of death. A notch provision of this nature will be a trap for the unwary and the poorly advised, as well as leading to potential valuation disputes (or arguments over what the exact date of the gift was) in an attempt by the Service to claim the benefit of the notch.

An additional problem is the possibility that records will be searched to find payments not normally considered taxable gifts, such as Christmas, birthday and anniversary gifts and having those amounts bring the transfers for the year to a sum in excess of $3,000.

The Ways and Means Committee Report expresses concern over serious administrative burdens that may be imposed upon executors under the present law, because it will be necessary to ascertain whether the decedent had made gifts during the three-year period preceding his death (even though no return was required) and, if so, the value of the gifts at the time of the donor's death. This type of "burden" has always existed, since executors under the law prior to the 1976 Tax Reform Act were required to disclose all transfers of $1,000 or more made within three years of death. Under present law, they are required to disclose transfers in excess of $3,000 and, according to the Report, ascertain whether transfers of a lesser amount appreciated to more than $3,000 at date of death. This isn't a serious additional administrative burden and, in any case, the burden of searching for prior transfers will still exist even under the proposal.

The proposal in Section 3(f) of the Bill to make the exception to the three-year rule apply to the entire value of the property at death, if the property was $3,000 or less in value at the time of gift, would be acceptable if it is combined with the provision that the Committee's Report states is the present law, namely that gifts in exces of $3,000 will be included in the gross estate only to the extent the value at death exceeds $3,000. At the very least, the proposal should be modified to exclude $3,000 of a split gift of up to $6,000 where a gift tax return and spousal consent are required.

The phrase in Section 3(f) of the Bill that excludes the gift of a life insurance policy from the benefit of the $3,000 exception is broad enough to include premium payments as well, and the Committee Report makes plain that this is the case. Section 3(f) provides that the exception "shall not apply to any transfer *with respect to* a life insurance policy." (Emphasis supplied). The Committee Report says that the $3,000 exception applies to premiums paid within 3 years of death "to the extent such payments would not have resulted in the inclusion of the proceeds of the policy in the decedent's gross estate under prior law." This explanation appears to be an attempt to revive the premium payment test under Section 2042 without benefit of legislation, since premium payments within 3 years of death (as opposed to transfers of insurance policies) should not cause any part of the policy proceeds to be included in the gross estate, but only the premiums themselves.

Finally, if such substantive changes are to be made to Section 2035, they should certainly not apply to transfers made before April 28, 1977 (the date H.R. 6715 was introduced), since many gifts were made between December 31, 1976 and April 28, 1977, in reliance on existing law and the assumption that it would not be changed retroactively. (The Committee Report inadvertently excepts transfers before January 1, 1971 rather than January 1, 1977.)

19. *Estate tax marital deduction not to be reduced for gifts made to decedent's spouse within three years of death.*—Section 3(g)(1) amends Section 2056(c)(1)(B) to provide that where property given to the decedent's spouse is included in the decedent's estate as a transfer made within three years of death, the reduction of the estate tax marital deduction for marital gifts of less than $200,000 will not occur, since inclusion of the gift in the gross estate will have nullified any benefit of the deduction for gift tax purposes.

The removal of the unintended hardship here should be extended to situations where a marital deduction gift is included in the donor's gross estate as a transfer under Sections 2036–2038, 2040 or 2042. While the hardship is more obvious and widespread in the Section 2035 situation, it should not be permitted to exist merely because a marital deduction gift is brought back into the gross estate under one of the other enumerated Sections.

Section 3(g)(2) correctly amends Section 2056(c)(1)(B)(ii) to exclude any gift not required to be reported in a gift tax return from the computation of the marital deduction "cut-down" for gifts to the spouse aggregating less than $200,000.

20. *Amelioration of double burden where split gifts are made within three years of death.*—The purpose of the split gift provisions is to equate common law jurisdictions with community property jurisdictions. If two spouses in a community property state, each owning one-half of the community, give an identical amount to a third party, the death of one of them in three years would only bring back the decedent's transfer, not the entire gift, and the survivor's estate tax bracket would be increased by the amount of his or her transfer. The result should be the same when there is a split gift. But Section 3(h) takes the opposite approach, including the entire amount of the transfer, but eliminating the increase in the survivor's estate tax bracket. This is incorrect policy.

21. *Anti-Byrum rule modified to apply only to a controlled corporation but expanded to indirect retention of voting rights.*—Section 3(i) proposes to amend Section 2036 to restrict the anti-*Byrum* rule so that it will not apply to publicly-held stock. While this is an improvement over present law, Section 3(i) dangerously overreaches the *Byrum* situation by (1) not limiting the proscribed retention of voting rights to the stock actually transferred; and (2) by introducing the very ambiguous concept of "indirect retention" of voting rights. As to the first point, the anti-*Byrum* rule would apparently apply in all cases in which the decedent transferred less than his entire interest in closely held stock, regardless of the identity of the transferee and regardless of the nature of the transfer (whether outright or in trust), if after the transfers the decedent owned or had the power to vote as little as one share of stock in the corporation and the decedent at any time had attributed to him under Section 318 enough stock to meet the 20 percent test. This is because the proposed amendments does not speak in terms of controlling the vote of the transferred stock but in terms of "retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation." Thus, an individual who built up his own business would be unable to transfer any portion of the stock to any family member, even though the transfer is outright, unless he disposed of all of his stock. It is true that the Ways and Means Committee Report does state that "the rule would not apply to the transfer of stock in a controlled corporation where the decedent could not vote the transferred stock", but it would be far safer to insert after the phrase, "retention of voting rights", in proposed Section 2036(b)(1) the words "in the transferred stock."

As to the second point, the concept of "indirect retention" of voting rights is very ambiguous, and will prove to be a trap for the unwary, and should be dropped. The Committee Report interprets this phrase to require inclusion of the stock in the gross estate "where the decedent retained the voting rights of the stock which was directly or indirectly transferred by him". It gives as an example the situation where the decedent transferred cash or other property before his death to a trust of which he is trustee within 3 years of his death, and the trust uses those assets to purchase stock in the controlled operation from himself. Thus, the Committee Report looks to an *indirect transfer* of the voting stŏck rather than the *indirect retention* of voting rights. This disparity between the statutory language and the Committee Report will be a problem. Hopefully, the indirect retention of voting rights will be eliminated from Section 3(i): at the very least the statutory language should be conformed to the Committee Report and refer to indirect transfers of voting stock.

If the amendment is left in the Bill, it should be prospective only, affecting transfers made only after April 27, 1977, since many transfers were made prior thereto in reliance on existing law not being changed retroactively.

22. No comment.
23. No comment.
24. No comment.
25. No comment.

26. *Orphan's deduction for a "pot" trust to be allowed.*—While Section 3(l) of the Bill, amending Section 2057, is clearly an improvement over existing law, by allowing a single trust for minor children without separate shares, nonetheless by requiring that all initial trust beneficiaries must be the minor children, estate planning flexibility is unnecessarily lost. In the fairly frequent case where there are some children both over and under 21, it would be desirable if the orphan's deduction shares could be held in the same "pot" trust with shares of older children for which the orphan's deduction is not available.

27. *Disclaimer by surviving spouse to be valid although disclaimed interest passes to spouse.*—Section 3(m) amends Section 2518 to define a qualified disclaimer as including a refusal, as a result of which the interest passes directly to the decedent's spouse. The Bill language should be amended so as to make clear that it permits a disclaimer by a decedent's spouse, even though the latter has a beneficial interest in the income and principal of, and a special power of appointment over, the trust into which the disclaimed property passes. Furthermore, the Ways and Means Committee Report seems to interpret the amendment as applying only where the surviving spouse receives an "income interest" in the disclaimed property. The amendment should not be so restrictive. The Report should be changed to encompass the above-noted beneficial interest of the spouse in trust income and corpus and a special power of appointment.

Furthermore, the requirement that an interest "pass" should be enlarged to permit the disclaimer of powers of appointment by beneficiaries (when the power does not "pass"), and also disclaimers of fiduciary and other non-beneficial powers should be authorized.

28. *Powers of independent trustees will not attract the generation-skipping tax.*—Section 3(n)(1) proposes to amend I.R.C. Section 2613(e) to ameliorate the controversial provision which treats individual trustees possessing certain powers as beneficiaries for purposes of triggering the generation-skipping tax.

While the proposed amendment is some improvement over existing law, a better solution would be to eliminate the distinctions between individual and corporate trustees. In the event that Congress should be unwilling to eliminate this distinction in a technical corrections bill, the following suggestions for improvement are made.

The proposed amendment provides that an individual trustee shall be treated as not having a power in the trust which would make him a "beneficiary" as defined in Section 2613 if (1) such trustee has no interest in the trust, (2) is not a related or subordinate trustee, as specifically defined, and (3) has only certain limited powers to alter beneficial interests. If the trust contains a power of appointment given to a person other than the trustee which is exercisable among a class which includes the trustee, the individual trustee may have an "interest" in the trust as defined in Section 2613(d)(1)(B) and could not qualify under the first requirement. Also any individual who has a relationship to any person within the class of potential appointees described in the definition of a related or subordinate trustee could not qualify as an independent trustee.

Based on such an interpretation of the definitions of the terms "interest" and "beneficiary" in Sections 2613(c) and (d), in the case of a broad special power of appointment (for example, a power exercisable in favor of anyone other than the donee of the power, his estate, or his creditors), no individual could qualify as an independent trustee under the proposed amendment in its present form. To meet this problem, it is recommended that the proposed amendment be revised so that an interest as a potential appointee under a power held by another person should not be an interest in the trust for purposes of proposed Section 2613(e).

The definition of a related or subordinate trustee has been taken nearly verbatim from Section 672(c)'s definition of a related or subordinate party; but as used in the amendment, this definition has been expanded to include relationships between a trustee and any beneficiary as well as between a trustee and grantor. In order to eliminate possible problems in ascertaining who are the contingent income beneficiaries or remaindermen, the terms "beneficiary" and "beneficiaries" should have inserted after them the phrase "having a present interest in the trust." Likewise, consideration should be given to eliminating the disqualification arising from a relationship between a trustee and a beneficiary through the trustee's employment by a corporation in which a beneficiary has significant voting control or is an executive. Such a relationship of a trustee to a beneficiary could arise at any time and become a trap for the unwary. Alternatively, clauses (iii) and (iv) of proposed Section 2613(e)(2)(B) could be limited to such relationships existing at the time property is transferred in trust.

Subject to any changes made in accordance with the preceding paragraph, the definition of a related or subordinate trustee should be modified to conform more closely to Section 672(c) by tightening it in the following respects:

(1) By adding to clause (i) of proposed Section 2613(e)(2)(B) the words "if living with the grantor or such beneficiary," so that spouse of the grantor or any beneficiary who is living apart would not be disqualified as a related or subordinate trustee.

(2) By substituting in clause (ii) of proposed Section 2613(e)(2)(B) the word "issue" for the phrase "lineal descendants." Since the meaning is probably

the same, the suggestion is merely a matter of conformity to the words used in Section 672(c)(2). A similar substitution could be made in proposed subparagraph (1) to make it consistent with subparagraph (2) of proposed Section 2613(e).

3) By inserting in clause (ii) of proposed Section 2613(e)(2)(B) the words "or employee" following the word "sister." The failure of the Bill to include an employee of the grantor or beneficiary may have been an inadvertent omission in view of the provisions of clauses (iii) and (iv), relating to trustees who are employees of certain corporations.

(4) By inserting in clause (iv) of proposed Section 2613(e)(2)(B) the word "subordinate" preceding the word "employee." Again, the failure to track Section 672(c)(2) in this respect may have been inadvertent.

29. No comment.

30. No comment.

31. No comment.

32. *Reliance by an executor or information furnished by IRS concerning decedent's taxable gifts made after 1976.*—Pursuant to Section 3(p) of the Bill, Section 2204 of the Code is amended to relieve the executor of personal liability for additional federal estate taxes attributable to post-1976 gifts not shown on a return if the executor, in good faith, relied upon "gift tax returns furnished under Section 6103(e)(3)" by the Internal Revenue Service, but he is not relieved from such liability for gifts made within 3 years of decedent's death. The above-quoted language of Section 3(p), applied literally, would exclude relief for the executor if IRS furnished no gift tax returns pursuant to his request. The Committee Report does refer to "information" furnished by IRS, but any doubt would be resolved by substituting "information" for "gift tax returns" in Section 3(p).

There appears to be no good reason to restrict this relief for an executor to the situation where information has been furnished to him by IRS under Section 6103(e)(3). This would mean that every executor would have to request gift tax returns from IRS in order to avail himself of this relief, putting an administrative burden on both the executor and IRS. The provision should be liberalized to permit an executor to rely in good faith on gift tax returns of the decedent coming into the executor's possession from whatever source.

33. and 34. No comment.

PART II. COMMENTS WITH RESPECT TO S. 1954

The American College of Probate Counsel is already on record before the Ways and Means Committee (October 6, 1977 Hearing on Carryover Basis) as strongly favoring outright repeal of carryover basis, and it therefore wholeheartedly supports S. 1954, sponsored by Senator Curtis of Nebraska, providing for such repeal.

The American public has expressed a growing uneasiness over the extended time and substantial cost of probate, and we, as practitioners in this area of the law, are keenly aware that we have an obligation to do all we can to meet their concern. We also know from experience that the preparation and audit of the Federal estate tax return has been the main cause for this delay and expense.

The Tax Reform Act of 1976 did take one big step toward eliminating the Federal estate tax as the bottleneck in the probate process by providing a much higher exemption in the form of a credit and an increased marital deduction so that for deaths after 1980, estate of married taxpayers up to $425,625 (the sum of the $175,625 exemption equivalent to the new credit and the $250,000 marital deduction) escape Federal estate tax entirely. Thus, the need to deal with the Federal estate tax no longer exists in administering smaller estates.

But, ironically, the carryover basis provisions of the Tax Reform Act of 1976 constitute a giant step backwards from the goal of achieving inexpensive and expeditious probate; not just for the large estate, but for all estates, including those in which the aggregate adjusted basis of carryover basis property is under $60,000. Executors who formerly could rely on date of death values for the basis of assets in the hands of a decedent's estate or beneficiaries must now attempt to determine the acquisition date and cost of every carryover basis asset except for $10,000 of tangible personal property (if the executor makes the section 1023(b) election). Moreover, this same information is required for all substantial improvements to carryover basis assets. In an era when record-keeping has been inadequate, and records were often discarded after three years, who will know the cost and acquisition date of each item in a stamp or coin collection, the cost of a home gifted through several generations, and the date of installation, and cost, of a subsequently-installed furnace, air conditioning, porch, etc? While section 1023(g)(3) does provide that where decedent's basis is unknown, such basis shall be treated as being the fair market value of such property as of the approximate date of acquisition, yet such fair market value itself may be hard to determine, and, furthermore, the fiduciary will still be under pressure to determine the actual basis to see if it is greater than the assumed fair market value. All this examination of records, as well as the elaborate calculations required to determine the four separate adjustments to carryover basis provided by section 1023 as to each carryover basis asset, will greatly increase both the time and cost of probate for all estates, whether small, medium or large. The services of a large computer will often be the only feasible solution.

We are concerned that the sense of trust and confidence which hopefully exists between the executor and the estate's beneficiaries will be greatly eroded, not only because the great complexity of these carryover basis provisions will necessarily result in many errors in calculations, but also because changes in estate tax values on audit of the estate tax return will often result in income tax deficiencies because the income tax returns as filed cannot correctly show gain on the sale by the estate or the beneficiary of carryover basis assets until final determination of the Federal estate tax values. Furthermore, the executor will be put to an impossible task in having to decide who is to receive high-basis assets, who receives low-basis assets and who receives cash from the estate. Obviously, executors are going to be faced with a sharply higher number of court contests of their accountings and malpractice suits against their attorneys will also greatly increase. Finally, executors are required to file an information report on carryover basis property with both the Internal Revenue Service and with the recipient of the property, and a penalty of up to $7,500 will be imposed for failure to comply. We predict that many individuals will hereafter refuse to serve as executors and this role will be increasingly filled by banks and trust companies, a result which we do not believe to be healthy.

Carryover basis has had a very adverse effect on the traditional estate planning for a small businessman for it has apparently eliminated the possibility for section 306 stock to qualify for a section 303 redemption (but see H.R. 6715, as reported), and there may be insufficient redemption proceeds to pay the income tax on the gain now arising from the redemption. In short, the Act, whose purpose was to afford the small businessman tax relief, has, through carryover basis, heightened his already severe liquidity problems and may even cost his business.

PART III. COMMENTS WITH RESPECT S. 2228

The American College of Probate Counsel is on record before the Ways and Means Committee (October 6, 1977 Hearing on Carryover Basis) as favoring simple, fix-up legislation to make carryover basis less burdensome if it cannot be repealed outright. Moreover, five of the seven specific legislative proposals submitted by it at such Ways and and Means Committee hearing are reflected in whole or in part in S. 2228, sponsored by Senator Byrd and Senator Dole, namely:

(1) grandfathering under the prior law all assets the adjusted basis of which immediately before the decedent's death reflects the adjusted basis of any property on December 31, 1976;

(2) increase the minimum basis to $175.625;

(3) estate tax adjustments under Section 1023(c) and (e) are to be at marginal rather than average estate tax rates and Section 691(c) deduction is to be computed as under prior law;

(4) carryover of capital losses of the decedent to his estate; and

(5) expansion of the maximum amount of the redemption proceeds qualifying under Section 303 to include federal. state and local income tax on the gain.

The College endorses in principle S. 2228. despite some technical problems, but it would add the following provisions:

(a) The present $10.000 exclusion for tangible personal property should be increased to $50.000, or such other amount that would prevent a substantial administrative burden to the estates of all persons other than collectors.

(b) Section 7(a)(1) of the Bill. relating to the maximum amount of a stock redemption qualifying under Section 303. should be amended to include state and local income taxes on the redemption gain as well as the federal income tax.

(c) Sections 6166(g)(1)(B) and 6166A(h)(1)(B) provide that to avoid acceleration of federal estate tax installments upon a redemption, the entire proceeds must be applied to the unpaid federal estate tax. An exception should be made for the amount of any federal, state and local income taxes arising from the redemption in order not to penalize the illiquid estate.

(d) With respect to generation-skipping trusts, S. 2228 should provide for a change in the effective date for wills and revocable trusts from May 1, 1976 to October 4, 1976, the date of enactment of the 1976 Tax Reform Act, and a change in the effective date for taxing generation-skipping transfers under irrevocable trusts from May 1, 1976 to August 5, 1976, the date the U.S. Senate voted to change the effective date of the transitional rules retroactively from May 1, 1977 to May 1, 1976. These changes will avoid substantial hardships to innocent parties arising from ignorance or uncertainty as to the effective date.

AUTHORITY AND IDENTITY OF THE AUTHORS OF THESE COMMENTS

The comments on the preceding pages were made by the Estate and Gift Tax Reform Committee of The American College of Probate Counsel and approved by the Executive Committee of the College. The Estate and Gift Tax Reform Committee is a duly authorized committee of the College, created by the College's Board of Regents, whose members were appointed by the President of the College, in consultation with the Executive Committee of the College. The Executive Committee of the College is the governing body, appointed from the members of the Board of Agents. The Estate and Gift Tax Reform Committee consists of the following lawyers: Frank S. Berall, Chairman, Hartford, Connecticut; Luther J. Avery, San Francisco, California; Edward B. Benjamin, Jr., New Orleans, Louisiana; Joseph Kartiganer, New York City, New York; Malcolm A. Moore, Seattle, Washington, Arthur Peter, Jr., Washington, D.C.; Raymond A. Reister, Minneapolis, Minnesota; and John A. Wallace, Atlanta, Georgia.

In addition, the following lawyers serve on the committee as Special State Representatives:

Lyman F. Holland, Jr., Mobile, Alabama; C. L. Cloudy, Ketchikan, Alaska; Roland Kruse, Phoenix, Arizona; Leonard L. Scott, Little Rock, Arkansas; Robert W. Morrison, San Francisco, California; Hover T. Lentz, Denver, Colorado; Frank S. Berall, Hartford, Connecticut; Thomas P. Sweeney, Wilmington, Delaware; J. Bruce Kellison, Washington, D.C.; Sherwin P. Simmons, Tampa, Florida; John A. Wallace, Atlanta, Georgia; Arthur B. Reinwald, Honolulu, Hawaii; J. Charles Blanton, Boise, Idaho; Richard O. Hart, Benton, Illinois; Charles F. Cremer, Jr., Indianapolis, Indiana; Arlev J. Wilson, Marshalltown, Iowa; L. H. Ruppenthal, McPherson, Kansas; Allen Schmitt, Louisville, Kentucky; Paul O. H. Pigman, New Orleans, Louisiana; Robert F. Preti, Portland, Maine; Allen H. Fisher, Jr., Baltimore, Maryland; Robert S. Bowditch, Worcester, Massachusetts; Joe C. Foster, Jr., Lansing, Michigan; Raymond A. Reister, Minneapolis, Minnesota; C. Denton Gibbes, Jr., Laurel, Mississippi; Guy A. Magruder, Jr., Kansas City, Missouri; Ben E. Berg, Bozeman, Montana; Thomas M. Davies, Lincoln, Nebraska; Leslie B. Gray, Reno, Nevada; Arthur H. Nighswander, Laconia, New Hampshire; Alfred C. Clapp, Newark, New Jersey; Michal G. Sutin, Albuquerque, New Mexico; Elliott W. Gumaer, Jr., Rochester, New York, (upstate); Philip J. Hirsch, New York, New York, (downstate); Leon L. Rice, Jr., Winston-Salem, North Carolina; Charles A. Feste, Fargo, North Dakota; Howard N. Bullock, Columbus, Ohio; James C. Gibbens, Oklahoma City, Oklahoma; Campbell Richardson, Portland, Oregon; George H. Nofer, Philadelphia, Pennsylvania; Joachim A. Weissfield, Providence, Rhode Island; Ray M. Seigler, Columbia, South Carolina; Martin P. Farrell, Hot Springs, South Dakota; Thomas A. Caldwell, Jr., Chattanooga, Tennessee; Robert Hyer Thomas, Dallas, Texas; Clark P. Giles, Salt Lake City, Utah; Austin B. Noble, Montpelier, Vermont; Waller Horsley, Richmond, Virginia; E. Frederick Velikanje, Yakima, Washington; Noel P. Copen, Huntington, West Virginia; Harrold J. McComas, Milwaukee, Wisconsin; and Byron Hirst, Cheyenne, Wyoming.

The Executive Committee of the College consists of:

John E. Rogerson, Boston, Massachusetts; Charles A. Saunders, Houston, Texas; Harley J. Spitler, San Francisco, California; Arthur Peter, Jr., Washington, D.C.; E. Frederick Velikanje, Yakima, Washington; William P. Cantwell, Denver, Colorado; Merrill R. Bradford, Bangor, Maine; Milton Greenfield, Jr., St. Louis, Missouri; and Wesley L. Nutten, III, Los Angeles, California.

THE AMERICAN COLLEGE OF PROBATE COUNSEL,
Los Angeles, Calif., October 27, 1977.

Re Supplemental Written Statement of The American College of Probate Counsel, being submitted for the record of October 27 and 28, 1977, hearings by the Subcommittee on Taxation and Debt Management of the Senate Finance Committee.

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

DEAR MR. STERN: The American College of Probate Counsel has already submitted seventy-five copies of its written statement and has testified orally with respect thereto at the above described hearings on October 28, 1977. We would now like to submit the attached supplemental written statement amplifying some of our points in the former dealing with postponement of the effective dates of the generation-skipping trust provisions.

While we recognize that the Technical Corrections Act, as passed by the House of Representatives, does not contain any provisions dealing with problems caused by the effective dates of the generation-skipping transfer tax, the subject was deemed of sufficient importance so that the House Ways and Means Committee included it in hearings held in that Committee on October 6, 1977, and we respectfully submit that these provisions should be added to the Technical Corrections Act by the Senate Finance Committee.

The attached statement was prepared by the Estate and Gift Tax Reform Committee of the American College of Probate Counsel for the October 6, 1977, hearings in the House Ways and Means Committee and has been submitted as part of our written statement to the Ways and Means Committee. It has been reviewed by the Executive Committee of the American College of Probate Counsel and submitted under direction of the College's president (John E. Rogerson, Esq.). The membership of both of the above committees is listed on the last two pages of the statement we filed with you prior to our October 28, 1977 testimony. We would appreciate it if the attached statement and this cover letter could be printed in the hearing records.

Very truly yours,

FRANK S. BERALL,
Chairman, Estate and Gift Tax Reform Committee.

PART II. POSTPONEMENT OF THE EFFECTIVE DATE OF THE GENERATION-SKIPPING TRUST PROVISIONS IN THE TAX REFORM ACT OF 1976

The 1976 Tax Reform Act added a tax on generation-skipping transfers which was made applicable to taxable distributions and taxable terminations of trusts occurring after April 30, 1976. Section 2006(c) of the Act provides certain transitional rules. First of all, transfers under irrevocable trusts in existence on April 30, 1976 (to the extent they are not out of corpus added after that date) are exempt from the tax. Secondly, transfers made by decedents or settlors who die prior to January 1, 1982, under a Will (or revocable trust) which was in existence on April 30, 1976, and "was not amended at any time after that date in any respect which will result in the creation of, or increasing the amount of, any generation-skipping transfer" are also excluded. This latter exemption is extended in certain cases where the testator or settlor was incompetent on April 30, 1976, and remains incompetent on January 1, 1982.

The American College of Probate Counsel believes that many of the problems probate attorneys are encountering in trying to abide by the above-noted transitional rules are capable of being solved by Regulations, and it urges that the issuance of such Regulations be given the highest priority. The views of the College as to such Regulations are set forth in letters to the Chief Counsel, Internal Revenue Service, dated November 5, 1976 and October 4, 1977. (See Exhibits 1 and 2 attached.)

There are, however, several problems in such transitional rules which appear capable of solution only by new legislation. The American College of Probate Counsel advocates that the April 30, 1976, transitional date for wills and revocable trusts be changed from April 30, 1976, to October 4, 1976, the date of enactment of the 1976 Tax Reform Act, and that the effective date for taxing generation-skipping transfers under irrevocable trusts be August 5, 1976, the date the U.S. Senate voted to change the effective date of the transitional rules from May 1, 1977 to May 1, 1976.

In view of the uncertainty whether there would be any generation-skipping transfer tax (or for that matter, any estate and gift tax changes at all) until late in the summer of 1976, a transitional date for wills and revocable trusts which reflects the October 4, 1976 enactment date of the new law would be far more equitable than April 30, 1976. A great many inadvertent changes were made to what otherwise would have been protected wills and trusts between April 30, 1976, and October 4, 1976, and the earlier date will cause substantial hardship to innocent parties. It is unlikely that many individuals created, added to, or made changes in their wills or trusts prior to October 4, 1976 in the hope that the effective date would be postponed, and that they could thereby avoid the generation-skipping tax. Thus, the hardship cases undoubtedly outweigh any cases of deliberate tax avoidance, and should be given relief.

Furthermore, the existing statutory transitional rules should be modified to allow a permissable change in a pre-May 1, 1976 will or revocable trust by means of a subsequent new will or trust instrument and not merely by way of a codicil or a trust amendment. There appears to be no sound reason to continue the present restriction, and it is certainly a trap for the unwary.

The statutory transitional rules should be amended to indicate that where a protected instrument is "tainted," the "taint" should only be a proportionate one. The addition of corpus to a protected irrevocable trust or the change in a provision which would increase the amount of a generation-skipping transfer created in a revocable trust or will that would otherwise be protected should only result in tainting the proportionate part of the corpus resulting from the addition or the change in the will or revocable trust provision. In other words, an addition to corpus of an irrevocable trust after the effective date of the generation-skipping transfer tax in an amount equal to five percent of the corpus of the trust on that date should only taint five percent of the corpus at the time of a taxable transfer. The revocation of a $5,000 legacy in an otherwise protected will, followed by the death of the testator before 1982, without being in any other way altered so as to increase the amount of any generation-skipping transfer or create any other generation-skipping transfer, should result in tainting the corpus of the generation-skipping trust only by the percent which the $5,000 was of the entire value of the corpus at the time of the death of the testator.

Where a protected will has been revoked by a subsequent will or modified by a codicil or where a protected trust has been amended, and the changes made by the new instrument would, if allowed to stand, remove the protection from the generation-skipping tax, and the new instrument is subsequently revoked, provision should be made to treat the old instrument containing the protected transfers as having been in existence continuously, leaving to applicable state law to determine whether the provisions of the old instrument should be reinstated under the doctrine of dependent relative revocation or similar principles.

AMERICAN COLLEGE OF PROBATE COUNSEL,
Los Angeles, Calif., November 5, 1976.

Hon. MEADE WHITAKER,
Chief Counsel, Department of the Treasury, Internal Revenue Service, Washington, D.C.

DEAR MR. WHITAKER: The American College of Probate Counsel ("ACPC"), an organization of nearly 2,000 lawyers located all over the United States who specialize in probate practice and estate planning has followed with great interest the legislative process which led to enactment of the major estate and gift tax revisions in the Tax Reform Act of 1976. We would now appreciate the opportunity to make our views known to the Internal Revenue Service while regulations are prepared.

Last month I was one of the speakers at the Notre Dame Annual Estate Planning Institute. While there I had several opportunities to visit with Meade Emory (who was also on the program) and to talk to Jim Heinhold, who was one of the big registrants. I discussed with both of them ACPC's concern about certain ambiguities in the grand fathering provisions of the transitional rules applying to the generation-skipping transfer tax. I told them that it appeared to us that the problems could be solved by regulations. However, since there is a need for immediate guidance on certain pressing issues, the ACPC suggests that some form of temporary rules be issued as soon as possible dealing with the most pressing problems, as set forth in this letter. In subsequent letters, we will discuss other less urgent but quite important problems. All of the views expressed in this letter are the official ones of the ACPC.

1. Where an addition to an irrevocable trust is made by a pour-over from a probate estate under a will executed on or before April 30, 1976, the amount added should not be subject to the generation-skipping transfer tax, anymore than it would be if the pour-over had occurred from such a will to a protected revocable trust. On the other hand, if an unprotected will pours a probate estate into a protected irrevocable trust, the generation-skipping transfer tax would later appear to apply.

2. Only the pro rata portion derived from a post-April 30, 1976 addition to corpus held under a protected instrument should be subject to the tax. In other words, the entire corpus should not be tainted as a result of an addition.

3. Similarly, any change made in a protected instrument which results in an augmentation of the amount that will be subjected to the generation-skipping transfer should result in the loss of protection only for the amount added to the generation-skipping transfer. For example, if a $5,000 legacy is eliminated by codicil from a protected will, only the $5,000 should be subject to the generation-skipping transfer tax.

4. A number of questions arise as to what constitutes an increase in the amount of any generation-skipping transfer under a protected revocable trust or will. The Conference Committee Report indicates that a change of trustee, beneficiaries or a change in the size of the share used for the benefit of a particular beneficiary does not disqualify the trust, so long as the number of younger generations provided for under the trust (or the potential discussion of the trust in terms of younger generation beneficiaries) is now expanded and the total value of the interests of all beneficiaries in each generation below the grantors generation is not increased. But if there is a reduction in the number of trustees, possibly reducing the cost of administering the trust and thereby augmenting trust corpus, it is not clear whether this will taint the trust. A similar situation occurs if there is a codicil decreasing the number of executors receiving commissions or even if without any change in the instrument, not all of the fiduciaries named qualify. The ACPC believes that when augmentation taxes place as an indirect consequence of decreasing the number of executors or trustees, this should not taint the trust to any extent. The ACPC does, however, acknowledge that if the augmentation takes place as a result of the elimination of a pre-residuary cash legacy or any other pre-residuary bequest, then to the extent of the increase and only to that extent, the trust should be tainted.

5. A limited power of appointment over a protected trust should be exercisable to extend the duration of the trust, provided it cannot extend it beyond the period of the rule against perpetuities measured from the date of creation (or irrevocability) of the trust without making the transfer subject to the generation-skipping tax. Otherwise, the exercise of the general power of appointment should be protected from the date of creation of the trust.

Very truly yours,

FRANK S. BERALL,
Chairman, Committee on Estate & Gift Tax Reform.

AMERICAN COLLEGE OF PROBATE COUNSEL,
Los Angeles, Calif., October 4, 1977.

Hon. STUART E. SEIGEL,
Chief, Department of the Treasury, Internal Revenue Service, Washington, D.C.

DEAR MR. SEIGEL: On November 5, 1977, the American College of Probate Counsel ("ACPC"), sent a letter (copy enclosed) to the IRS setting forth suggestions for Regulations on the new generation-skipping tax. Since no Regulations have been proposed yet, we urge you to issue at least temporary rules in this area and also to consider ruling on other problems dealing with the exemption from the generation-skipping transfer tax of pre-May 1, 1976 wills and revocable trusts. Unless properly clarified by Regulations (or temporary rules, initially), Congress' intent could be defeated and what is generally believed to be quite liberal transitional rules applicable to these wills and trusts will be wholly ineffective.

1. There are inconsistencies between the Senate Finance Committee and Conference Reports on H.R. 10612 (both of which appear to carry out the intent of Congress) on the one hand and the House Ways and Means Committee Report to H.R. 14844, coupled with the Summary of the Conference Agreement on H.R. 10612 as prepared by the Ways and Means Committee, as these statements interpret section 2206(c)(2) of the Tax Reform Act. This section excepts from the generation-skipping transfer tax transfers under a trust which was irrevocable on April 30, 1976, but only to the extent that the transfers are not made out of corpus added thereafter, as well as transfers under a will or revocable trust in existence on April 30, 1976, if the decedent dies before January 1, 1928, without having amended the instrument in any respect which will result in the creation of, or increase in the amount of, any generation-skipping transfer. The provisions with respect to wills and revocable trusts do not restrict the exception to pre-May 1, 1976, corpus, as contrasted with the irrevocable trust exception. Other than the difference in effective dates and in the kind of amendments permissible, the language with respect to the exception as it applies to wills and irrevocable trusts is identical to that appearing in both the original title XXII of the Senate Amendments to H.R. 10612 and the comparable provisions in H.R. 14844, as reported to the House on August 2, 1976.

The Conference Committee Report to H.R. 10612 says that the conference agreement generally follow the rule of the Senate Bill with respect to effective dates, with certain modifications. This Senate Bill permitted certain amendments without the loss of the exception to the generation-skipping trust; the House Bill did not. Both the Senate Finance and Conference Reports state that the tax does not apply in the case of transfers under irrevocable trusts in existence on April 30, 1976, or in the case of decedents dying before January 1, 1982, pursuant to a will (or revocable trust) which was in existence on April 30, 1976, and was not amended in ways affecting the generation-skipping transfer. Nothing is said in the Conference Reports with respect to corpus added after April 30, 1976, being made subject to the generation-skipping transfer tax, either in irrevocable trusts or revocable trusts. The Senate Finance Committee Report makes the same distinction between revocable and irrevocable trusts as does the Senate Bill.

On the other hand, the Summary of the Conference Agreement on H.R. 10612, prepared by the Ways and Means Committee, states that the generation-skipping tax will not apply to any transfers under a trust which was irrevocable on April 30, 1976 (but only to the extent that the transfer is not made from corpus added to the trust after that date). The Summary of the Conference Agreement further provides that in the case of a revocable trust or will in existence on April 30, 1976, the provisions do not apply "to transfers from corpus in the trust on that date" if the grantors dies before 1982 and the trust instrument or will is not revised after April 30, 1976. The above parenthetical phrase, indicating that the exception to the generation-skipping transfer tax only applies to corpus in a trust as of April 30, 1976, in the case of a will or revocable trust, is certainly not in accordance with the statutory language or the Senate Finance Committee Report. But the Ways and Means Committee Report to H.R. 14844 had identical language with respect to the effective dates and exceptions as the Summary of the Conference Agreement.

If the exception for wills and revocable trusts is to have any meaning, it would have to apply to corpus added after April 30, 1976. Otherwise, insofar as testamentary trusts are concerned, the exception established under it is not in existence until after the death of the testator and the qualification of the trustee in the probate court. Obviosuly, there can be no corups in a testamentary trust until that time. In the case of an inter vivos trust, if the parenthetical phrase in the Ways and Means Committee Report and the Summary of the Conference Agreement is followed, only the relatively small number of revocable inter vivos trusts that were funded by April 30, 1976, will be within the exception. Most revocable inter vivos trusts do not have substantial property added to them until after the death of the settlor, at which time there is a pour-over from his will.

Despite the language in the Ways and Means Committee Report, interpreting language in the Bill which has not been changed, it could not have possibly been the intent of Congress to grant such a limited exception to revocable inter vivos trusts and a meaningless exception to testamentary trusts. The Senate Finance Committee Report confirms this view. The transition rules, as applied to revocable trusts and testamentary trusts, will only exempt these from the generation-skipping transfer tax if their creators died prior to January 1, 1982. This distinction clearly justifies the difference in treatment between irrevocable trusts on the one hand and wills and revocable trusts on the other hand. The statutory language certainly bears this out.

The ACPC urges that Regulations interpret the exception for pre-May 1, 1976, wills and revocable trusts to apply to corpus placed in them regardless of the date it was, or is thereafter, added. A contrary interpretation would not be in accord with the statutory language or the Senate Finance Committee or Conference Committee Reports and would emasculate what would appear to be the true intent of Congress in providing the exception.

2. Another question about which the ACPC is concerned deals with the nature of corpus held in irrevocable trusts prior to May 1, 1976. The generation-skipping transfer tax is not going to apply to irrevocable trusts in existence on April 30, 1976, to the extent of the corpus in them on that date.

Obviously, appreciation in the value of this corpus subsequent to that date is not an addition to the corpus and should therefore be exempt from the generation-skipping transfer tax. For example, if an irrevocable trust owned corpus valued at $500,000 on April 30, 1976, which is worth $1,000,000 at the settlor's death and $2,000,000 at the death of a beneficiary one generation younger than the settlor, who would be considered a deemed transferor, the statutory exception to the imposition of the generation-skipping transfer tax would exempt the entire $2,000,000 worth of corpus from the tax, even though $1,500,000 worth of that corpus was due to growth in the value of the corpus originally in the trust on April 30, 1976. It should be noted that in most cases it would be next to impossible to ascertain the value of the trust corpus as of April 30, 1976, at some future date when, were it not for this exception, a tax would otherwise be due.

Irrespective of the type of corpus in an irrevocable trust on April 30, 1976, subsequent appreciation in that corpus is not an addition to the corpus and thus should be exempt from the generation-skipping transfer tax. For example, some or all of the corpus of such a trust may consist of whole life or term life insurance policies, insuring the settlor. In the case of whole life policies, there probably was some ascertainable value on April 30, 1976, based upon the sum of the interpolated terminal reserve plus the unearned premium less any indebtedness due on the policy. In the case of term policies, particularly one year term policies, there was probably little or no ascertainable value, other than the potential value inherent in such a contract at such future time as it becomes a death claim. In both cases, the augmentation of the trust corpus at the death of the settlor, caused by the receipt of the face amount of the insurance, as well as any subsequent appreciation resulting from the investment of those insurance (and other) monies by the trust prior to the death of a deemed transferor, should also be considered appreciation in the value of the original corpus, rather than corpus additions to the trust.

3. A further problem arises where a portion of the face amount of the insurance is attributable to premiums paid subsequent to April 30, 1976. Where these premiums are paid from existing trust corpus, the premiums represent a mere conversion from one type of investment (cash or other property) into another (an interest in a life insurance contract). Where the premiums are paid from income earned by corpus in the trust on April 30, 1976, they represent income accumulations from existing trust corpus and should not be considered corpus added to the trust after April 30, 1976. Where the premiums are paid from funds not included in corpus held in the trust on April 30, 1976, or income earned on those funds, whether the premiums are paid by the trustee from additions made to the trust or by someone else (without passing through the trust), then it would seem that the proportionate amount of the face value of the policy (together with the proportionate amount of subsequent appreciation thereon) attributable to the premiums paid from additions made to the trust (directly or indirectly) after April 30, 1976, would be subject to the generation-skipping transfer tax.

Very truly yours,

FRANK S. BERALL,
Chairman, Committee on Estate & Gift Tax Reform.

Senator BYRD. The next witness is Mr. Arthur Hoffman, Chairman of the Committee on Financial and Estate Planning, Federal Tax Division of the American Institute of Certified Public Accountants.

Welcome, Mr. Hoffman. If you will just make yourself comfortable, the committee will take a 1-minute recess.

[A brief recess was taken.]

Senator BYRD. The committee will come to order.

Mr. Hoffman, you may proceed.

STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN, COMMITTEE ON FINANCIAL AND ESTATE PLANNING OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. HOFFMAN. Thank you for your introduction, Senator Byrd.

We appreciate the opportunity to participate in your hearings on the two bills, S. 2227 and S. 2228, dealing with carryover basis.

The AICPA testified on this subject before the House Ways and Means Committee when the Tax Reform Act of 1976 was being formulated. At that time, on March 15, 1976, we advocated a number of changes in the estate and gift tax provisions which later were enacted.

However, in our testimony, we warned that the two proposals for taxing the appreciation in a decedent's assets—both (1) capital gains at death or an additional estate tax; and (2) carryover of basis—would unnecessarily introduce extraordinary complications into the tax law. Nevertheless, carryover was adopted after consideration only by the conference committee.

Recently, on October 6, 1977, we returned to testify before the House Ways and Means Committee and offered our views of the difficulty of administering the carryover provisions. This subcommittee has heard and digested similar testimony. The two bills introduced by Senators Byrd and Dole, S. 2227, the two-year deferral provisions, and S. 2228, containing amendments to carryover indicate that the significance of such testimony was clearly perceived.

The AICPA's positions on the bills before this subcommittee rests upon the following programs:

We believe that deferral or even repeal of carryover and thus the temporary or permanent reinstatement of stepped-up basis upon death, is not the re-opening of a loophole in the tax law. We have long contended that it was incorrect to allege that unrealized appreciation was not subject to tax prior to the Tax Reform Act of 1976.

Such appreciation is subject to estate taxes reaching 70 percent—formerly 77 percent—plus state death taxes in excess of the Federal credit. The present unified transfer tax adequately plugs any loophole that might exist in the income tax.

The recordkeeping obligation imposed by carryover applies to almost all taxpayers. A young person, regardless of his present circumstances, would be foolish to decide today that over his lifetime he surely will not accumulate enough assets for carryover to present a serious problem for his wife and family.

This is particularly true when we consider the impact of inflation upon the value of assets over an extended period. Consequently, even though the minimum basis adjustment is raised to conform to the exemption equivalent of the unified credit, as proposed under section

3(b) of S. 2228, the duty of maintaining records of dates and prices of all of ones' assets—of every variety—is imposed upon an enormous segment of our population.

Even if carryover was limited in its application, we consider repugnant the oft-repeated contention that it does not matter how complex a tax provision may be so long as it applies only to very few taxpayers. This subcommittee is aware from past testimony of the efforts necessary to establish the acquisition date and prices of every one of the multitude of assets owned by a decedent, and of the time consumed by professionals in computing bases.

With respect to Mr. Cohen's testimony, there was a lot of time spent in establishing those bases.

This subcommittee is also aware that amendment of previously filed income tax returns will become the rule since subsequent determinations will cause changes in the bases of all assets. For example, if the valuation of any asset or the amount of any liability of administration expense is changed by the Internal Revenue Service during its examination of the estate tax return, the bases of all assets will be affected.

This problem of repeated amendments of income tax returns would remain despite the elimination of the "fresh start" adjustment, and the "grandfathering" of property held on December 31, 1976 as provided in section 3(a) of S. 2228. We believe that carryover, however modified, will add inordinately to the time and expense of administering most estates.

We considered the compound tax consequences of carryover. Carryover piles taxes upon taxes. The obligation to pay estate taxes usually necessitates the sale of assets. This often occurs in the case of the estate of the owner of the closely held business.

Under carryover, the sale or redemption of stock will result in recognition of gains. Round upon round of sales will be required to satisfy the burgeoning income tax liabilities generated by prior sales. In too many cases, small businesses will be sold in anticipation of the compound tax impact upon the death of a shareholder.

I expect, in part, that that also motivated the sale of the New York Post, as mentioned before.

Last, in establishing our position with respect to the two bills considered by this subcommittee, we took account of the possibility that the present administration soon may propose a method of taxing appreciation at death. Envision the combination in the tax law of: One, stepped-up basis on death; two, carryover; and three, some form of immediate taxation of appreciation.

Each provision would stand in philosophical conflict with the other; each eventually would possess a body of interpretative case law developed after litigation costly to both taxpayer and government. And yet, each would depend for its application strictly upon the date of the decedent's death in 1976, 1977, 1978 or 1979. Such a patchwork would serve as an example for historians of the failings of our legislative process.

The AICPA's evaluation of the foregoing leads us to the conclusion that carryover should be repealed outright. If repeal is not feasible at this time, we recommend the adoption of S. 2227, the 2-year deferral provision.

We do not hesitate to say that S. 2228 improves carryover. However, we have no doubt that carryover will remain bad law—difficult to administer, and replete with complexities virtually mandating noncompliance. The provisions of S. 2228 are most compelling for they focus upon a number of serious problems associated with carryover. But the known problems of carryover are legion, and many more will come to light as we attempt to apply it to the infinite variety of circumstances present in estates.

Accordingly, the AICPA vigorously supports repeal, as Senator Curtis has proposed. However, if the time is not ripe for repeal, we urge the adoption of S. 2227, the deferral of carryover. Its impact is about to be felt.

Taxpayers throughout the country at all economic levels very soon will come to the realization that there has been imposed upon them utterly preposterous recordkeeping requirements. We believe that the implications of carryover for all taxpayers deserve study by Congress; and that such study will result in comprehension of the fact that carryover is unworkable. The AICPA urges deferral so that the study may begin.

We would like to add to our prepared remarks our view of yesterday's testimony by Deputy Assistant Secretary Donald C. Lubick. In certain limited respects he expressed Treasury's support of S. 2228. He rejected out of hand S. 2227 and repeal.

We believe that Treasury support of S. 2228 is ephemeral for the modifications proposed thereto are highly significant and what will be left will be strikingly similar to the unadministerable law that we have at present.

Contrary to section 3(a) Treasury proposes to retain the fresh start adjustment and eliminate the grandfathering of assets held on December 31, 1976.

Contrary to section 3(c), the basis of adjustment for estate taxes would not apply to property funding the marital or charitable deduction. Treasury would counter section 4, the simplification of the contemplation of death rule by modifying sections 203, 6166, and 6166(a) so that property transferred within 3 years of death would be added back for purposes of percentage qualification requirements of those sections.

Contrary to section 6, Treasury would bar the decedent's net operating losses from passing to his estate and would prevent the decedent's capital loss carryovers from passing through his estate and to his heirs. In addition, Treasury objects to extending section 303 redemptions to cover the income taxes attributable to redemption to pay death taxes.

The AICPA believes these changes would eviscerate S. 2228. Treasury adopts the theme that we referred to as "repugnant" in our prepared remarks, that is: it does not matter how complex a provision may be so long as it applies to very few taxpayers.

Specifically, Treasury stated, "If S. 2228 is modified as we propose, we will have a truly workable carryover basis provision that will affect only that part of the population which is able to manage any problems it may cause." The AICPA believes the problems will remain unmanageable despite the purported exclusivity of the affected group. Why should carryover, with all of its complexities, remain part of its tax law?

Treasury states the following at page 7 of Secretary Lubick's testimony:

At the most, only 2 percent of all decedents' estates will be concerned with carryover basis. In point of fact, it is likely that many of the 2 percent will not have the problem because those estates will be composed largely of liquid, non-appreciated assets.

The AICPA submits, that if that is true, the justification for carryover, the contention that it is designed to reach enormous amounts of appreciation which is escaping taxation, is stripped away. If we accept Treasury's premise then so complex a provision of such limited application should not remain a part of the tax law; at worst, its provision should be deferred pending further study.

Thank you, Senator.

Senator BYRD. Thank you, sir.

If S. 2228 is enacted, do you regard it as essential or not that the grandfather clause be a part of it?

Mr. HOFFMAN. Absolutely essential. One of the most serious problems with carryover and this subcommittee has heard a lot about the computations necessary. The fresh start rule involves an extraordinary amount of computations by professionals and I think it was discussed here in previous testimony that there have been tests made of the hours to calculate the bases of a particular asset under simple circumstances.

The fresh start rule is the cause of these problems, and without grandfathering, I do not see that S. 2228 does very much for carryover.

Senator BYRD. As I understand it, your first recommendation would be a repeal of carryover?

Mr. HOFFMAN. Yes, sir.

Senator BYRD. The second would be a 2-year deferral?

Mr. HOFFMAN. During that 2 years—when I referred to a study, I meant hearings that could take place where we could evaluate the impact of the changes you proposed in S. 2228 because we are on very short notice as to the nature of those changes and their impact.

I think that it would be sound if we evaluate the law as it would stand with S. 2228 and then also the law as it would stand with the Treasury proposals. We would all come to the conclusion that it remains unworkable.

Senator BYRD. What I am trying to get at, do you feel that S. 2228 should or should not be enacted?

Mr. HOFFMAN. If we are going to have carryover, if we are not going to have repeal and if we are not going to have deferral, then S. 2228 had better be enacted, because the law as it now stands is totally unworkable. The law as it would stand after S. 2228 would modify it and would perhaps be manageable.

Senator BYRD. You feel, by deferring consideration for 2 years, then there would be an opportunity of getting a better program perhaps than S. 2228?

Mr. HOFFMAN. Indeed. I think with the passage of S. 2228 we will have carryover for a long time unless the administration comes along and decides that another form of taxation would be appropriate, but it would perpetuate carryover if we did pass the bill. It would be hard, then, to return here and criticize the bill with the modifications in effect until, in years past, we see how it operates and we find then all the difficulties of applying it in practice.

Senator BYRD. Thank you, sir.
[The prepared statement of Mr. Hoffman follows:]

STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN OF THE COMMITTEE ON FINANCIAL AND ESTATE PLANNING OF THE FEDERAL TAX DIVISION

We appreciate the opportunity to participate in your hearings on the two bills (S. 2227 and S. 2228) dealing with carryover of basis.

The AICPA testified on this subject before the House Ways and Means Committee when the Tax Reform Act of 1976 was being formulated. At that time, on March 15, 1976, we advocated a number of changes in the estate and gift tax provisions which later were enacted. However, in our testimony, we warned that the two proposals for taxing the appreciation in a decedents assets—both (1) capital gains at death or an additional estate tax, and (2) carryover of basis—would unnecessarily introduce extraordinary complications into the tax law. Nevertheless, carryover was adopted after consideration only by the Conference Committee.

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The AICPA's positions on the bills before this Subcommittee rests upon the following premises:

We believe that deferral or even repeal of carryover, and thus the temporary or permanent reinstatement of stepped-up basis upon death, is not the re-opening of a loophole in the tax law. We have long contended that it was incorrect to allege that unrealized appreciation was not subject to tax prior to the Tax Reform Act of 1976. Such apprecication is subject to estate taxes reaching 70 percent (formerly 77 percent), plus state death taxes in excess of the Federal credit. The present unified transfer tax adequately plugs any loophole that might exist in the income tax.

The recordkeeping obligation imposed by carryover applies to almost all taxpayers. A young person, regardless of his present circumstances would be foolish to decide today that over his lifetime he surely will not accumulate enough assets for carryover to present a serious problem for his wife and family. This is particularly true when we consider the impact of inflation upon the value of assets over an extended period. Consequently, even though the minimum basis adjustment is raised to conform the exemption equivalent of the unified credit, as proposed under Section 3(b) of S. 2228, the duty of maintaining records of dates and prices of all of ones assets—of every variety—is imposed upon an enormous segment of our population.

Even if carryover was limited in its application, we consider repugnant the oft-repeated contention that it does not matter how complex a tax provision may be so long as it applies only to very few taxpayers. This Subcommittee is aware from past testimony of the efforts necessary to establish the acquisition date and prices of every one of the multitude of assets owned by a decedent, and of the time consumed by professionals in computing bases. This Subcommittee is also aware that amendment of previously filed income tax returns will become the rule since subsequent determinations will cause changes in the bases of all assets. For example, if the valuation of any asset, or the amount of any liability or administration expense is changed by the Internal Revenue Service during its examination of the estate tax return, the bases of all asssets will be affected. This problem of repeated amendments of income tax returns would remain despite the elimination of the "fresh start" adjustment, and the "grandfathering" of property held on December 31, 1976, as provided in Section 3(a) of S. 2228. We believe that carryover, however modified, will add inordinately to the time and expense of administering most estates.

We considered the compound tax consequences of carryover. Carryover piles taxes upon taxes. The obligation to pay estate taxes usually necessitates the sale of assets. This often occurs in the case of the estate of the owner of a closely-held business. Under carryover the sale or redemption of stock will result in recognition of gains. Round upon round of sales will be required to satisfy the burgeoning income tax liabilities generated by prior sales. In too many cases small businesses will be sold in anticipation of the compound tax impact upon the death of a shareholder.

Lastly, in establishing our position with respect to the two bills considered by this Subcommittee, we took account of the possibility that the present Administration soon may propose a method of taxing appreciation at death. Envision the combination in the tax law of: (1) stepped-up basis on death; (2) carryover; and (3) some form of immediate taxation of appreciation. Each provision would stand in philosophical conflict with the other; each eventually would possess a body of interpretive case law developed after litigation costly to both taxpayer and government. And yet, each would depend for its application strictly upon the date of the decedent's death in 1976, 1977, or 1978 (or 1979). Such a patchwork would serve as an example for historians of the failings of our legislative process.

The AICPA's evaluation of the foregoing leads us to the conclusion that carryover should be repealed outright. If repeal is not feasible at this time, we recommend the adoption of S. 2227, the two-year deferral provision.

We do not hesitate to say that S. 2228 improves carryover. However, we have no doubt that carryover will remain bad law—difficult to administer, and replete with complexities virtually mandating noncompliance. The provisions of S. 2228 are most compelling for they focus upon a number of serious problems associated with carryover. But the known problems of carryover are legion, and many more will come to light as we attempt to apply it to the infinite variety of circumstances present in estates.

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Contrary to Section 3(c), the basis adjustment for estate taxes would not apply to property funding the marital or charitable deduction.

Treasury would counter Section 4, the simplification of the contemplation of death rule, by modifying sections 303, 6166 and 6166A so that property transferred within three years of death would be added back for purposes of the percentage qualification requirements.

Contrary to Section 6, Treasury would bar the decedent's net operating losses from passing to his estate, and would prevent the decedent's capital loss carryovers from passing through his estate and to his heirs.

In addition, Treasury objects to extending Section 303 redemptions to cover the income taxes attributable to redemption to pay death taxes.

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Treasury adopts the theme that we referred to as "repugnant" in our prepared remarks, that is: it does not matter how complex a provision may be so long as it applies to very few taxpayers. Specifically, Treasury stated, "If S. 2228 is modified as we propose, we will have a truly workable carryover basis provision that will affect only that part of the population which is able to manage any problems it may cause". The AICPA believes that the problems will remain unmanageable despite the purported exclusivity of the affected group.

Why should carryover, with all of its complexities, remain part of the tax law? Treasury states the following (Page 7 of Secretary Lubick's testimony):

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The AICPA submits that if that is true the justification for carryover—the contention that it is designed to reach enormous amounts of appreciation which is escaping taxation—is stripped away. If we accept Treasury's premise, then so complex a provision of such limited application should not remain a part of the tax law; at worst, its provisions should be deferred, pending further study.

Senator BYRD. The next witness would be Mr. John Butala, Jr., cochairman, Taxation Committee, Trust Division of the American Bankers Association.

STATEMENT OF JOHN BUTALA, JR., COCHAIRMAN, TAXATION COMMITTEE, TRUST DIVISION OF THE AMERICAN BANKERS ASSOCIATION

Mr. BUTALA. Mr. Chairman, my name is J. H. Butala, Jr., and I am a senior vice president of the Cleveland Trust Co.

I appear on behalf of the American Bankers Association which is a trade association of 13,252 banks, approximately 4,000 of which have fiduciary powers and serve as trustees and as executors and administrators of estates. Consequently, we are vitally interested in the carryover basis provisions of the current law and in H.R. 6715.

I am accompanied by Mr. Paul F. Butler, vice president of the State Street Bank & Trust Co. of Boston, who is a member of our committee.

Carryover basis was enacted in 1976 against the virtually unanimous advice of expert witnesses and organizations who testified before the House Committee on Ways and Means.

Senator BYRD. I might say that most, if not all, virtually all of the Members of the Senate were somewhat astonished when they learned that this was passed as a result of a conference report without any consideration by the Senate or by the committee.

Mr. BUTALA. The carryover basis law has been referred to by Professor Brannon of Georgetown who is a tax liberal as a disaster involving hopeless complexity. I might say that this judgment is confirmed by the experience of our member banks during the past year.

We support S. 1954 and urge the repeal of carryover basis and a return to prior law. If this cannot be done without offsetting the long-term revenue loss, we would not oppose a freezing of the unified credit at some figure below $47,000 which otherwise would become applicable in 1981.

We believe that carryover basis should be repealed for three reasons: (1) the difficulty in proving basis; (2) the inordinate complexity of the law; and (3) the excessive rate of taxation it imposes on property passing through an estate. Our written statement discusses these three reasons for opposing carryover basis in some detail.

On the complexity matter, I would like to put in the record a five-page worksheet developed by First National Bank of Denver for its own use in computing carryover adjustments. The mere tabulation of the necessary steps stands on its own as eloquent evidence of the complexities involved.

Senator BYRD. At this point, I will ask that the computation of carryover basis will be exhibit A, from the First National Bank of Denver, will be inserted in the record.

[The material referred to follows:]

EXHIBIT A.—COMPUTATION OF CARRYOVER BASIS (AS OF MAY 15, 1977) (1), WILLIAM R. McDONALD, TRUST OFFICER, FIRST OF DENVER

Complete this form for all items except excluded personal goods, life insurance, and transferred property disposed of prior to death.

I. COMPUTATION OF FRESH START BASIS (2)

(If traded security complete lines 1 and 5, enter 12/31/76 value on line 10, skip lines 2–4 & 5–9.)

1. Estate Tax value of asset. (If income in respect of decedent, Sec. 72 annuity, or certain stock options, enter decedent's adjusted basis here and on lines 10 and 26. Skip lines 2–9 and 11–25).
2. Date of death value of asset (2031 or 2032 A if elected; not 2032).
3. Decedent's cost or acquired basis.
4. Total depreciation, depletion or amortization for total holding period.
5. Decedent's adjusted basis at death (line 3 minus line 4).
6. Not appreciation of asset during total holding period (line 2 minus lines 4 and 5).
7. *Pre-1977 holding period (days)* (*percent*).

Total holding period (days).

8. Assumed pre-1977 net appreciation (line 6 times line 7).
9. Actual pre-1977 depreciation, etc.
10. Fresh start basis (total lines 5, 8 and 9).

(Not to exceed line 1, except traded security.)

11. Remaining allocable appreciation (line 1 minus line 10).

II. COMPUTATION OF PROPERTY SUBJECT TO TAX

12. Non-recourse mortgage on property at date of death.

(If none, enter amount on line 11 on line 14.)

13. Amount of asset subject to tax (line 1 minus line 12).
14. Remaining appreciation subject to tax considering mortgage (line 13 minus line 10).
15. Net value of asset for Federal estate tax purposes.
16. Amount of asset qualifying for marital or charitable deduction.
17. Amount of transfer subject to tax (line 15 minus line 16).
18. Percent of transfer subject to tax (line 17 divided by line 15).
19. Amount of transfer subject to tax attributable to basis of asset (line 18 times line 10).
20. Remaining appreciation subject to tax considering deduction (line 18 times line 11).

III. ADJUSTMENT FOR TAXES PAID BY ESTATE (3)

21. Maximum adjustment for taxes (lesser of lines 11, 14 or 20).
22. Federal gross estate:

Less: Marital Deduction.
 Charitable Deduction.
 Non Recourse Mortgages.

Total property subject to Federal tax.

23. Total taxes paid by estate:
    a. Federal estate tax.
    b. State death taxes.
24. Overall tax rate (line 23 divided by line 22) (percent).
25. Adjustment for taxes paid by estate (line 21 times line 24).
26. Basis after adjustment for taxes paid by estate (line 10 plus line 25).

IV. MINIMUM BASIS ADJUSTMENT

27. Basis for purposes of minimum basis adjustment (for non-excluded personal and household goods, the lesser of line 1 or line 26. For all other items, line 26).
28. Total aggregate adjusted basis of all assets subject to carryover basis rules (total all lines 27).
29. Minimum basis adjustment: 60,000.
30. Maximum allocable minimum basis adjustment (line 29 minus line 28).
31. Aggregate estate tax value of all assets subject to carryover basis rules (totals all lines 1).
32. Remaining net appreciation of all carryover basis property (line 31 minus line 28).
33. Portion of minimum basis adjustment allocable to each asset (line 30 divided by line 32) (percent).
34. Remaining allocable appreciation (lesser of line 11 or line 14, minus line 25).
35. Minimum basis adjustment for asset (line 33 times line 34).
36. Basis after minimum basis adjustment (line 26 plus line 35).
37. Remaining appreciation subject to tax (line 34 minus line 35).

V. ADJUSTMENT FOR STATE TAXES PAID BY BENEFICIARY

38. Amount of asset subject to state death taxes, minus line 36.
39. Total state death taxes paid by beneficiary.
40. Value of all property subject to state death tax passing to beneficiary. (Separately computed).
41. Overall tax rate (line 39 divided by line 40) (percent).
42. Adjustment for state death taxes (line 41 times line 38).
43. Final adjusted basis for purposes of determining capital gain or sale of asset (line 36 plus line 42).

VI. BASIS FOR LOSS PURPOSES

44. Net appreciation of asset for loss purposes (line 1 minus line 5).
45. Remaining appreciation subject to tax considering mortgage (line 13 minus line 5).
46. Amount of appreciation of transfer subject to tax for loss purposes (line 18 times line 4).
47. Maximum adjustment for taxes (lesser of lines 44, 45, and 46).
48. Adjustment for taxes paid by estate (line 47 times line 24).
49. Basis after adjustment for taxes paid by estate (line 5 plus line 48).
50. Remaining allocable appreciation (lesser of lines 44 or 45 minus line 48).
51. Basis for purposes of minimum basis adjustment. (For non-excluded personal and household goods lesser of line 1 or line 49. For property subject to nonrecourse mortgage, line 45 minus line 48. For all other items, line 49.
52. Total basis all assets subject to tax. (Total all lines 51).
53. Minimum basis adjustment: 60,000.
54. Maximum allocable minimum basis adjustment (line 53 minus line 52).
55. Remaining net appreciation of all carryover basis property (line 31 minus line 52).
56. Portion of minimum basis adjustment allocable to each asset (line 54 divided by line 55) (percent).
57. Minimum basis adjustment for asset (line 50 times line 56).
58. Basis after minimum basis adjustment (Line 49 plus line 57).
59. Remaining appreciation in asset (line 50 minus line 57).
60. Adjustment for state death taxes (line 41 times line 59).
61. Final adjusted basis for purposes of determining capital loss on sale of asset (line 58 plus line 60).

(1) H.R. 6715 proposes several changes to the carryover basis rules, including:
(1) Treating estate taxes on income items in the estate as an addition to basis.
(2) Ignoring non-recourse debts against the property.
(3) Making the basis for loss purposes same as for gain, ignoring the fresh start adjustment.

(2) It is not necessary for the decedent to have actually held the property on December 31, 1976. If the property held by the decedent at his death was acquired in a non-taxable exchange for property that he did own on Decem-

ber 31, 1976, the fresh start adjustment will be available. Also the property on December 31, 1976.

(3) The adjustment for taxes paid does not include any additional tax imposed because of a disposition of property which qualified for the special form or closely held business valuation.

The taxes used in the computation of the second adjustments are the regular federal estate taxes and any estate, inheritance, legacy or succession taxes, for which the estate is liable, actually paid by the estate to any state or the District of Columbia.

Mr. BUTALA. Perhaps the most fundamental objection to carryover basis is that it represents an undesirable intrusion by the Federal Government in the administration of estates. The rules for administering estates, developed over many years, have now been revolutionized by tax law. The sale of assets to meet estate obligations is now significantly impacted by tax considerations, and in many cases executors will be required to make sale decisions involving substantial monetary consequences despite less than adequate basis information. The basis of assets must now be taken into account in distributing assets among several beneficiaries. A beneficiary entitled to a fractional share of an estate is presumably entitled to an identical fractional share of the basis of the estate's assets. This will lend to complicated and costly distribution processes particularly where assets have been purchased in multiple lots or under repetitive purchase plans.

Executors and administrators are also faced with a difficult problem in funding marital deduction and residuary gifts. Funding a marital deduction gift with appreciated property minimizes the basis increase. Funding the residuary gift with such property may lead to increased capital gains tax liability. Planners and fiduciaries throughout the country are now at a complete loss as to what to do. The total effect of the carryover basis law is that a fiduciary must now slash his way through an underbrush of tax complications to administer the estate, and even a routine estate now requires the assistance of a professional expert.

The required basis adjustments are difficult and complex. We doubt that there is any way to make them in a fair and simple manner. Current law does not do so, and those parts of H.R. 6715, which relate to the basis adjustments are inadequate and defective. The basis adjustments are wrong today, and despite the passage of 1 year's time since the enactment of the Tax Reform Act of 1976, no consensus has developed on how the adjustments should work, despite the fact that a highly competent professional staff has addressed the problem.

We have examined the proposals submitted to this subcommittee by the Treasury Department, and we do not believe that they are a sufficient answer to the problems of the carryover basis law. The Treasury agrees that the minimum basis should be increased to $175,000, but then proposes that this figure be reduced by the amount of any life insurance in the estate, and in some cases, by cash. Insurance is present in most estates and the present proposal for practical purposes translates into a minimum basis of something less than $175,000. We fail to see why a decedent who seeks to provide for estate liquidity and the needs of his family by the purchase of life insurance should be penalized for his prudence. The minimum basis of $175,000 in effect represents a partial repeal of a law. What is needed, really, is a total repeal or, failing that, a minimum basis of at least $1 million because only estates of millionaires should be required to deal with the tortures of carryover basis. Only they can afford the increased legal and accounting fees.

The Treasury's proposal for simplifying the basis adjustment for Federal and State death taxes on the appreciation element in an estate creates as many problems and complexities as it solves. The basis adjustment is to be made with respect to "net appreciation." Post-1976 carryover gains and losses are to be netted. This is actually a retreat from present law and may lead to unintended and severe impacts in estates. For example, since the fiduciary must net carryover gains and losses, he may be denied any basis increase whatsoever simply because he cannot prove the basis of any one asset and cannot prove net appreciation. Under current law, the adjustment is made on an asset by asset approach and the basis adjustment for assets distributed to one beneficiary is not affected by the appreciation or depreciation in assets distributed to another beneficiary. The Treasury's proposal would reverse this and raises a difficult policy consideration. Why should a beneficiary receiving only appreciated assets have his basis adjustment reduced because a second beneficiary receives depreciated assets?

Under current law, the basis of all assets in an estate cannot be determined until the Federal estate tax has been rendered final by Internal Revenue Service audit. This has been referred to as the problem of the "suspended" basis. The Treasury's recommendations do not eliminate this problem. Basis would be effectively suspended until the basis of each and every asset in the estate can be determined and until the Federal estate tax is rendered final by IRS audit.

Mr. Chairman, we would also like to clarify the record as to our position with respect to an appreciation tax at death. We do not regard a capital gains tax at death, even though deductible against the estate tax, as an acceptable alternative. Such a tax would represent a significant increase in the taxation of property at death and, because of its regressive nature, this increase would bear down most heavily on the more modest estates. If the marital deduction and charitable gifts are exempted from the tax, as is generally recommended, the complexities of carryover basis would be exceeded. The tax then becomes a hybrid—part carryover basis and part capital gains tax at death—and it has the worst elements of each.

For these reasons, the American Bankers Association developed and advanced the concept of an additional estate tax on appreciation, but only as the lesser of possible evils in the event that Congress, unwisely in our opinion, should decide that an appreciation tax at death must be enacted. We do not support the enactment of an additional estate tax on appreciation.

We do support the prompt enactment of H.R. 6715 with appropriate amendments to improve its operation which we discuss in detail in our written statement. In our opinion, H.R. 6715 should be considered and enacted independently of the other bills before this committee which involve difficult, substantive policy matters.

If immediate repeal of carryover basis is not possible, the American Bankers Association supports S. 2227 to defer the effective date of carryover basis and related changes in the Tax Reform Act of 1976 until January 1, 1979 and recommends that all carryover basis provisions of H.R. 6715 be stricken. We believe that the Joint Tax Committee staff should be directed to prepare a report within the next few months which would discuss possible approaches to the problems in this area and hearings should be conducted on those problems.

While we applaud the objectives of S. 2228, we believe that such sweeping changes should be enacted only after overall consideration of the formidable technical and policy considerations involved. A quick-fix approach would only repeat the mistakes made on the original enactment of carryover basis and a moratorium would provide the time needed to do the job properly and would, in our opinion, be a more prudent course of action.

Thank you, Senator.

Senator BYRD. Thank you.

Assuming that S. 1954; namely, the repeal of carryover, or S. 2227, the moratorium, could not be enacted in the short period of time now remaining in this Congress, would you think it profitable to enact S. 2228?

Mr. BUTALA. If it could be enacted with the grandfather provisions remaining in the law, we think that it could be lived with. Our fear is that the grandfathering provisions would be stripped in the conference committee or in some way lost along the way in the legislative process, in which case we would regard it as totally unacceptable. In the form that you propose, we could live with it.

Senator BYRD. The grandfathering is essential?

Mr. BUTALA. The grandfathering is essential to remove complexities in the problems of proving basis of all assets. I disagree thoroughly with Mr. Cohen. We have been involved in this process for a year with some large estates and we have had a real horror show in trying to prove basis of assets. Of course, grandfathering would eliminate problems of the fresh start rule which has created a terrible amount of complexity.

Senator BYRD. Thank you very much.

[The prepared statement of Mr. Butala follows:]

STATEMENT OF AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is a trade association composed of 13,252 banks, or about 92 percent of the banks in the country. Approximately 4,000 member banks have fiduciary powers and serve as trustees and as executors and administrators of estates. Consequently, the ABA is vitally interested in the carryover basis provisions of current law and in H.R. 6715.

SUMMARY OF POSITION

Repeal of carryover basis

The ABA supports S. 1954 and urges the repeal of carryover basis and a return to prior law, with the result that the income tax basis of property included in a decedent's gross estate and the surviving spouse's share of community property would be its estate tax value, but favors such action being taken independently and not as a part of a technical amendments act such as H.R. 6715.

Two-year moratorium on carryover basis

If an immediate repeal of carryover basis is not possible, the ABA supports S. 2227 to defer the effective date of carryover basis and related changes in the Tax Reform Act of 1976 until January 1, 1979 and believes that because of the unusual manner in which carryover basis was enacted and the difficult problems presented by its operation that such a moratorium would be a "technical amendment" consistent with the spirit and purpose of a technical amendments act.

H.R. 6715

The ABA supports the prompt enactment of H.R. 6715, with appropriate amendments to improve its operation.

REPEAL OF CARRYOVER BASIS

Carryover basis was enacted into law as a part of the Tax Reform Act of 1976 over the virtually unanimous advice of persons testifying before the House Committee on Ways and Means and without the Senate Committee on Finance or the Senate itself ever considering the subject. This mistake should be promptly rectified, but not as a part of a technical amendments act such as H.R. 6715. However, we urge that through some agreed upon procedure carryover basis be put to a separate vote within the next year and believe that such a vote will "overrule" the past mistake.

We desire that carryover basis be repealed for three reasons. First, the difficulty of proving basis, which will result in a significant increase in the time required in, and the cost of, administering estates; second, the complexity of carryover, which is inordinate; and, third, the excessive rate of taxation when the estate tax and income tax on appreciation are combined in effect.

Proof of basis

Much has already been said regarding the difficulties which fiduciaries will experience in establishing information as to a decedent's basis for assets included in his gross estate. Reformers are generally skeptical as to the difficulties that will be encountered, in part because most of them favor a capital gains tax at death which raises the same proof problem. While it is impossible at the present time to prove that this skepticism is wrong, we are convinced that as time passes the difficulty of proving basis will be substantiated. Our experience since the beginning of this year in attempting to establish basis information confirms our belief that major difficulties lie ahead in this area. Appendix A, attached to this statement, describes a number of actual situations which have already been encountered.

Complexity

1. "*Suspended Basis*" *and Basis Adjustments.*—Much has been said about simplifying our tax laws, which the President has referred to as a "national disgrace". Carryover basis is not simple in operation. The basis adjustments are both defective and complex. In fact, the situation is so bad that accurate income tax returns reporting sales of property acquired from decedent cannot in many cases be prepared until a substantial period of time after the returns are due. This does not make much sense.

If an income tax and an estate tax were imposed on the entire appreciation included in a decedent's estate, the aggregate federal taxes on the appreciation could exceed 100% since the highest estate tax rate is 70% and the highest capital gains rate (including the minimum tax) is approximately 40%. In order to prevent the obvious unfairness of a full double tax on the appreciation, section 1023 (c) and (e) provide in general for increasing basis by federal and state estate and death taxes on the appreciation. This increase is determined on an asset by asset basis by multiplying the total taxes by a fraction having a numerator equal to the appreciation in the asset and a denominator equal to the total value of all property subject to the tax. It cannot be computed accurately until the federal and state taxes are determined, which will usually not occur until several years after the decedent's death. Thus, each appreciated asset will have a "suspended" basis until final death tax determinations are made. If a federal estate tax issue is litigated, the basis of all assets will be suspended until the litigation is concluded. Amended income tax returns and refund claims will become a way of life.

Current law is defective in a number of respects regarding the basis adjustments. H.R. 6715 would cure some but not all of the problems. The complexity of the basis adjustments is demonstdated by the fact that they don't work property even with the proposed changes. These adjustments cannot be substantially simplified in a manner which operates fairly. S. 2228 achieves some simplification but does so in an unfair and uncertain manner.[1] State income tax laws must also be considered. If carryover basis is enacted on the state level, basis adjustments may be required in computing the state income tax.

2. *Marital Property and Fiduciary Responsibility.*—The complexity does not end with the "suspended basis" problem. Section 1023(f)(4) provides that in determining the basis increase for federal and state estate and death taxes under

[1] See pages 18–19.

subsections (c) and (e) property qualifying for the marital and charitable deduction will be treated as not subject to tax, *viz.*, will not be entitled to an increase. The legislative history makes clear that a tracing approach is applied, and decisions made by a fiduciary as to the allocation of specific property in satisfaction of a marital or charitable bequest will have an effect on the interests of beneficiaries.

Section 1023(f)(4) creates a significant problem for a fiduciary, which may be illustrated by a hypothetical case. Assume that an estate of a decedent dying after 1980 consists of two assets, asset A with a basis of $100,000 and a value of $500,000 and asset B with a basis of $400,000 and a value of $500,000, and that the value of each asset remains constant after the decedent's death. The gross federal estate tax would be $155,800 and, after allowing for the $47,000 unified credit, the federal estate tax (after the state death tax credit of $10,000) would be $98,800.[2]

The combined effect of section 1023(c) and (f)(4) is that if asset B is used to fund the formula provision the basis increase of asset A attributable to the federal estate tax is 400,00/500,000 x $98,800 or $79,040 and that if asset A is so used such basis increase of asset B is only 100,000/500,000 x $98,800, or $19,760. The denominator of $500,000 in each case is obtained by subtracting the marital deduction of $500,000 (property "not subject to tax" in the words of section 1023(f)(4) from the gross estate of $1,000,000 ("property which is subject to the tax imposed by section 2001" in the words of section 1023(c)).

The executor is thus presented with an unenviable choice—he must choose between maximizing the basis increase for the estate by selecting asset B to fund the marital bequest or minimizing the capital gains taxes that will have to be incurred to raise funds to pay these taxes and the federal and state death taxes by selecting asset B to fund the non-marital bequest in part. The words "in part" are used because both of the objectives—maximizing the basis increase and minimizing the capital gains taxes—are inconsistent only to the extent sales must actually be made to raise needed funds. To the extent that asset A or asset B is allocated to the marital bequest, its basis will remain the same as the decedent's basis. The choice must also take into account state estate taxes and the taxes which will be imposed on the marital deduction property either before, at or after the death of the surviving spouse.

Carryover basis presents significant problems under applicable state law and in our opinion improperly intrudes in the administration of estates. Is a fiduciary required to take income tax basis into account in distributing property in kind to different beneficiaries? The answer to this question is not clear. The duty of impartiality that a fiduciary owes to all beneficiaries suggests an affirmative answer, but this may depend upon the facts of a particular case. To illustrate, assume that a decedent by his will leaves a legacy of $50,000 to X and the balance of his estate to his surviving children. Under prior law if the legacy were funded with property in kind (as was permitted under the law of many states), the estate recognized a gain in an amount equal to the difference between the date of distribution value of the property and its estate tax value and X would have an income tax basis in the property equal to its date of distribution value.

Under current law (section 1040), the estate will recognize the same amount of gain by X will have an income tax basis in the property equal to the decedent's basis plus any section 1023 adjustments and the gain recognized by the estate. X would, of course, prefer to receive cash. The children would, however, prefer to satisfy X's legacy with property having the greatest amount of appreciation. Courts will have to resolve this conflict.

If a duty to take income tax basis into account exists under applicable state law when distributions in kind are made to different beneficiaries, this duty may be negated by a provision in the governing instrument, but the effect of specific language will in many cases be put before the courts for construction. Elimination of section 1023(f)(4) and allocating the section 1023(c) and (e) adjustments to all appreciated carryover basis property as does S. 2228 does not eliminate the state law problem and would introduce new problems and inequities.[3]

3. *Item by Item Computation of Basis Adjustment.*—As previously mentioned, the basis adjustments under section 1023(c) and (e) are made on an item by item

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[2] For simplicity, the increase in basis for state estate taxes is ignored.
[3] See pages 18–19.

basis. Many corporations have divided reinvestment plans for the purchase of their stock, and permit optional cash purchases without incurring brokerage charges. Mutual funds also have dividend reinvestment plans. Each acquisition of stock on a different date will have a separate basis. Dividends are usually paid quarterly. Thus over a ten-year period an individual participant in such a plan would have forty separate acquisition prices for the stock and at least forty separate basis adjustments would be required. Some financial advisors have advised clients to terminate their interests in dividend reinvestment plans because of carryover basis.

An item by item computation of the basis increase is also questionable tax policy in that this increase is not affected by unrealized losses in other estate assets. For example, assume that an estate consists of two assets, asset A with a basis of 160 and a value of 300 and asset B with a basis of 700 and a value of 500. Despite the estate having net depreciation of 60, asset A is entitled to a basis increase of 140/800 times the federal and state estate taxes. This result, combined with the failure to permit a capital loss carryover from a decedent's final year, mandates that no sales of loss property be made by an elderly person unless the losses are matched by sales at a gain during the same year.

Excessive rate of taxation

Carryover basis seems more palatable than a tax on appreciation at death because the timing of the tax may be controlled by the estate or its beneficiaries. This notion is, however, to a significant degree specious because there is little difference between carryover basis and a tax on appreciation at death to the extent that sales are required to pay estate and death taxes and other estate obligations, which would include income taxes on sales required to raise funds to pay the estate taxes.

Barber M. Conable, Jr., the ranking Republican on the Ways and Means Committee who led a fight on the House floor to eliminate carryover from the 1976 Act, has said:

"This act will create a new class of taxpayers—people who will not have to worry about estate taxes, but will have to pay a capital-gains tax. But this was not understood. As soon as you gave them the appreciation up to December 31, all the old people lost interest in fighting it." Ross, *The Tax Practitioners Act of 1976*, *Fortune*, April 1977, 106.

Conable's point may be illustrated by a specific case. The maximum federal estate tax savings resulting from the $47,000 unified credit replacing the $60,000 exemption is slightly more than $25,000 (the tax on the first $115,0000 of taxable estate under the old law). If the basis for assets included in the decedent's estate of $175,000 is less than $100,000 substantially all of the estate tax savings of approximately $25,000 will disappear in the form of income taxes when the property is sold. Thus, in the case of estates of between $60,000 and $175,000 the overall tax savings resulting from the "trade-off" of a relatively high credit for carryover basis is significantly less than one would think.

For medium sized estates—estates of between $175,000 and $500,000—the marginal rate of income tax and estate tax on appreciation is quite high. The estate tax rate is between 32% and 34% and the income tax rate, after providing a basis increase for the estate tax which will not exceed 20% of the appreciation, may fall in the 15 to 18% range. Thus, the combined marginal federal estate and income tax rate on the appreciation is roughly 50% when compared with a 32% rate under the old law. For the large estate the highest combined rate is approximately 82%, or 5% more than the highest estate tax rate under the old law. Thus, although the top estate tax rate has been reduced from 77 to 70%, there may be an increase in federal estate and income taxes for large estates when carryover basis is considered.

The foregoing discussion has ignored the effect of state taxes which often reduce the disposable estate further. For a New York decedent, the highest combined income and estate tax rates for federal and state purposes may exceed 90% for estates in excess of $5,000,000. In many cases, the combined federal and state estate taxes on the appreciation will exceed 60% for estates of not more than $500,000. This could occur for example in Vermont where the state death tax is 30% of the federal tax before the unified credit.

The effect of carryover basis is too severe on estates of all levels above $60.000 and should be reduced. S. 2228 is a step in the right direction and would solve the problem of carryover basis for estates of below $175,000 by increasing the minimum basis from $60,000 to $175,000. We support this change if carryover is not repealed.

TWO YEAR MORATORIUM ON CARRYOVER BASIS

Under normal conditions a two year deferment on an important part of a tax law, such as carryover basis, would not belong in a technical amendments act. However, the circumstances surrounding the enactment of carryover and the problems presented by it cannot by any stretch of imagination be considered as normal. The Senate never considered the subject and H.R. 6715, while a step in the right direction, is clearly an inadequate solution to the problems of carryover. What is needed is not a "quick fix", but rather deliberate consideration of the subject *after* the various issues and possible solutions are presented to the Congress and the public by means of a report on the subject by the Staff of the Joint Committee on Taxation. Thus, the only sensible solution to the problem is a moratorium so that such a report may be prepared. A discussion of a few of the inadequacies of current law will make the reasons for our recommendation clear.

"Fresh Start"

The current "fresh start" rule is one of several possible approaches to a transition rule for carryover basis. Its problems are numerous and the changes made in this rule by H.R. 6715 do not solve most of them. The fundamental issue is whether the fresh start rule should be substantially modified or should be replaced by another approach. S. 2228 would "grandfather" all pre-January 1, 1977 assets in the sense that such assets would receive an income tax basis equal to their estate tax value when included in a decedent's gross estate. After the first such inclusion, carryover basis would apply to such assets. While this approach would solve almost all of the problems relating to the fresh start rule, it would create some difficulties of its own.

Most of the problems with the current fresh start rule are caused by the different methods of computing the fresh start for (1) marketable bonds and securities and (2) all other assets. A marketable bond or security receives a basis adjustment for computing gain equal to the difference between its December 31, 1976 value and its income tax basis on that date. All other assets receive a basis adjustment for computing gain determined by the application of a formula, pursuant to which the difference between the value of the asset on the date of the decedent's death (the value under the alternate valuation method of section 2032 is ignored) and its adjusted basis immediately before the decedent's death is multiplied by a fraction having a numerator equal to the number of days the asset was held through December 31, 1976 and a denominator equal to the number of days held until the date of the decedent's death.

A. *Unfairness to "Nonmarketables."*—The result of this dual approach is to treat assets other than marketable bonds and securities as second class citizens for at least five reasons.

1. A marketable bond or security may have a basis (after the fresh start adjustment) for determining gain in excess of its estate tax value, but this cannot occur for any other asset because under the time-apportionment formula the appreciation in an asset is conclusively presumed to occur in an equal daily amount. Thus, the sale of such an asset will always result in some gain.

2. Farms or other qualified real property as to which section 2032A applies have a particularly heavy burden in terms of the fresh start adjustment. If a section 2032A election is made, the adjustment is based on the difference between the section 2032A value (not the fair market value) and the adjusted basis. Thus, the use of section 2032A is a mixed blessing and involves an income tax penalty. We would be amazed if Congress intended this result.

3. Preferred stock, whose changes in value are largely attributable to interest rate changes, receives widely disparate treatment depending upon whether it is a marketable security. If it is, its fresh start adjustment is frozen and will remain constant. If the preferred stock is "nonmarketable" the time apportionment formula will apply and the fresh start adjustment will decrease as time passes. This difference in treatment is untenable.

4. The "fresh start" basis increase for a marketable bond or security is frozen in the sense that it is not affected by changes in basis after December 31, 1976. This is not so for all other assets. Thus, if a gift is made of such an asset and a basis increase occurs under section 1015(d)(6) for the appreciation in the asset, the fresh start adjustment is reduced as a result of this increase. No such reduction occurs with a gift of a marketable bond or security. We cannot believe this difference in treatment was intended.

5. If the four points mentioned above are not enough, a further hardship has been created by not permitting the fresh start adjustment to reflect the use of estate tax values when the section 2032 alternate valuation method is used. The result is that the fresh start adjustment will be uncertain because it will reflect the date of death value of the asset which is never determined in the federal estate tax proceeding. We recommended to the House Committee on Ways and Means that this problem be eliminated by striking the words "(as determined with respect to the estate of the decedent without regard to section 2032)" from section 1023(h)(2)(A)(ii), as did the Treasury. The recommendation was ignored.

B. *Separate Bases for Gain and Loss.*—The fresh start problems do not end with the unfair treatment of assets other than marketable bonds or securities. The "split" basis for gain and loss is troublesome because for many pre-1977 assets proof of basis will be difficult and in some cases impossible. The "fresh start" provisions of section 1023(h) do not eliminate the problem of proof of basis for pre-January 1, 1977 assets. The values on December 31st for listed securities are useful only if there has been appreciation in the value over original cost; they are of no assistance if there has been a loss. At the closing of an estate, the executor has no way of knowing whether the assets he turns over to the heirs or other distributees will eventually be sold at a gain or a loss. The consequence is that the executor must provide the heirs or distributees with basis information for gain and loss as to each pre-1977 asset distributed to them. Thus, he cannot stop with December 31, 1976 values on marketable securities. He must ferret out and furnish to the heirs and distributes both the December 31, 1976 values and original cost information as to each marketable security. As regards nonmarketables (such as residences, partnerships, closely-held businesses and farms), original costs as well as costs of improvements over the years may be even more difficult to determine and tabulate on an asset-by-asset basis. Yet this is necessary to apply the time-apportionment rule for determining the December 31, 1976 values for each such property.

Even when the basis information of a decedent's assets has been obtained, many estate distributees will be unable to cope with multiple cost figures which section 6039A requires an executor to furnish to them. As indicated, in most estates, the heirs and distributees will receive information concerning two bases as to each pre-1977 asset distributed to them, one for gain and one for loss. The task of explaining the meaning and application of each set of figures will be difficult, and after the executor has done this, neither he nor the Government has any assurance that the explanations will be understood or correctly applied without help.

C. *Difficulty of Separating "Marketables" from "Nonmarketables".*—Since two different rules are applied in determining the fresh start adjustment, the amount of the adjustment will be different depending upon whether the asset is a marketable bond or security. In particular cases the determination of whether an asset is a marketable bond or security is going to be uncertain and thus the amount of the fresh start adjustment will remain uncertain. Regulations cannot avoid this problem because a factual test is involved in determining whether a marketable bond or security is involved.

D. *S. 2228 and "Grandfathering" Pre-1977 Assets.*—H.R. 6715 does not address the important issues discussed above regarding the fresh start rule. S. 2228 would eliminate each of these issues as a consideration by grandfathering all pre-1977 assets.

The approach of S. 2228 has considerable merit. If accepted, some qualifications would need to be developed to prevent assets acquired after 1976 from being grandfathered through their addition to a corporation or partnership which was in existence on December 31, 1976 and through other devices. This is provided for in S. 2228 by creating an exception for "transfers to a corporation, partnership, or trust" which would be treated as a separate property for purposes of grandfathering, with broad regulatory authority being granted to explain the exception. We believe the granting of regulatory authority with such a vague concept is undesirable. The statute itself should provide some general guidance regarding what is intended.

Federal and State death tax adjustments on appreciation

We have discussed the section 1023 (c) and (e) basis adjustments for federal and state death taxes on appreciation and the special rule of section 1023(f)(4) for marital and charitable property above. They are a source of complexity but,

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as stated, are required in order to prevent a "double" tax on appreciation and to produce a fair result. As noted, current law provides for a tracing approach in determining what property receives a basis adjustment as a result of section 1023(f)(4) which states that property qualifying for the marital or charitable deduction will not be treated as being subject to tax. Thus, property allocated in satisfaction of a marital or charitable deduction will receive no increase in basis. Logically, this result is sound because the marital or charitable property does not incur any federal estate tax.

S. 2228 would change this result by eliminating section 1023(f)(4) and by providing that all property included in a decedent's gross estate which is appreciated carryover basis property would receive an increase in basis under section 1023(c) based upon its proportionate share of appreciation. While this approach achieves some simplification, it will produce considerable hardship, particularly in the case of charitable bequests and will make it virtually impossible for a large estate with substantial appreciation to make charitable bequests in large amounts without producing adverse results for taxable beneficiaries. Also, it does not solve the problem which faces an executor of deciding what property to use to satisfy marital or charitable bequests where the assets available for distribution have different income tax cost bases and is uncertain in effect.[4]

We believe that the elimination of the section 1023(f)(4) rule is undesirable, but do favor the "single" death tax adjustment concept in S. 2228 in place of the current section 1023(c) and (e) adjustments, which would also eliminate our objection to the definition of "net appreciation" in H.R. 6715 in computing the adjustment for state death taxes. S. 2228 makes a number of other changes which would improve the operation of carryover basis and estate tax provisions that were modified by the Tax Reform Act of 1976. Again, our major concern with S. 2228 is that the changes are significant and there is not sufficient time adequately to consider them in the context of H.R. 6715. One obvious shortcoming is the proposed amendment of section 2035 without taking into account the percentage requirement tests of sections 303, 6166, 6166A and 2032A which would be significantly affected by the amendment.

Coordination of section 1015(d)(6) and section 1023 adjustments

Section 1015(d)(6) provides a basis for the federal gift tax adjustment on appreciation and acts as a companion to the section 1023(c) and (e) adjustments. However, while section 1023 (c) and (e) adjustments encompass both federal and state death taxes, section 1015(d)(6) applies only to federal gift tax. Several states have gift taxes and these taxes should be reflected in the section 1015(d)(6) adjustment.[5]

A lack of coordination exists between sections 1015(d)(6) and 1023 with regard to the basis adjustments which produces unintended and bizarre results when a gift tax is paid on appreciation in a gift which is included in the decedent's gross estate. To illustrate, if appreciated property qualifying for the marital deduction is transferred at death no basis increase is available under section 1023(c), but if that same property is transferred "in contemplation of death" the result is otherwise even though the property qualifies for the marital deduction. This point may be illustrated by an example.

Let us assume that an individual who has an estate of $4,000,000 consisting of two assets, asset A with a basis of zero and a value of $2,000,000 and asset B with a basis of $2,000,000 and a value of $2,000,000, desires to take full advantage of the marital deduction and his domiciliary state has a marital deduction which is the same as the federal marital deduction. If asset A passes under the will and is allocated to the marital deduction bequest, no increase in basis will be available under section 1023(c) because section 1023(f)(4) directing that for purposes of subsections (c) and (e) marital deduction property will be treated as not being subject to tax. On the other hand, if the individual makes a deathbed gift of asset A to his wife, a basis increase of $298,200 ($345,800—47,000) will be available under section 1015(d)(6). One-half of the gift qualified for the gift tax marital deduction and thus, ignoring the annual exclusion, the taxable gift is $1,000,000. The gift tax of $298,200 acts as a pre-

[4] For example, where appreciated carryover basis property is specifically bequeathed to a charity or qualifies for the marital deduction, we are uncertain how the estate tax is computed "without including the net appreciation" with respect to such property.

[5] S. 2228 makes this change.

payment of the estate tax under section 2001(b)(2), with the result that the total transfer taxes are the same as they would be if the gift had not been made.

The basis increase may be increased by more than 100 with a slight change in the terms of the gift. If the gift does not qualify for the gift tax marital deduction but does qualify for the estate tax marital deduction, the section 1015 (d)(6) basis increase will be $733,800 ($780,800—$47,000), namely, the gift tax on a taxable gift of $2,000,000. Again, the gift tax of $733,800 will be a full credit against the estate tax of the same amount. The gift property may be qualified for the estate tax marital deduction by meeting the requirements of section 2056 if the wife survives her husband from the date of his death rather than satisfying the requirements of section 2523 from the date of the gift.

Deathbed gifts, or any other gifts which are included in the gross estate under section 2035, may produce unusual results in other cases such as where the estate has substantial indebtedness or section 2032A property. The results may operate "for" or "against" taxpayers. Changes must be made in coordinating sections 1015(d)(6) and 1023.

Summary

The preceding discussion of three specific problem areas relating to carryover basis, namely, the fresh start adjustment, the federal and state death tax adjustments on appreciation and the coordination of the section 1015(d)(6) and 1023 adjustments demonstrates that much needs to be done. We doubt whether there is sufficient time to resolve these problems and other related matters before the Congressional recess. A moratorium on the application of carryover would provide the needed time to do the job properly if carryover is not to be repealed immediately.

H.R. 6795

Carryover basis

The following two comments are not relevant if the section 1023(c) and (e) basis adjustments are modified as provided in S. 2228.

1. "*State Estate Taxes*".—The definition of "State estate taxes" in section 1023(f)(3) should be amended to omit the words "for which the estate is liable" and "by the estate", with the result that the source of payment of the state tax would be irrelevant as is the source of payment of the federal estate provide the needed time to do the job properly if carryover is not to be repealed has been suggested why the source of payment of the federal estate tax should tax in determining the basis increase for the federal estate tax. No sound reason has been suggested why the source of payment of the federal estate tax should be irrelevant in determining the basis increase for the federal tax but have an effect on the basis increase for state estate taxes. With our suggested change in section 1023(f)(3), section 1023(e) could be eliminated, thus simplifying the basis adjustments by eliminating one possible adjustment. This change would cause the state succession tax adjustment now covered by subsection (c) to be made before instead of after the minimum basis adjustment of section 1023(d), but this difference is not a sufficient justification for an additional basis adjustment.

2. "*Net Appreciation*".—Section 1023(f), defining net appreciation would be amended by H.R. 6715 to provide that in computing the subsection (c)(2) adjustment for the net appreciation attributable to the state estate tax, the decedent's adjusted basis is to be increased by the subsection (c)(1) adjustment for the net appreciation attributable to the federal estate tax. This upward adjustment in computing net appreciation for subsection (c)(2) purposes, which has the effect of reducing the basis increase attributable to state estate taxes, is clearly wrong. If the net appreciation is less for state purposes than for federal purposes the "triple tax" element on the same property works imperfectly. No unwarranted tax benefit is involved from using the same "net appreciation" amount for both federal and state purposes, as is indicated by the different (and correct way) of computing the section 691(c) deduction. Furthermore, under current law the section 1023(c) adjustment for state estate taxes is correctly based upon the same net appreciation amount as the adjustment for federal estate taxes. The full amount of the net appreciation for federal purposes is also taxed for state purposes. Current section 1023(f)(2) is erroneous in making an upward adjustment for the subsection (c) adjustment in computing net appreciation for purposes of the subsection (e) adjustment.

Split gifts—coordination of sections 2035 and 2513

As noted in the Joint Committee Explanation (page 26), when a nondonor spouse consents under section 2513 to a gift by the donor spouse which is included in the donor spouse's estate pursuant to section 2035 "the transfer tax consequences to the consenting spouse are not reversed. For example, any unified credit used is not restored and the amount of aggregate taxable gifts for prior periods is not adjusted."

The proposed amendment would change this result for transfers occurring at or after the death of the nondonor spouse, but not for gift tax transfers of the nondonor spouse occurring after the death of the donor spouse. We believe the "reversal" should apply to such gift tax transfers.

Disclaimers

The House Committee Report fails to resolve an important issue regarding the disclaimer provision. It is whether a surviving spouse may make an effective disclaimer of a trust income interest if under the trust of the trust he or she retains the possibility of receiving all or a part of the trust principal in the discretion of the trustee or has a limited testamentary power of appointment or right of withdrawal (see sections 2041(b)(2) and 2514(e)) over all or a part of the trust principal. In our written testimony before the House Committee on Ways and Means, we requested that its Committee Report resolve this issue and permit a disclaimer under these circumstances. The Treasury Department opposes the disclaimer amendments and therefore would also oppose the clarification which we request. The point should be resolved one way or another either in the statute or in the legislative history.

Generation-skipping transfers

1. *Individual Trustees.*—This change would create a second exception to the rule that an individual with a discretionary power is treated as a beneficiary under Chapter 13 for an "independent trustee". In our written testimony before the House Committee on Ways and Means we advocated repeal of the individual power-beneficiary rule and said "this exception creates further complexity and uncertainty as to meaning of certain requirements which will not be resolved without years of litigation".

There are obvious problems with the independent trustee rule as drafted. The classification of the spouse, father, mother, brother or sister of the grantor as a related or subordinate trustee is strange because none of these persons is assigned to a generation younger than the grantor and treating such a person as a beneficiary will never result in an additional Chapter 13 tax. For the same reason the classification of any person who is related to a beneficiary but is not assigned to a generation below the grantor is puzzling. This could be avoided by limiting the related or subordinate trustee concept to a trustee who is assigned to a generation below the grantor.

The expansion of the related or subordinate concept to include relationships to any beneficiary as well as to the grantor also creates problems with broad tax-free testamentary powers of appointment. To illustrate, let us assume that an individual has a power to appoint to any person other than himself, his estate, his creditors, the creditors of his estate or any individual trustee. Read literally, no employee of any corporation could be an independent trustee, because the "beneficiaries of the trust" include every human being (and thus every stockholder and corporate executive). Therefore, the beneficiaries' holdings of *every* stock is "significant from the viewpoint of voting control" (subdivision (iii)), and *every* corporation is one in which a "beneficiary of the trust is an executive" (subdivision (iv)). The independent trustee concept needs to be modified.

2. *Alternate Valuation.*—A proposed change would make the alternate valuation method available upon the death of a beneficiary of a trust assigned to a higher generation than the deemed transferor. The change is an improvement in current law, but does not go far enough. A taxable termination occurring at or after the death of the deemed transferor is treated as an estate tax in the sense that the amount of the Chapter 13 transfer is computed "on top of" the taxable estate of the deemed transferor. Parity of tax treatment requires that all Chapter 13 transfers occurring at or after the death of the deemed transferor be entitled to use the alternate valuation method.

The change is premised on the assumption that the alternate valuation method is appropriate only when the death of a beneficiary is the taxable event. The Joint Committee Explanation states (page 30):

"Under present law, the alternate valuation date is to be available for generation-skipping trusts where the taxable termination occurs by reason of death."

Assuming this is an accurate statement of intent, the objective will still not be fully effectuated by the amendment. To illustrate, assume that a grantor creates a trust for his son and directs that income and principal shall, in the discretion of the corporate trustee, be paid to the son and that upon the son's death the trust property is to be distributed as the son appoints by will pursuant to a non-general power of appointment. Assume further that the son exercises his power by appointing an income interest to his widow, until her death or earlier remarriage at which time the principal is to be distributed outright to his grandchildren (the grantor's great-grandchildren) and that his widow does not remarry. Upon the death of the son, no taxable termination occurs because of section 2613(b)(2)(D). A taxable termination does occur upon the death of the widow as to which the son is the deemed transferor. However, the alternate valuation method is not available under section 2602(d). This method could be made available and section 2602(d) greatly simplified by modifying it to provide:

"If a generation-skipping transfer occurs at or after the death of the deemed transferor and as a result of the death of a beneficiary (including the deemed transferor) with a present interest or power, the trustee may elect to value all of the property transferred in accordance with section 2032."

Equally important, we reject the premise that use of the alternate valuation method is appropriate only when a taxable termination occurs by reason of the death of a beneficiary. There are other cases when the trustee will not necessarily know that a taxable termination has taken place until after it has occurred. For example, a taxable termination would result from the remarriage of the widow in the case discussed in the preceding paragraph. The remarriage may not become known to the trustee until several weeks after it occurs. The trustee cannot protect against a decrease in the value and secure the funds to pay the Chapter 13 tax by sale until he knows a tax is incurred.

3. *Double Tax on Chapter 13 Transfers.*—

a. *Throwback Distributions.*—The purpose of the proposed change in section 667(b) is to prevent the full amount of an accumulation distribution from being subject to both income tax and transfer tax. Proposed paragraph (6)(A) refers to the "tax imposed by chapter 11 or 13", thus creating some ambiguity concerning whether this refers to the gross tax before credits or something less. Since the double tax problem exists for the state death tax as well as for the federal estate tax, paragraph (6)(A) should encompass both of these taxes, as is done for purposes of section 1023(c) and section 691(c).

b. *Current Income.*—The adjustment in the partial tax relating to accumulation distributions solves the "double tax" problem when such a distribution is involved. The double tax problem on current income is, however, not solved. Current income may be subject to a Chapter 13 tax where principal distributions are made in the same year. See section 2613(a) (1) and (2). The combined income tax and Chapter 13 tax on current income could exceed 100% of the income distribution. This result is wrong and should be changed. One solution would be to provide:

"If a taxable distribution, as defined in section 2613(a)(1) is made to any person and such person is required to include all or a part of the distribution in his gross income (other than as a part of an accumulation distribution, as defined in section 664(b) such person shall be allowed a deduction against the tax imposed by chapter 1 in an amount equal to the tax imposed by chapter 13 as a result of the taxable distribution."

4. *Effective Date.*—The application of section 667(b), which is amended, is caused by an accumulation distribution not by the imposition of a Chapter 11 or 13 tax. Accordingly, the effective date provision should be amended to read:

"The amendment made by paragraph (1) shall apply to accumulation distributions occurring after December 31, 1976."

A Chapter 13 tax ca. of course, only occur with respect to a transfer after April 30, 1976. If a Chapter 11 tax was incurred ten years ago, there is no reason to deny the use of the change, which prevents an inequitable result.

Fractional interest rule for certain joint tenancies

H.R. 6715 would add a new subsection (c) to section 2040. The House Committee Report explains the provision as follows:

"The bill allows a donor spouse to have a pre-1977 joint tenancy to be treated as a 'qualified joint interest' without formally severing the joint tenancy and then recreating it. This treatment is to be available if the taxpayer elects to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979. A taxpayer making the election is to be treated as having made a gift at the close of calendar quarter for which the return is filed. The amount of the gift generally is to be equal to the appreciation attributable to the gift portion of the consideration furnished by the donor spouse at the time of the creation of the joint interest."

In some cases the donor spouse may have elected to treat the original acquisition of the property in joint names as a gift under section 2515(c) to the donee spouse in an amount equal to one-half of the value of the property. In such a case, the donor-spouse should not have to make a gift of one-half the appreciation occurring since acquisition as required by section 2040(c)(4) when the joint tenancy can be severed with no gift tax under section 2515(b).

All prior valuations for gift tax, estate tax or the chapter 13 tax should be "binding" in computing the tax for later transfers

Section 2504(c) provides as follows:

"*Valuation of Certain Gifts for Preceding Calendar Years and Quarters.*—If the time has expired within which a tax may be assessed under this chapter or under corresponding provisions of prior laws on the transfer of property by gift made during a preceding calendar year or calendar quarter as defined in section 2502(c), and if a tax under this chapter or under corresponding provisions of prior laws has been assessed or paid for such preceding calendar year or calendar quarter, the value of such gift made in such preceding quarter shall, for purposes of computing the tax under this chapter for any calendar quarter, be the value of such gift which was used in computing the tax for the last preceding calendar year or calendar quarter for which a tax under this chapter or under corresponding provisions of prior laws was assessed or paid."

With the "unification" of gift and estate tax rates and the introduction of Chapter 13 where the generation skipping tax is determined "on top of" prior gift or estate taxes of the deemed transfer and prior Chapter 13 transfers, the rule set forth in section 2504(c) should be broadened to cover the value of all prior transfers of an individual for gift, estate or Chapter 13 tax purposes.

TREASURY DEPARTMENT RECOMMENDATIONS

In its testimony relating to H.R. 6715 before the House Committee on Ways and Means, the Treasury made a number of recommendations which were not acted on and which are of concern to us. We assume that the Treasury will make these same recommendations to the Senate and have the following comments on recommendations 6 through 12, 15 through 18, and 25, 26, 28 and 29.

6. We agree with this recommendation.

7. We do not believe this recommendation is needed.

8. While this recommendation would improve current law, it is not a satisfactory solution to the basis adjustment for state estate taxes for the reasons previously discussed in this statement.

9. We agree with this recommendation.

10. We agree with this recommendation.

11. We disagree with this recommendation and point out that it presents a number of problems, one of which is its effect on the percentage requirement tests of sections 303, 3032A, 6166 and 6166A as a result of "deathbed" gifts.

12. The first part of this recommendation relates to recommendation 11. We disagree with the second part because it represents a "retreat" from prior law.

15. We disagree with this recommendation.

16. We disagree with this recommendation. It would have the effect of eroding what we regard as a legitimate use of the unified credit in preference to the marital deduction.

17. Conceptually we agree with this recommendation but, for the reasons previously discussed, we believe the "independent trustee" rule needs to be modified in more important respects.

18. We agree with this recommendation, but do not believe it goes far enough for the reasons described above.

25. Current law creates a rebuttable presumption that the marital deduction of a deemed transferor is to be increased to reflect generation-skipping transfers in certain cases. This recommendation would reverse the presumption. We do not feel strongly about which way the presumption runs.

26. We oppose this recommendation because it is unnecessary and would create further confusion with regard to the treatment of "minimum worth" pecuniary bequests under section 1040.

28. We believe the matters covered by this recommendation are more appropriately handled by regulation.

29. We agree with this recommendation.

APPENDIX A. EXAMPLES OF ACTUAL CARRYOVER BASIS PROBLEMS IN EXISTING ESTATES

1. An asset in an estate of a recently deceased widow is an 8-unit apartment building. Ownership of the apartment building passed to the decedent as surviving joint tenant on the death of her husband in 1962. Neither a federal nor a state death tax return had to be filed at the death of the husband; no appraisal was made of the property at that time nor was the depreciation basis altered. In order to apply the "fresh start" provisions of Section 1023(h)(2), the executor is now confronted with the task of securing an appraisal of the real estate as of the death of the husband in 1962.

2. Securities owned by the decedent were held in street name by broker A. Broker A acquired decedent's account when broker B was merged into the successor firm. The records of broker A are sketchy for many of the securities as to both date of acquisition and cost. Since the securities are in street name, it is not possible to secure any of this information from the transfer agents.

3. Decedent owned certain stocks and bonds which were acquired through his broker during the period of 1955–1965 and were held by his broker. On the decedent's death, it was discovered that the broker was not able to produce any information respecting actual acquisition dates and cost. It appears that the rules of the SEC only require brokers to maintain copies of statements for 6 years and copies of confirmations for 3 years.

4. The estate of a recently deceased widow contains a large holding of stock of a publicly traded company which was received many years ago in a tax-free exchange for the shares of a privately held company. Some of the shares of the privately held company owned by the decedent were the subject matter of a gift to the decendent from her husband who died 10 years ago. No records appear to be available to permit a determination of the basis of the original shares.

5. Decedent acquired a 2% interest in a partnership in 1968 for $10,000 and an additional ½% interest in 1970 at a cost of $3.00. The value of the decedent's partnership interest on 3/1/77, the date of death, was $20,000. The following is a summary of the partnership income allocable to the decendents' interest and of his withdrawals:

Taxable year ending—	Share of income	Withdrawals	Net
December 31, 1968	($250)	$1,000	($1,250)
December 31, 1969	(250)	1,000	(1,250)
December 31, 1970	(300)	1,200	(1,500)
December 31, 1971	(100)	1,200	(1,300)
December 31, 1972	100	1,300	(1,200)
December 31, 1973	500	1,500	(1,000)
December 31, 1974	1,500	1,700	(200)
September 30, 1975	2,000	1,500	500
September 30, 1976	2,500	1,500	1,000

How are the Section 1023(h)(2) adjustments to be calculated? For example, is the net increase in the decedent's account for the partnership taxable year ending 9/30/75 to be deemed to be a separate asset for purposes of Section 1023(h)(2) . . . as if it were similar to a building?

6. In a very large estate, there is a Florida residence valued at approximately $3,500,000 and a Cleveland residence valued at approximately $1,250,000. The land for the Florida residence was acquired in 1894. The original structure was put up in 1920. There have been major additions to the property from 1920 to the present. The original architect is deceased. The original and subsequent building plans are available, but incomplete. Preliminary drawings are difficult to distinguish from the final plans used. The cost records are incomplete and they are difficult to document because the family archives contain numerous records for five substantial residence properties owned by the decedent over a period of seventy years. Consequently, both the cost of the original property

and construction and the history of the improvements and additions are virtually impossible to document. Yet the executor has substantial monetary consequences at stake with respect to the cost of the original structure and improvements.

7. A decedent has died since January 1, 1977 with approximately $1 million in personalty, consisting of numerous items of furniture, pictures, jewelry, silverware, china, etc. maintained in four separate homes and acquired from innumerable sources including substantial gifts and inheritances from a long line of family members during the lifetime of the decedent who died at age 94. Cost records for these items are incomplete, and since some were acquired by gift, they may well trace back to more than 100 years. Any attempt to list and define anything approaching an accurate cost for these items could well lead to the expenditure of 100 or more manhours of the Executor's time.

8. A sampling of trust accounts at Bank X in which the Grantor has died after January 1, 1977 indicates that even when cost figures are available, there will be extensive adjustments to basis required which will be time-consuming and complicated. For example, in one trust, there are 84 different securities represented by 98 different blocks. In another trust, there are 62 securities represented by 97 different blocks. Under current law, the executor may therefore be required to make 196 and 194 adjustments for death taxes on the appreciation element in each block. If a separate fraction is developed under the Technical Amendments Act for state death taxes, these figures may be increased respectively to 392 to 384 adjustments. These are representative normal trust accounts in which Grantors have died, and it is apparent that TRA 76 has injected enormous complexity into what used to be routine accounts.

Senator BYRD. The next witness is Mr. David W. Richmond.

STATEMENT OF DAVID W. RICHMOND, ESQ., MILLER & CHEVALIER, WASHINGTON, D.C.

Mr. RICHMOND. My name is David W. Richmond. I am a partner in the Washington law firm of Miller & Chevalier. We represent Mr. H. E. Butt of Corpus Christi, Tex. While we represent a single taxpayer in this matter, we think that the point that we would like to make is probably applicable to a great number of taxpayers who have made wills including generation-skipping provisions.

As this committee knows, the Tax Reform Act of 1976 included a provision that eliminated generation-skipping from the tax law. That provision had been in effect for many years. There were many wills that included generation-skipping provisions in reliance on that longstanding provision.

The bill was enacted and approved by the President on October 4, 1976. I have been in practice for a great many years and belong to a very old school that things that Federal tax legislation, particularly that which tightens up on taxpayers, should be effective no earlier than the approval of the bill by the President. I know that is an outmoded concept; and in this case, if it cannot be made effective on October 4, the date of approval, I suggest that at least the elimination of the generation-skipping provision should be made effective no earlier than the first date on which the Congress, and in this case the Senate, announced its intention to do something about generation-skipping provisions and took action in that respect.

That date was August 5, 1976, at which time the Senate adopted the floor amendment which incorporated the generation-skipping provision in the bill.

The reason that it is unfair to use a date earlier than August 5 is because there were announcements made by the Finance Committee earlier in the consideration of the bill, particularly on June 11 and on July 20, 1976. In the first of these announcements, the committee suggested they would include some generation-skipping provisions in H.R. 10612. That was the bill that had passed the House containing no generation-skipping provisions; those provisions were added by the Senate.

On June 11, the announcement said that an amendment to that effect would be considered, but it would be effective on January 1, 1978.

Then on July 20, the committee print of the amendment was released; it contained an effective date of May 1, 1977. A supplemental report issued by the committee at that time indicated that the effective date would be May 1, 1977, obviously still in the future.

When the Senate finally acted upon this provision on August 5, 1976, the effective date of the amendment was made retroactive to May 1, 1976 and that date was continued by the conference committee and was enacted into law.

We suggest that this particular amendment in its effective date provisions is unfair because in tightening up with respect to generation-skipping, however appropriate that may be, it should not have been done in a manner that would penalize those people who had made wills long since in reliance on existing law and were now faced with the fact that this tightening up of the generation-skipping area is made retroactive to a date earlier that the announcement by the Finance Committee of its intention to take action in this area.

I would ask, Mr. Chairman, that my very short statement be made a matter of record.

Senator BYRD. Yes; your statement has been incorporated in the record. Thank you, Mr. Richmond.

[The prepared statement of Mr. Richmond follows:]

STATEMENT OF DAVID W. RICHMOND

SUMMARY

In fairness and equity, the retroactive May 1, 1976, effective date of the generation-skipping provision included in the Tax Reform Act of 1976 should be changed to the date of enactment of the act, October 4, 1976, or at the very least to a date no earlier than that on which Congress gave notice to taxpayers of its intentions, August 5, 1976.

My name is David W. Richmond. I am a partner in the Washington law firm of Miller & Chevalier. We represent Mr. H. E. Butt of Corpus Christi, Tex. I am appearing to express our concern regarding the effective date of the provision in the Tax Reform Act of 1976 relating to generation skipping.

As you know, the Tax Reform Act was approved on October 4, 1976. The generation-skipping provision, however, was made applicable to wills executed after April 30, 1976. Thus, if a will was in effect on April 30, 1976, it could contain a generation-skipping provision. If it was executed after April 30, 1976, however, it could not.

We believe the effective date of this provision should be the date on which the Tax Reform Act became law—October 4, 1976.

If it is fair and equitable to make restrictive provisions of law effective prior to their final adoption by Congress and approval by the President, then it is pertinent to consider the history of the generation-skipping provision.

Bills had been introduced in the House containing generation-skipping restrictions which were to be effective on May 1, 1976. However, no action was taken by this committee on any of these bills until August 2, 1976, when it reported H.R. 14844. That bill never went to the floor of the House because the committee's request for a closed rule was rejected.

In the meantime, the Senate Finance Committee had been considering H.R. 10612, which had passed the House on December 5, 1975, with no estate and gift tax revisions. On June 10, 1976, the Finance Committee reported H.R. 10612 with no generation-skipping provisions, but additional amendments were reported the following day. Among them was a generation-skipping provision, but the Finance Committee said it would not be effective until January 1, 1978. The print of the generation-skipping amendment was released by the Finance Committee on July 20, and while the effective date was changed, it was still prospective. The Finance Committee supplemental report confirmed that the provision would not be effective until May 1, 1977.

On August 5, the Senate amended H.R. 10612 by voice vote to change the effective date of the generation-skipping provision from May 1, 1977, to the retroactive date of May 1, 1976. The May 1, 1976, date was agreed to in conference and became law.

We urge the committee to consider that the proper effective date of provisions of a revenue law which are restrictive in their effect should be no earlier than the date on which the law is approved. In this case, that is October 4, 1976. In no event, however, should the effective date be earlier than the date on which Congress gives notice of its intentions. In this case, that would be August 5, 1976. This was the date on which the taxpayers were first put on notice that the Finance Committee had changed its mind and in effect had withdrawn the indications given on June 11 and July 20 that the effective date would be May 1, 1977.

We urge the committee to change the effective date of the generation-skipping provision from May 1, 1976, to October 4, 1976, or to a date no earlier than August 5, 1976.

Senator BYRD. There will be another hearing next week, probably Tuesday, possibly Monday afternoon. Those who have an interest in the matter could keep in touch with the staff.

In the meantime, the committee will stand in adjournment until either Tuesday, probably Tuesday, or possibly Monday afternoon.

[Thereupon, at 11:40 a.m., the subcommittee recessed, to reconvene at the call of the Chair.]

TECHNICAL CORRECTIONS ACT OF 1977—INCLUDING CARRYOVER BASIS PROVISIONS

MONDAY, OCTOBER 31, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m. in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood presiding.

Present: Senators Hansen and Packwood.

Senator PACKWOOD. The committee will please come to order.

This morning we are holding hearings to enable interested parties to submit their comments on H.R. 6715, the Technical Corrections Act of 1977, which involves technical, clerical, conforming, and clarifying amendments to provisions enacted by the Tax Reform Act of 1976. In addition, we will be receiving testimony this morning on the provisions of S. 1954, S. 2227, and S. 2228 concerning various estate and gift tax matters, and in particular, the subject of "carryover basis" enacted into law in 1976.

I am pleased to be able to hear your comments this morning.

We will start this morning with the statement that the Senate is in session this morning. If by chance I am presiding alone, there may be some short recesses while I go vote. I will try to move things along as best I can and not be gone long for those votes.

Mr. Nordberg.

STATEMENT OF CARL A. NORDBERG, JR., ESQ., ON BEHALF OF READING & BATES OFFSHORE DRILLING CO., AND TIDEWATER MARINE SERVICES, INC.

Mr. NORDBERG. Thank you. I will submit a full statement for the record.

I appear here this morning on behalf of Reading & Bates Offshore Drilling Co. and Tidewater Marine Services, Inc. These two companies hold minority interests in production sharing contracts with Indonesia.

My testimony this morning is in support of section 2(t)(9) of the bill before you. That section insures that fiscal year taxpayers, such as Reading & Bates and Tidewater Marine, will receive equality of treatment with production sharing contracts and the foreign tax credit.

In the spring of 1976, the Internal Revenue Service ruled that taxes paid to Indonesia under production sharing contracts did not qualify for the foreign tax credit. In general, the IRS rule was not to take effect until 1977. Following the issuance of the ruling, the Congress added a provision to the Tax Reform Act of 1976 which was intended to provide a 1-year period to correct the deficiencies in the Indonesian tax system. The legislative history is replete with statements which make it clear that the purpose of the amendment was to provide this 1-year renegotiation period.

The technical concept used to limit the renegotiation period to 1 year was to restrict the amendment to taxable years ending before January 1, 1978. While this cutoff date worked properly for the vast majority of taxpayers, it may not provide any renegotiation period to 2 or 3 fiscal year taxpayers.

If you would turn to the chart at the end of my oral testimony, I can explain the problem very briefly. Assume you have two taxpayers involved. One is a calendar year taxpayer whose year would run from January to December 31, 1977. The other taxpayer is a fiscal year taxpayer whose year runs from January 1, 1977 to March 31, 1977.

If you assume further that both of these taxpayers earn $100 in Indonesia under production-sharing contracts for the year 1977 and both pay Indonesia $50 tax on December 31, 1977, you can see that the calendar year taxpayer's year ends before 1978 and thereby receives full benefits under the amendment. But the fiscal year taxpayer who pays the same amount of tax for the same period, whose year ends after the cutoff date, would not receive the benefit of the amendment.

Therefore, it would be denied any renegotiation period. This fiscal year taxpayer needs the 1-year renegotiation period just as much as the calendar year taxpayers. Actually, as holders of a minority interest, their ability to renegotiate is largely dependent on the calendar year taxpayers that hold the majority interests in the Indonesian contracts.

When this situation was brought to the attention of the Committee on Ways and Means, they changed the technical language of the 1976 amendments cutoff date so as to provide that all taxpayers are to receive the foreign tax credit for their 1977 Indonesian taxes paid on 1977 income.

We would like to point out, Mr. Chairman, that this amendment passed all the procedures utilized by the Ways and Means Committee—it was found to be a technical conforming amendment by the special screening committee and it was approved on its merits by the full committee. The House amendment provides fiscal year taxpayers with the same treatment accorded calendar year taxpayers under the 1976 amendment—no more, no less. The Treasury Department does not oppose this amendment. We ask that the Senate approve the House amendment.

Senator PACKWOOD. To the best of your knowledge, is there any opposition from anybody?

Mr. NORDBERG. I am not aware of any opposition, no, sir.

Senator PACKWOOD. It makes good sense to me. I would be happy to support it.

Mr. NORDBERG. Thank you.

Senator PACKWOOD. Thank you for coming.

[The prepared statement of Mr. Nordberg follows:]

STATEMENT OF CARL A. NORDBERG, JR.

Mr. Chairman and members of the subcommittee, I appear on behalf of Reading and Bates Offshore Drilling Company and Tidewater Marine Services, Inc. These two companies hold minority interests in production sharing contracts with Pertamina, the government-owned oil company of Indonesia. My testimony this morning is in support of section 2(t)(9) of the Technical Corrections Act of 1977 (H.R. 6715). That section insures that fiscal-year, U.S. taxpayers with an interest in Indonesian production sharing contracts will receive the same treatment under the 1976 Tax Reform Act provision as calendar year taxpayers.

In May 1976, the Internal Revenue Service issued a Revenue Ruling which held that the income taxes paid to Indonesia with respect to income derived from production sharing contracts did not meet the requirements of the U.S. foreign tax credit provisions.[1] In general, the ruling of the IRS was applied to taxes paid Indonesia beginning in 1977.[2] Following the issuance of the Ruling, an amendment was included in the Tax Reform Act of 1976 (section 1035(c)) for the purpose of providing U.S. taxpayers affected by the Ruling with a "reasonable time" to renegotiate their Indonesian production sharing contracts so as to remedy the defects deemed to exist by the IRS in the Indonesian tax system.[3]

The method adopted by the Congress in limiting the renegotiation period to a reasonable time was to provide that the amendment is not to apply to taxable years ending after December 31, 1977. The effect of the amendment was to provide, in general, that the IRS Ruling was not to apply to taxes paid Indonesia before 1978. Therefore, the consequence of the amendment was to provide the affected taxpayers with approximately a one-year renegotiation period.

A very technical interpretative issue of restricted scope and application could arise regarding this termination date provision. The language of the termination provision, read without consideration of the legislative history could produce an interpretation which would preclude fiscal year taxpayers from receiving the foreign tax credit for taxes paid Indonesia for 1977. This unintended interpretation could arise because, although the fiscal year taxpayers' Indonesian taxes will be paid on or before December 31, 1977, the U.S. taxable year in which the foreign taxes were paid does not end until after December 31, 1977. It is the general position of the IRS that with respect to fiscal year taxpayers' foreign taxes paid in 1976 are creditable on their 1977 U.S. return and those paid in 1977 are creditable on their 1978 U.S. return, etc. Accordingly, a technical clarification would be desirable which would remove any doubt that a U.S. taxpayer, utilizing a fiscal taxable year, is to receive the same "reasonable time" to renegotiate their production sharing contracts as U.S. taxpayers using a calendar year. The vast majority of taxpayers affected by last year's amendment are calendar year taxpayers. In essence, the requested clarifiction would provide that whether a taxpayer is using a calendar year or a fiscal year for U.S. tax purposes, the IRS Ruling will not apply to taxes paid Indonesia before 1978. Such a clarification will insure that the calendar year taxpayers and fiscal year taxpayers are provided with precisely equal treatment and precisely the same renegotiation period.

The requested clarification conforms the 1976 amendment to the Congress' stated purpose in enacting the 1976 amendment. In this regard the initial Committee Report provided that the 1976 amendment "will apply only with respect to taxes designated as having been paid under such contracts before January 1, 1982." S. Rept. 94-938, 94th Cong., 2d Sess. p. 255. This amendment was reconsidered and it was determined that the five-year renegotiation period was not necessary. Accordingly, the renegotiation period was reduced to one year. This change was explained as follows:

"Finally, the date change . . . of the Committee amendment modifies the provision dealing with production sharing contracts in Indonesia by limiting the provisions so that basically it only applies for 1 year rather than 5 years." Cong. Rec., July 26, 1976, p. S2495.

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[1] Rev. Rul. 76-215, 1976-1 C.B. 194.

[2] Specifically, the effective date provision of the Revenue Ruling stated that the Ruling was not to apply to "taxable years beginning before June 30, 1976".

[3] General Explanation of the Tax Reform Act of 1976, p. 251.

During the period that this amendment was being developed in the Senate, the Ways and Means Committee Task Force on Foreign Source Income also developed a preliminary recommendation relating to the IRS production sharing contract Ruling. The Task Force's preliminary recommendation was that the application of the IRS Ruling be deferred for two years. When the Conference Committee considered the production sharing contract amendment, the purpose of the amendment was once again explained as providing a one-year renegotiation period. The Conference Committee was informed that the Task Force had agreed to recommend a two-year renegotiation. The amendment was thereafter adopted.

The entire legislative history of the 1976 amendment reflects that the Congress was concerned with the question of how long, if at all, it should continue to permit the foreign tax credit provision to apply tax payments made to Indonesia. As the foregoing discussion reflects, at different times decisions were made which involved payments made for the years 1977 through 1981; for the years 1977 and 1978; and finally, only for 1977. No matter which period was under consideration, the underlying and critical concept was to permit taxes paid Indonesia for some period to continue to be creditable so as to provide a reasonable time to modify the Indonesia tax system. This concept—the purpose of the amendment—was briefly but clearly described as follows:

"Thus, . . . generally the companies should continue to be allowed the foreign tax credit for another year." General Explanation of the Tax Reform Act of 1976, p. 251.

Accordingly, it would be appropriate to amend the 1976 legislation to insure that this reasonable renegotiation period—the period during which taxes paid Indonesia would continue to be creditable—is not denied fiscal year taxpayers pursuant to a technical interpretation of the 1976 amendment which not only would fail to consider the legislative intent but would, in fact, be directly contrary to clearly expressed legislative intent.

It should also be noted if the adverse technical interpretation mentioned above were adopted, it would completely exclude some fiscal year taxpayers from any benefit from the 1976 legislation. Such a result could not have been intended because such fiscal year taxpayers not only faced the same problem as was faced by calendar year taxpayers—but, in all known situations, they are not masters of their own fate because they merely hold minor interests in production sharing contracts being negotiated by calendar year taxpayers. It makes no sense to conclude that the Congress intended to provide a reasonable renegotiation period to calendar year taxpayers, that could control the taxpayer's renegotiations, but not to fiscal year taxpayers holding minority interests in the same contract. This is particularly true in view of the fact that the 1977 Indonesian tax liability of calendar and fiscal year taxpayers is to be paid on exactly the same date—December 31, 1977. Finally, the requested clarification does not provide the fiscal year taxpayer with any special benefit, but rather makes it clear that whether a taxpayer is a fiscal or calendar year taxpayer the foreign tax credit will be available for taxes paid to Indonesia under production sharing contracts through the year 1977 and only for that period. Whether one approved or disapproved of the 1976 amendment, one should recognize that the amendment which was adopted should apply fairly and equally to all taxpayers that had incurred the problem which the amendment sought to modify. Clearly, the 1976 amendment should provide the same treatment to all taxpayers participating in the same production sharing contract where their ascribable foreign taxes are paid on precisely the same date.

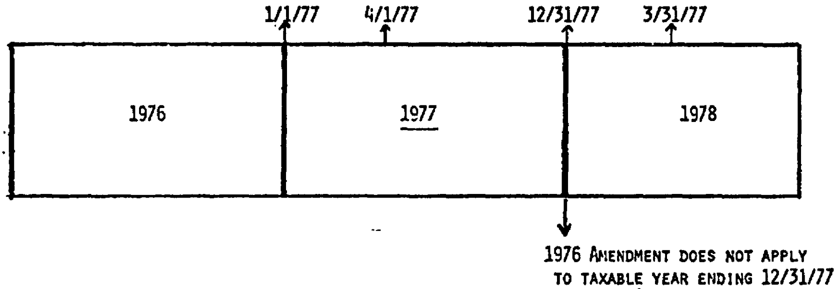
In response to the problem described above, the House Committee on Ways and Means included in H.R. 6715 an amendment which insures that fiscal year taxpayers will receive the same treatment as calendar year taxpayers under section 1035(c) of the Tax Reform Act of 1976. It should be emphasized that the House amendment provides fiscal year taxpayers with no more or no less than what was accorded calendar taxpayers under the 1976 Act, nor what we believe was intended to be accorded fiscal year taxpayers by that legislation.

It is the position of the Treasury Department that it is not opposed to this amendment.

The report of the House Committee on Ways and Means estimates that this provision will decrease budget receipts by $5 million in fiscal year 1978 only. It should be noted in this regard that any decrease in revenue attributable to this amendment was a decrease that had already been expected because the revenue estimate prepared in connection with the 1976 legislation was intended to take into account the total amount of taxes paid by all (calendar and fiscal year) U.S. taxpayers operating production sharing contracts in Indonesia.

The House amendment is a clarifying and conforming amendment and we urge its adoption.

EXHIBIT A



Assume there are two taxpayers, one with a U.S. tax year that runs from January 1, 1977, to December 31, 1977, and a fiscal year taxpayer whose year runs from April 1, 1977, to March 31, 1978. Assume further that both earn $100 under an Indonesian production sharing contract for the year 1977 and pay a $50 tax to Indonesia on December 31, 1977. Since the calendar taxpayer's U.S. year ends on December 31, 1977, the 1976 amendment applies but the fiscal year taxpayer is not covered because its U.S. taxable year ends after December 31, 1977. The effect of being excluded is the denial of any renegotiation period.

Senator PACKWOOD. Next is Mr. Leonard Silverstein.

STATEMENT OF LEONARD L. SILVERSTEIN, ESQ., ON BEHALF OF CHAMPION INTERNATIONAL CORP.

Mr. SILVERSTEIN. Good morning. My name is Leonard L. Silverstein, a member of the firm of Silverstein & Mellon. I appear here today on behalf of Champion International, a company engaged principally in the manufacture and sale of wood, paper, and related products in the United States and abroad.

Champion's headquarters are now located in Stamford, Conn.

The concern of Champion relates to section 904(f) of the code, proposed to be amended by section 2(t) of H.R. 6715. We believe that the amendments, which include extension of section 904(f) to cover carryovers and carrybacks of capital losses are valid, if at all, only within the scope of what we believe, and submit, is an excessively broad statutory framework.

Champion's position is that section 2(t) should be enacted only if section 904(f) is recast so that it is limited either to the narrow startup law, tax avoidance situation to which it was originally addressed, or restricted so that it does not apply to loss arising out of bona fide circumstances from termination of a business interest.

In all events, neither section 2(t) or 904(f) should apply in the case of losses attributable to investments substantially worthless as they are defined in section 1032(c) (3) of the Tax Reform Act of 1976 before the effective date of 6715, provided the losses are incurred, in any event, when the taxes for 1976 are finally due.

In the case of Champion, an existing Belgian company was acquired, a company that for many years had been engaged in the manufacture of paper products. The corporation was capitalized in part as a financing subsidiary with Champion's planned overseas operations.

Unplanned operating losses have made this business substantially worthless in 1976 and Champion therefore determined to dispose of the business, a transaction which, because of normal business exigencies, could not be legally consummated until March 4, 1977, 63 days after the effective date of the exceptions to 904(f).

Our written statement describes more fully the operational defects of section 904(f) that apply not only with respect to Champion but also to other similarly situated taxpayers. We will refer briefly here to the following.

By treating as U.S. income the amount of an overall foreign loss, irrespective of the reasons for which the loss was incurred, section 904(f) effectively and except for certain limited situations, differentiates unfavorably between foreign and U.S. losses, even though with respect to a U.S. taxpayer both have the same economic effect.

This can be so, notwithstanding that the foreign losses occurred when the U.S. taxpayer receives no benefit from the loss.

Further, 904(f) is not symmetrical in its application, since foreign earnings and current tax credits of U.S. losses, the tax credits are not restored in which the U.S. source, but no foreign source income is realized.

While Champion realizes the interplay of 904(f) and the required use of the U.S. tax credit provided in 904, we note the general inconsistency of 904(f) since it does not apply to overall foreign source losses realized as a result of expropriation, fire, storm, shipwreck, casualty, or theft.

This has seriously caused circumstances to stand in sharp contrast to the program start-up situation in which the situation is first applied. We submit that these circumstances, for example casualty loss, do not differ in substance from the case of taxpayers such as Champion which enters into a business fully expecting it to be profitable abroad and later disposes of that business at a loss due to market or other conditions quite beyond its control.

Since the foreign casualty loss which reduces U.S. income and tax is outside the scope of this provision in 904(f), we submit that similar treatment should be afforded a loss on any foreign disposition that occurs because of bona fide business conditions.

In light of the foregoing, Champion recommends that section 904(f) be amended, ideally to continue to apply only to the start-up situation to which it was originally addressed. If this is not feasible, we believe that section 2(t) of H.R. 6715 should not be adopted except as a part of an amendment which would exempt termination losses from dispositions which would occur under bona fide circumstances. And in all events, we believe, because of the complexities of the section, a need for review of its structure and its scope, that the effective date be generally stated at least to exclude a loss arising because of a sale, liquidation or other disposition after December 31, 1976, if the loss reflects substantial worthlessness of stock and indebtedness and the tax action is effected on or before the date for extensions in the year 1976.

We missed the boat by 63 days, and that is our problem.

Senator PACKWOOD. I find no quarrel with your statement except the inference that there is a possibility that this committee might have imperfectly drafted the statute. It was only 1,600 or 1,700 pages long. I do not know how we would miss a significant point.

Mr. SILVERSTEIN. I appreciate your keen perception, Senator. There are indeed problems with this provision.

Senator PACKWOOD. I am surprised, as I have looked at the testimony today, that there are not more witnesses coming in one fashion or the other to suggest that either we imperfectly drafted something or perfectly drafted something we did not realize the consequences of. I would expect before next year that we would have other points.

I agree with your point and appreciate your bringing it here.

Mr. SILVERSTEIN. Thank you very much, Senator.

[The prepared statement of Mr. Silverstein follows:]

STATEMENT OF CHAMPION INTERNATIONAL CORP.

This statement is submitted on behalf of Champion International Corporation, a multinational enterprise with headquarters located in Stamford, Connecticut. Champion is engaged principally in the manufacture and sale of wood, paper, and related products in the United States and abroad.

The concern of Champion relates to the structure and application of section 904(f) of the Internal Revenue Code, added by the Tax Reform Act of 1976, and the corrections thereto proposed in H.R. 6715, the Technical Corrections Act of 1977. Champion submits that section 904(f) was imperfectly drafted and in fact operates beyond the scope of the narrow tax avoidance situation to which it was addressed, and that it does so in an improperly harsh manner. Indeed, the corrections to section 904(f) proposed in section 2(t) of H.R. 6715 (which, inter alia extends section 904(f) to cover carryovers and carrybacks of capital losses) are valid, if at all, only within the present excessively broad framework of such section.

Although the principal objective of section 904(f) was to assure that foreign losses from start up operations abroad which offset U.S. tax in early years would account for their proper share of U.S. tax in later years when the start up operations became profitable,[1] section 904(f) in fact subjects to U.S. tax (through denial of the foreign tax credit) an equivalent amount of income from foreign operations whether or not such income was in any way related to the activities which gave rise to the initial loss.[2] That circumstance, when coupled with the requirement that all taxpayers utilize the overall foreign tax credit limitation, has the effect of denying to a U.S. taxpayer the foreign tax credit which would have been utilized had the same loss occurred in the United States.[3]

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[1] See the statement of Former Secretary of the Treasury William E. Simon on Major Tax Revisions and Extension of Expiring Tax Cut Provisions, before the Senate Finance Committee, May 17, 1976 at page 89. See also the General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation, p. 239 (December 29, 1976).

[2] Moreover, such recapture will occur even though the foreign loss did not produce a "tax benefit" in the U.S. because such loss arose in a year in which the U.S. operations were themselves conducted at a loss.

[3] The inequality in the operation of section 904(f) with respect to foreign loss vs. domestic loss is demonstrated by a comparison of two U.S. taxpayers, both of whom derive foreign source income and U.S. source capital gains. In the case of taxpayer A, a foreign source capital loss is incurred which results in an overall foreign loss, whereas in the case of taxpayer B, a U.S. source capital loss is incurred in the same amount. In each case, the value of the capital loss as an offset to the U.S. capital gain is the same in the year in which the loss arises. However, in the case of taxpayer A, the fact that the capital loss produced an overall foreign loss will preclude utilization of all or part of the foreign tax credit in the year the foreign loss was incurred and may result in loss or reduction of foreign tax credits under section 904(f) in future years. Accepting the fact that section 904 prior to the Tax Reform Act of 1976 impacted on the utilization of foreign tax credits for taxpayers such as taxpayer A in the year the foreign loss was incurred, it is questionable whether the resulting impact on the foreign tax credit in years subsequent to the year of loss which are caused by application of section 904(f) is equitable when contrasted to the situation of taxpayer B.

Champion submits that the result produced by section 904(f) extends substantially beyond the principal objective of such section. It thus should be modified to address only the tax avoidance situation sought to be eliminated.

At a minimum, Champion recommends that section 904(f) be corrected to provide equal treatment of taxpayers similarly situated but differently treated under the exceptions and exclusions to such section. The need for equality in treatment exists in the following situations:

1. EXTRAORDINARY LOSSES

Section 904(f) presently draws a sharp distinction between foreign losses which are incurred in the ordinary course of an ongoing business, and those which are extraordinary, arising by reason of unplanned events. Thus, under section 904(f)(2)(B), expropriation, casualty, or theft losses are not "recaptured" by reduction of future foreign tax credits. Although the rationale underlying these provisions is not articulated in the Committee Reports or other legislative history, section 904(f) does not apply to these losses because they are not, like start up losses, ordinary or expectable incidents of conducting a business outside the U.S.

Similarly, losses incurred when a taxpayer disposes of or otherwise terminates a foreign business operation are extraordinary losses, not unlike an expropriation or a casualty. There is no greater opportunity to recoup or recover that loss against future profits and no opportunity for tax planning (e.g., by incorporation of a branch) to take undue advantage of that loss. In that respect, a business-disposition loss is conceptually and economically comparable to an expropriation, casualty, or theft loss.

Since there is no greater posibility of a tax advantage for a business-disposition loss than for an expropriation, casualty, or theft loss, there is no justification for depriving the taxpayer of the normal foreign tax credit.

Accordingly, we recommend that section 904(f) be amended to provide that a loss realized upon the termination or disposition of a foreign business operation (whether in corporate, or in branch form) in which the taxpayer owns directly or by attribution more than a 50 percent interest should be treated in the same manner as the exceptions now provided in section 904(f)(2)(B).

2. LOSSES ATTRIBUTABLE TO INVESTMENTS SUBSTANTIALLY WORTHLESS BEFORE DECEMBER 31, 1976

Champion submits that the exceptions to section 904(f)* should be corrected to cover comparable economic situations which do not fall within the procedural limitations of such exceptions. Such exceptions are intended to exclude from the recapture provision losses sustained in transactions consummated after the effective date of the Tax Reform Act of 1976 which are attributable to investments which were substantially worthless prior to such date. For reasons which are not explained, however, losses which occur before January 1, 1977 are not subject to the exception unless a dispositive transaction was also effected before January 1, 1977. This anomaly should be corrected to afford relief to similarly situated taxpayers who did not affect a disposition by December 31, 1976 but did so within a reasonable period of time thereafter.

Thus, section 1032(c)(3)* of the Tax Reform Act of 1976 should be extended to apply to a loss arising by reason of a sale, liquidation or other disposition after December 31, 1976, if (i) such loss reflects substantial worthlessness (as provided in such section) of stock or indebtedness prior to such date. and (ii) the transaction is effected on or before the date (including extensions) prescribed for filing the taxpayer's return for the taxable year ending December 31, 1976. Champion submits that such losses should fall within the exception in section 1032(c)(3) since they were attributable to investments which were substantially worthless prior to the December 31, 1976 cut-off date.

Further, due to balance of payments concerns, finance companies having access to the shareholders' market were often utilized to finance foreign operations.

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*Contained in section 1032(c)(3) and (4) of the Tax Reform Act of 1976.

*Under such provision, section 904(f) will not result in recapture with respect to losses incurred on the loss from stock or indebtedness of a corporation in which the taxpayer owned at least 10 percent of the voting stock and which has sustained losses in 3 out of the last 5 taxable years beginning before January 1, 1976, which has sustained an overall loss for those 5 years, and with respect to which the taxpayer has terminated or will terminate all operations by reason of sale, liquidation, or other disposition before January 1, 1977, of such corporation or its assets.

While such corporations may not have experienced the 5 year operating life otherwise required by section 1032(c)(3) of the Tax Reform Act of 1976, their business was inextricably linked to the companies which they financed. The exception in section 1032(c)(3), therefore, should apply with equal force to the substantially worthless investment in the finance company.

The Senate Finance Committee, in fact, contemplated application of the exception to the termination of interest in a "group of corporations which are operated in the same line of business." * For example, if foreign Corporation A sustained an overall loss in its operations over a five-year operating period prior to the effective date, and foreign Corporation B was operated solely to finance Corporation A during part of such period, section 1032(c)(3) should be applicable to the substantially worthless investments in both A and B. It is submitted that provided the principal activity of the other corporations was directly related to the operation of a corporation or the financing thereof, the exception properly applies to the economic loss of all of the constituent corporations.

Finally, Champion recommends that the proposed amendment in H.R. 6715 ** to the exception provided in section 1032(c)(4) of the Tax Reform Act of 1976 be adopted. Section 1032(c)(4) of the Tax Reform Act of 1976 provides that in the case of a loss sustained in a transaction which otherwise qualified under section 1032(c)(3) of such Act but which was effected after December 31, 1976 and before January 1, 1979, section 904(f) will not apply to such loss to the extent that there was on December 31, 1975, a deficit in earnings and profits in the loss corporation. The amendment in H.R. 6715 provides that in computing the December 31, 1975 deficit in earnings and profits, there would be taken into account only earnings and profits which were accumulated in taxable years after December 31, 1962, in which the taxpayer owned stock of the loss corporation, and are attributable to such stock.

Champion submits that the proposed amendment is desirable since it would eliminate the necessity for determining the earnings and profits of the loss corporation in years prior to 1963 which may be difficult in many situations because of the unavailability of the pertinent records for such prior years. This is true in the case of the loss corporation owned by Champion.

Senator PACKWOOD. Next is Cornelius Shields and Larry Fox.

STATEMENT OF H. LAWRENCE FOX, ESQ., CADWALADER, WICKERSHAM & TAFT

Mr. FOX. Mr. Chairman and members of the committee, Mr. Shields was not able to come down today, so I will testify on behalf of the Sun Co. I am a partner in the law firm of Cadwalader, Wickersham & Taft. The testimony today relates to section 2(t) of the bill that amends the effective date of section 904 of the code relating to the recapture of foreign oil related losses.

For your information, I have testified on this topic before the full Finance Committee last year, on July 21, 1976. I request that the written testimony filed on that date be made a part of the official record of these hearings.

[The testimony referred to above follows:]

WRITTEN TESTIMONY PRESENTED TO THE SENATE COMMITTEE ON FINANCE, JULY 21, 1976, ON BEHALF OF SUN CO., INC., CORNELIUS C. SHIELDS, CHIEF TAX COUNSEL, SUN CO., INC., AND H. LAWRENCE FOX, PEPPER, HAMILTON & SCHEETZ, COUNSEL

SUMMARY

(1) Section 907 of the present Code was added by the Tax Reduction Act of 1975. Subsection 907(f) provides rules for recapture of foreign oil-related losses. Although Congress intended that Section 907(f) operate prospectively, in its

*See S. Rep. N. 94-938, 94th Cong., 2d Sess., p. 241.
**Section 2(t)(7)(A).

present form the Section can operate retroactively by requiring a taxpayer who relied upon prior law to recapture losses incurred pursuant to pre-existing contractual obligations even though such obligations were entered into well before the 1975 Tax Act.

(2) Section 1035(b) of H.R. 10612 is a technical amendment which provides a deferral-type transition rule to the foreign loss recapture provision. It does not eliminate loss recapture in the case of pre-existing contracts, but only extends the time period over which recapture occurs. Specifically Section 1035(b) provides that foreign oil-related losses which are sustained in a taxable year ending before January 1, 1979, and which are incurred pursuant to a binding contract entered into on or before July 1, 1974, need not be recaptured in an amount exceeding 15 percent of such loss for the first four years after they become subject to recapture and are fully subject to recapture thereafter.

(3) Sun is requesting relief from Congress because of an oversight contained in Section 907(f) when enacted. Classification of the Company's petition as special in nature and therefore questionable would be as unfair as the statute itself. The Company has not suggested eliminating the principle of law contained in Section 907(f) but merely reducing its inequitable application. Section 1035(b) of the Bill provides significantly less relief than most "grandfather" amendments and does not reduce Sun's ultimate tax burden.

(4) Finally, in addition to filing testimony with this Committee on April 22, the Company has brought its position to the attention of one, the Treasury Department, two, the entire U.S. Senate, and three, many of the so-called public interest groups. Clearly, the Company has not sought this amendment without public scrutiny or a public hearing.

INTRODUCTION

Prior testimony and Finance Committee action

Sun Company filed testimony with the Committee on Finance on April 22, 1976, indicating its concern with the apparent but unintended requirement of present Code Section 907(f) that a taxpayer which relied upon existing law must recapture, to its detriment, losses incurred pursuant to binding contractual obligations entered into with foreign governments or their national oil companies well before the Tax Reduction Act of 1975.

Following this testimony, the Finance Committee adopted a deferral-type transition rule to redress this inequity. The technical amendment is in Section 1035 (b) of H.R. 10612 as reported to the Senate.[1] Prior to the Committee's determination, Sun representatives met with each Senator on the Committee or his staff to ensure that the equities of this amendment were understood. Subsequent to the Committee's favorable decision, correspondence was sent to all other members of the Senate explaining the amendment, along with a copy of the testimony.

July 21, 1976, testimony

Due to concern expressed by several members of the Senate that this provision and numerous others contained in the Bill were not subject to sufficient public hearings, the Finance Committee issued a press release on July 8, 1976, announcing that additional hearings would be held on over 60 provisions of H.R. 10612 including Section 1035(b). On behalf of Sun Company, we are here to offer additional testimony.

EFFECTIVE DATE OF 907(f)

Statute to be prospective

The Tax Reduction Act of 1975 added Section 907 to the Code. In general, this Section applies a strict limitation on the use of foreign tax credits from foreign oil extraction income and foreign oil-related income. Section 907(f) provides rules for recapture of foreign oil-related losses. When enacted, Congress intended that it be prospective by providing an effective date after December 31, 1975, instead of the general effective date, December 31, 1974, for Section 907. However, in Sun's case it is unintentionally retroactive because it requires this taxpayer, who

[1] Present Code Section 907(f) is renumbered as Section 904(f) in the Bill as a consequence of other decisions made by the Finance Committee. References in this statement to present Code Section 907(f) should be understood as equally applicable to the proposed renumbered Section 904(f).

relied upon prior law, to recapture losses incurred pursuant to pre-existing contractual obligations, even though such obligations were entered into well before the 1975 Tax Reduction Act.

Application of 907(f) to Sun Company

Before July 1, 1974, Sun entered into contracts with a number of foreign governments or their national oil companies pursuant to which Sun is required to expend over $100 million through 1978 in drilling and exploring new areas. This program was initiated a number of years ago in reliance on the tax law prior to the enactment of Section 907(f) in order to develop additional sources of crude oil for Sun's U.S. refineries.

It is anticipated that as a result of Sun's contractual foreign exploration effort, the Company will have net foreign losses totaling approximately $70 million over the next two to three years. As enacted, Section 907(f) would recapture these losses thereby requiring Sun to pay approximately $33 million in additional Federal income taxes. This retroactive tax increase is directly attributable to contracts entered into prior to the enactment of Section 907(f). It is a burden that the Company could not have anticipated in making its financial commitments. Notwithstanding the unfair windfall to the Federal Government, the amendment contained in Section 1035(b) of the Bill will not relieve Sun of its obligation to pay these increased taxes. It will only provide a measure of relief by extending the time over which they must be paid.

EQUITABLE RELIEF

In general

As previously stated, Section 907(f) produces an inequitable and unintended tax burden on Sun. It is fair to assume that this would not have occurred if Congress were aware of Sun's facts at the time of enactment. For example, it probably would have provided a transition rule "grandfathering" binding contracts as it did in Section 604(b)(2), relating to the investment credit on drilling rigs used outside the northern part of North America. This would have been consistent with the historic policy of Congress in providing equitable transition rules in cases where tax law changes alter the economics of existing binding contracts.[8]

Deferral concept

When Senator Carl T. Curtis (R-Neb.) suggested a grandfather amendment to Section 907(f) last December, this Committee recognized the need for a technical amendment to Section 907(f) and directed the Joint Committee Staff to study an appropriate amendment.

From Sun's perspective, losses under binding contracts existing prior to the enactment of Section 907(f) should not be subject to recapture at all. From the Staff's view, that type of amendment might reopen the statute. Therefore, it suggested in the alternative a deferral transition rule.

Section 1035(b)

On May 18, 1976, this Committee unanimously adopted Senator Curtis' deferral amendment as Section 1035(b). This provision provides that foreign oil-related losses which are sustained in a taxable year ending before January 1, 1979, and which are incurred pursuant to a binding contract entered into on or before July 1, 1974, need not be recaptured in an amount exceeding 15 perecnt of such loss for the first four years after they become subject to recapture and are fully subject to recapture thereafter.[9] Accordingly, Sun continues to be subject to the full $33 million of tax under Section 907(f). However, the amendment provides Sun with some deserved relief by allowing the tax to be paid over a 5-year period. This means that the revenues to the Federal Government are not lost. Also, Sun's projections indicate that there would be no recapture under present Section 907(f) until 1978. Therefore, in Sun's case, this provision will have no effect on the Federal revenues in 1977.

[8] The Code is replete with examples (in particular, the investment tax credit).

[9] The intent of this provision is to eliminate any unforeseen and inequitable application of the Code. Accordingly, it should be optional, as appears to be the intent of the Committee when Section 1035(b) of the Bill is read in conjunction with Section 1032(a) of the Bill.

SUMMARY

Sun is requesting relief from Congress because of an oversight contained in Section 907(f) when enacted. Classification of the Company's petition as special in nature and therefore questionable would be as unfair as the statute itself. The Company has not suggested eliminating the principle of law contained in Section 907(f) but merely reducing its inequitable application. Section 1035(b) of the Bill provides significantly less relief than most "grandfather" amendments and does not reduce Sun's ultimate tax burden.

Finally, in addition to filing testimony with this Committee on April 22, the Company has brought its position to the attention of one, the Treasury Department, two, the entire U.S. Senate, and three, many of the so-called public interest groups. Clearly, the Company has not sought this amendment without public scrutiny or a public hearing.

Mr. Fox. Congress intended that the new loss recapture rule be prospective by providing an effective date for taxable years beginning after December 1, 1975, instead of the general effective date, December 31, 1974. Notwithstanding this intent, the statute can operate retroactively by requiring a taxpayer who relied upon prior law to recapture losses incurred pursuant to preexisting contractual obligations even though such obligations were entered into well before the 1975 Tax Act.

Sun will have approximately $70 million of these binding contract losses which it cannot avoid because of obligatory work commitments. Despite this, the 1975 Act subjects these losses to recapture. In Sun's case, this means effectively a retroactive tax increase of approximately $33 million—directly attributable to contracts entered into prior to the enactment of section 904(f).

From the company's perspective, losses under binding contracts existing prior to the enactment of section 904(f) should not be subject to recapture at all. Last year, however, the staff of the joint committee indicated that a grandfathering type amendment might reopen the statute. Therefore, it suggested, in the alternative, a technical deferral transition rule, which would have no overall revenue impact.

It is respectfully requested that this committee expand section 2(t)(5) to include an elective, technical amendment to provide that foreign oil-related losses which are sustained in a taxable year ending before January 1, 1979, and which are incurred pursuant to a binding contract, entered into on or before July 1, 1974, need not be recaptured in an amount exceeding 15 percent of such loss for the first 4 years after they become subject to recapture and are fully subject to recapture thereafter.

Under such an amendment, Sun will continue to be subject to the full tax under section 204(f). However, the provision would provide Sun with a small measure of relief by allowing the tax to be paid over a 5-year period.

Senator Packwood. Did we not pass an amendment like this one time last year; Dr. Woodworth supported it, but it did not have any hearings and we pulled the bill back and a whole lot of amendments were taken out.

Mr. Fox. Yes; and this was one of those.

Senator Packwood. It was one, although it had no opposition. The argument at the time was it never had a hearing and we were going to follow a procedure of not putting in even technical amendments without hearings.

Mr. Fox. Yes, that is accurate. Chairman Long at the time indicated that the Finance Committee would try to enact amendments just like this one, that is, that that have no overall revenue impact and no real opposition but, as you know, last year there was no time for Congress to so act. Therefore, we are testifying today on a bill that directs itself to the 1976 act, even though this is a 1975 amendment, because it is the most appropriate place.

This amendment, as you pointed out, was passed unanimously last year by the Finance Committee. It would not eliminate any of the taxes due by the company; although the company would tell you that they think that is an unfair burden, the substance of the amendment is merely to allow the company a time period to adjust to the retroactive tax.

I think that your question and the answer really brings my testimony to a conclusion, Senator.

Senator PACKWOOD. I have no questions.

Senator Hansen?

Senator HANSEN. I have no questions.

Senator PACKWOOD. Thank you very much.

Next is Richard Merrill, accompanied by Theodore R. Groom, representing Prudential.

STATEMENT OF THEODORE R. GROOM, ESQ., PRUDENTIAL LIFE INSURANCE CO.

Mr. GROOM. Good morning, Mr. Chairman. My name is Ted Groom. Mr. Merrill was unable to be here today. Our testimony is on behalf of the Prudential Insurance Co. of America.

Prudential is a leading U.S. life insurance company with over 50 million policyholders in the United States and Canada.

Our testimony today relates to section 2(r) of H.R. 6715. This provision makes some perfecting amendments to section 2137 of the 1976 Tax Reform Act, a provision which enables mutual funds that invest in municipal bonds to pass through the character of the tax-exempt interest to their shareholders. We are proposing an amendmnet that would extend equal treatment to individuals who invest in municipal bonds through separate accounts of life insurance companies.

We have submitted a statement for the record, and I will briefly summarize our main points.

First, before 1976, opportunities for investment by individuals of moderate means in diversified municipal bond funds were provided by fixed investment trusts, ordinarily sponsored by securities brokers, and, to a lesser extent, by common trust funds of banks and by limited partnerships.

As a result of a Senate floor amendment to the 1976 act, this opportunity was extended to shareholders of mutual funds.

Through what we regard as an oversight, life insurance companies were not included in this provision. As a result, we are the only principal financial intermediary currently excluded from this market. Our amendment would remove this competitive discrimination.

Second, allowing life insurance companies to provide exempt-interest annuities would increase the number of investors interested in purchasing State and local bonds. This would help reduce the cost of public improvements by States and localities below what it otherwise would be.

Third, some municipal bond funds are currently being used as an investment by those in their retirement years. Life insurance company annuities would serve the same market, but would provide the retired person with the additional assurances of a known, fixed income which he would not outlive.

Consequently, from the standpoint of the individual, the amendment is a socially desirable one.

Finally, we note that the estimated revenue cost of the mutual fund provision was zero or negligible. We believe, also, that the revenue cost of our proposed amendment will be zero or negligible.

We urge the committee to adopt our proposed amendment and we thank you for this opportunity to testify. Thank you very much.

Senator PACKWOOD. It seems fine to me. It does not cost any money.

Senator Hansen?

Senator HANSEN. I think that is a fair endorsement of it.

Senator PACKWOOD. I should not use the word "equitable" in Prudential's testimony.

Thank you very much. I have no questions.

[The prepared statement of Mr. Merrill follows:]

TESTIMONY OF THE PRUDENTIAL INSURANCE COMPANY OF AMERICA

My name is Richard G. Merrill. I am a Senior Vice President with overall responsibility for the Southwestern Home Office of The Prudential Insurance Company of America in Houston, Texas. With me today is Theodore R. Groom of the Washington, D.C. law firm of Groom and Nordberg, tax counsel to Prudential.

Prudential is a leading U.S. life insurance company with over 50 million policyholders. It conducts its insurance business in each state of the United States and in Canada.

Our testimony today relates to section 2(r) of H.R. 6715. This provision makes some perfecting amendments to section 2137 of the 1976 Tax Reform Act, a provision which enables mutual funds that invest in municipal bonds to pass through the character of the tax-exempt interest to their shareholders. We are proposing an amendment that would extend equal treatment to individuals who invest in municipal bonds through separate accounts of life insurance companies.

We believe our proposal is desirable for the following reasons:

(1) Before 1976, opportunities for investment by individuals of moderate means in diversified municipal bond funds were provided by fixed investment trusts, ordinarily sponsored by securities brokers, and, to a lesser extent, by common trust funds of banks and by limited partnerships. As a result of a Senate floor amendment to the 1976 Act, this opportunity was extended to shareholders of mutual funds. Through what we regard as an oversight, life insurance companies were not included in this provision. As a result, we are the only principal financial intermediary currently excluded from this market. Our amendment would remove this competitive discrimination.

(2) Allowing life insurance companies to provide exempt-interest annuities would increase the number of investors interested in purchasing state and local bonds. This would help reduce the cost of public improvements by states and localities below what it otherwise would be.

(3) Some municipal bond funds are currently being used as an investment by those in their retirement years. Life insurance company annuities would serve the same market, but would provide the retired person with the additional assurances of a known, fixed income which he would not outlive. Consequently, from the standpoint of the individual, the amendment is a socially desirable one.

Finally, we note that the estimated revenue cost of the mutual fund provision was zero or negligible. We believe, also, that the revenue cost of our proposed amendment will be zero or negligible.

COMPETITIVE DISCRIMINATION

Prior to the 1976 Tax Reform Act, opportunities for investment in diversified municipal bond funds were provided by fixed investment trusts, ordinarily sponsored by a securities broker. To a lesser extent, the same opportunity had been offered by bank common trust funds and by limited partnerships. The 1976 Tax Reform Act extended this opportunity to shareholders of mutual funds.

When the provision permitting tax-exempt mutual funds was originally proposed to the House Ways and Means and Senate Finance Committees last year, we discussed the need to provide similar treatment for life insurance companies with Members of Congress and Staff of the Joint Committee on Taxation. We also submitted a statement for the record in connection with hearings held by the Senate Finance Committee last summer.*

While the Committees ultimately chose to defer consideration of the mutual fund proposal, there seemed to be general agreement at that time that our proposal was parallel to the legislation proposed by the mutual funds. Thereafter, the mutual fund proposal was added to the 1976 Tax Reform Act by means of a Senate floor amendment, and hence it was not possible for this Subcommittee or the Senate Finance Committee to include life insurance companies within the provision. Consequently, life insurance companies are now the only major financial intermediary excluded from participation in the municipal bond market.

The competitive advantage enjoyed by mutual funds and other financial intermediaries is underscored by the success enjoyed by the new municipal bond mutual funds since the enactment of the Tax Reford Act in October of 1976. It was recently reported, for example, that there are now more than thirty funds which hold assets of more than $1.8 billion. Sales of $2 billion by municipal bond mutual funds are predicted for this year alone.

Our proposal raises no major policy issues not considered by Congress when the mutual fund proposal was originally enacted. We simply seek to remedy the competitive discrimination against life insurance companies resulting from the 1976 Act.

BROADENING THE MARKET

Our amendment would also help meet the widely recognized need to broaden the group of potential investors in state and local bonds.

One reason a broader market is needed is that demand by two of the primary investors in municipal bonds—commercial banks and nonlife insurance companies—has fallen off significantly in recent years. For example, a recent study of the municipal bond market documents the fall off in commercial bank demand for tax-exempt securities and concludes that such demand will not soon return to previous high levels.* Also, the study points out that due to inflation, record underwriting losses and no-fault insurance, nonlife insurance companies have been limited in the funds they can invest in the tax-exempt market, and thus it is unlikely that they will be able to sustain a high level of demand for municipal bonds in the near future.**

Another reason from broadening the municipal bond market is the well known and increasing need of our cities, counties and states for additional funds for capital improvements and other projects.

Life insurance companies, like mutual funds, can help broaden the group of potential investors by providing another opportunity for individuals of more modest means to participate in the municipal bond market through professionally managed commingled arrangements.

ADVANTAGES FOR THE INDIVIDUAL INVESTOR

For some individual investors, investing in mutual fund shares of fixed income trusts is an alternative to purchasing life insurance company annuity. For example, the individual concerned about accumulating income for retirement could do so by periodically purchasing mutual funds shares, oron the other hand, by purchasing an insurance company annuity. Similarly, both mutual fund investments and annuities have been used to provide periodic income during retirement.

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*Hearing on Taxation of Interest on Debt Obligations Issued by State and Local Governments Before the Sen. Comm. on Finance 156 (June 7, 1976).

**See* Twentieth Century Fund Task Force Report on the Municipal Bond Market, *Building a Broader Market*, 78–83 (1976) (background paper by R. Forbes and J. Peterson).

***Id.* at 83–84.

In recognition of this growing use of mutual fund shares as a source of current or retirement income, many mutual funds, including many of the new municipal bond mutual funds, provide for regular withdrawal plans under which an owner's holdings in the fund can be liquidated at regular intervals in fixed or variable amounts. To the extent that dividends are insufficient to make required payments, the funds redeem enough of an individual's shares to make up the difference.

While regular withdrawal plans and other arrangements resemble annuities in many respects, individuals are not guaranteed that their capital investment will last a lifetime. Additionally, there is no guarantee concerning the value of fund shares or the amount of income they will produce. Life insurance companies, on the other hand, could provide individuals with the assurance of a source of fixed income which they would not outlive.

* * * * * * *

We urge the subcommittee to adopt our proposed amendment and also express our appreciation for this opportunity to testify.

Senator PACKWOOD. Next, we have a panel consisting of Kenneth Hance, Alan Aronsohn, John Syzmanski, and Gil Thurm. I might indicate that after this panel I would like to call George Stewart from Johns Hopkins and William Tierney from Salomon Brothers, if they would be prepared to go after this.

Gentlemen?

STATEMENT OF KENNETH G. HANCE, JR., PRESIDENT, NATIONAL REALTY COMMITTEE

Mr. HANCE. Good morning, Senator.

My name is Kenneth Hance, and I am president of the National Realty Committee. After discussion among the members of the panel, we would like to proceed with our testimony in the following order, if it is agreeable to you: first, Mr. Szymanski on behalf of the International Council of Shopping Centers; second, Mr. Aronsohn, speaking on behalf of the National Realty Committee; and third, Mr. Thurm on behalf of the National Association of Realtors.

Senator PACKWOOD. Go ahead.

STATEMENT OF JOHN SZYMANSKI, DIRECTOR OF TAXES AND ASSISTANT CONTROLLER, THE ROUSE CO., ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. SZYMANSKI. Good morning. My name is John Szymanski. I am director of taxes and assistant controller of the Rouse Co., a regional shopping center developer. I am also a certified public accountant practicing in the State of Maryland.

I am a member of the ICSC Government Affairs Committee and its Tax Legislative Subcommittee. I also have with me Edward C. Maeder of Winston & Strawn, the legal counsel to the International Council of Shopping Centers.

The ICSC is a business association of more than 5,000 members. About 60 percent of our members develop and/or own shopping centers. About 15 percent are retail companies, the major share of whose stores are operated in shopping centers.

Most of our developer-owner members own from two to four shopping centers each and collectively represent a major share of the estimated 16,000 shopping centers in the United States.

H.R. 6715, the Technical Corrections Act of 1977 that we are discussing today, is intended to clarify, conform, and correct various provisions of the Tax Reform Act of 1976. Although it does not contain a specific amendment concerning the application of the carryover basis rule or other provisions of the 1976 act to shopping centers, it does contain amendments pertinent to parties involved in shopping centers.

I will limit my testimony to three basic areas of vital concern in the shopping center industry: First, the carryover basis rule; second, the amortization of real property construction period interest and taxes; and third, the "at risk" limitation on partnership losses.

Alan Aronsohn will be covering items, two and three and we are in complete agreement with the National Realty Committee's position on such items.

With respect to carryover basis of property acquired, one of the principal purposes of the 1976 act in the estate field was to reduce the tax burdens upon the owners of small business, many of whom are participants in shopping centers.

The 1976 act, however, has, in fact, increased the tax burden for many of these taxpayers, discriminating against small business and favoring large corporations.

The 1976 act has also created an administrative nightmare for taxpayers, adding substantially to complexity and cost of managing a decedent's estate.

The carryover basis provisions are diametrically opposed to the basic goals of tax reform, which are generally considered to be simplicity, fairness, and efficiency.

With respect to simplicity, the carryover basis rule has added greatly to the complexity of the laws which will be manifested in higher professional and administrative costs. It has been conservatively estimated that complexity doubled with the passage of this new law. Because most taxpayers did not have notice of the necessity of keeping records of the purchase of various items, few, if any, records of purchases have been maintained.

Many taxpayers acquired assets with the intention of holding them until death and had no need, under prior law, to maintain detailed records of such items. They acquired such assets in good faith, with thoughtful planning, and now the ground rules have been suddenly and drastically changed.

Four different calculations are now necessary for each asset in an estate.

In terms of fairness, the "fresh start" formula which determines the carryover basis as of December 31, 1976, is based upon an erroneous and artificial assumption that the appreciation and value of the property occurs ratably over the period that the decedent held the property. When, in fact, for example, a shopping center's value does not increase in conformity with such a ratable schedule. In fact, a great deal of the value of a shopping center occurs during the period of development when long-term leases are signed and agreements are executed with major department stores.

The arbitrary nature of the "fresh start" formula will encourage heirs of a decedent-owner to dispose of a business through a tax-free merger or exchange. The effect of the carryover basis provision, thus, is to encourage mergers of small businesses with larger companies. The formula fails to account for the actual high inflation rate occurring during the several years preceding December 31, 1976.

In addition, the "fresh start" formula also discriminates between owners of property other than marketable securities. Small business owners and shopping center developers in particular are penalized because they have no public market and because they have created the value of their assets.

With respect to efficiency, income tax revenues are generated only if the heirs sell the property of a decedent. The carryover basis provisions have an incentive which will encourage heirs of the property acquired from a decedent to hold on to the property unless it can be transferred by means of a tax-free merger or exchange.

As a result, investment capital, rather than having mobility, may become frozen.

We recommend and endorse Senate bill 1954 introduced by Senator Curtis which provides for a complete repeal of the carryover basis provisions. Alternatively, as provided in Senate bill 2228, we recommend that the carryover basis provision be amended to permit assets owned by the decedent prior to 1977 to fall within the provisions of the old law.

As an alternative, the law should be amended to give taxpayers the option of either computing the carryover basis under the "fresh start" formula——

Senator PACKWOOD. I am going to have to stop you. We are operating under a 5-minute rule. If you can wind down and conclude——

Mr. SZYMANSKI. Or establishing a fair market value on December 31, 1976 by an independent appraisal.

And lastly, as provided for in Senate bill 2227, the carryover basis provisions should be amended to apply prospectively from December 31, 1978.

Thank you.

Senator PACKWOOD. Thank you.

STATEMENT OF ALAN ARONSOHN, ESQ., ON BEHALF OF THE NATIONAL REALTY COMMITTEE

Mr. ARONSOHN. My name is Alan J. B. Aronsohn. I am speaking this morning on behalf of the National Realty Committee. We have filed a statement which I will not attempt to repeat.

We have also filed two or three other statements on these subjects recently with the House Ways and Means Committee.

We support the position enunciated on behalf of the International Council of Shopping Centers. I would like to use the short time that we have for oral presentation to discuss a few of the points raised in previous testimony before the subcommittee on these bills.

In connection with S. 1954, we support the repeal of the carryover basis rules. We want to make note of the fact that the old law, which we lived with for some 50 years, which provided for a step-up in basis, was not as bad as some of the witnesses before this subcommittee seemed to indicate.

It did have several distinct advantages. It did produce a good deal of administrative simplicity for both taxpayers and Government. It did present us with a statute of limitations on keeping records. Neither carryover basis proposal will do that for us.

Insofar as the so-called lock-in argument goes, while prior law may have induced 83-year-old widows to think twice about selling property, I would suggest most of our lock-in problem today comes from people of a far younger age who cannot sell assets in voluntary transactions, pay a very steep capital gains taxes that we now have, and reinvest the proceeds profitably.

If we have a lock in, that is not going to be cured by realization at death or any changes of the carryover basis rule that we may make.

The Deputy Assistant Secretary of the Treasury the other day mentioned the unfairness of the old rule. It seems to me that estate taxes become unfair in many cases.

If what we are worried about is the decedent who did not pay a capital gains tax during his life, I do not know what we can do to him. He is dead.

Insofar as the heirs are concerned, his heirs are going to be treated differently whether we change the capital gains tax or not, depending on a lot of different circumstances.

For example, if I am a single inheritor from an estate that is small enough that it does not pay any estate tax, I, in effect, do not pay an estate tax. On the other hand, a larger estate that does pay estate tax and is divided between several children may result in a child whose percentage interest otherwise would result in the same total assets as in the first case, receiving less, because the estate as a whole pays an estate tax.

We feel that if repeal of the carryover basis rule is not appropriate at this time, the suggestion that we made before the House Ways and Means Committee last August for a 2-year extension of the effective date makes a great deal of sense.

We remain of the opinion that carryover basis as now set forth in the statute is basically unworkable.

Senator PACKWOOD. You mean the carryover basis would be 1978 instead of 1976?

Mr. ARONSOHN. We think that that would give the Congress an opportunity to thoughtfully examine the thousands of questions coming up. Perhaps by then the Congress could have a workable carryover basis rule; perhaps the Congress will decide it does not want a carryover basis rule; perhaps it will want realization at death; or perhaps the Congress will elect to go back to the old law.

In any event, it seems to us even though Secretary Lubick referred to carryover basis as a step forward, as far as we are concerned, if we are going to step forward someplace, we would like to know where we are marching to.

There are too many other questions that remain here. For example, I keep asking the question, how are we supposed to treat a simple real estate partnership under the fresh start adjustments in current law? I do not get any answers.

I do not see anything in the current legislation that seems to deal with this other than Senator Hathaway's bill, S. 2238 which, if it does deal with it, deals with it in a way which we would not agree with.

We think there is an overwhelming, good sense argument to be made for a deferral of the effective date so that everybody can know where they are going before they go there. In the event that that position is not acceptable to the Congress, we do support the changes proposed by S. 2228 in the carryover basis provisions. We think they are improvements.

In this respect, we would like to particularly say that we take issue with Secretary Lubick in his disagreement with section 6 of that bill. He stated the other day, I understand, that he was not in favor of extending the net operating loss carryover to estates. We think that such an extension is only fair if the estate may have to pay a capital gains tax on inflationary gains at a time when the decedent had an operating loss carried forward that had otherwise expired.

A few words on 704(d), the partnership at risk rule.

Secretary Lubick referred to this in his testimony before the subcommittee and indicated that the bill that was introduced, H.R. 6715, would clarify the problem that was bewildering people—were hotels covered by the real estate exception of the partnership at risk rules?

We do not think that the language of H.R. 6715 does that. We think that Secretary Lubick's testimony does not clarify it at all. We think that it could be clarified either by an appropriate statement in the legislative history of the Senate Finance Committee or, we would prefer, the legislative substitute set forth in our written statement.

Senaor PACKWOOD. Thank you.

Senator HANSEN. Mr. Chairman, if I could interrupt a moment, let me observe that I am supposed to be in an energy conference with the House and I am going to have to go there. I want to express my appreciation to you for chairing these hearings and also my appreciation to the witnesses who have testified so far.

I am sorry I will not be here to hear the testimony from the representatives of the Farm Bureau as well as those representing the Ad Hoc Agricultrral Tax Committee of the American Horse Council and the American Association of Wheat Growers, the National Cattlemen's Association, the Cotton Council, the Livestock Committee, the Milk Producers Association and the Wool Growers.

I read the testimony. I endorse it to the subcommittee. It calls attention to some very damaging and injurious effects that these changes in the tax law had a year ago.

As a rancher myself, I fully appreciate the sincerity of the organizations whose testimony I read, but I will not be permitted to hear, in saying, typically a farmer or a rancher is engaged in a rather long, continuing operation. The trouble with this carryover basis, among other things, is that it totally disregards the impact of inflation. From practical observation, I can say it is going to wipe out many of the ranch and farm operations as we know them now when death occurs. There is no way that the heirs can pay the taxes and keep the ownership of the operation.

I apologize for having to leave. I do want to say that I hope this full committee will give early and serious consideration to the wisdom of the advice that we have been hearing so far this morning.

Senator PACKWOOD. Are you going to have to serve on both energy conferences when we pass the tax part of the bill?

Senator HANSEN. I am afraid I will, Mr. Chairman, as you will be sitting on the one from the Finance Committee. We have four others going on over here now.

Senator PACKWOOD. Thank you for coming.

Go ahead.

STATEMENT OF GIL THURM, STAFF LEGISLATIVE COUNSEL AND DIRECTOR OF TAX PROGRAMS, NATIONAL ASSOCIATION OF REALTORS

Mr. THURM. My name is Gil Thurm. I am the staff legislative counsel and director of tax programs, National Association of Realtors.

The positions and recommendations of the National Association of Realtors have been ably presented by my colleagues on this panel. In light of the heavy agenda of this subcommittee today, we will forego our oral statement, file our written statement, and be pleased to answer any questions.

Thank you.

Senator PACKWOOD. You mentioned a 2-year moratorium, and during that 2 years we could see what we could come up with. You said perhaps a workable carryover basis could be written. What would that be?

What would you suggest would be a workable carryover basis?

Mr. ARONSOHN. I am not sure that there is a workable approach to carryover basis. I am not in a position to propose one.

Senator PACKWOOD. Could there be a prospective one?

Mr. ARONSOHN. It would certainly be easier to have a prospective one in the sense if everyone knew, if we had some kind of cut-off date in the future and everybody knew that from there on it was going to apply, that would certainly ease a lot of the problems that we now have.

Senator PACKWOOD. Let me ask you this. If a workable one cannot be written unless you say it is prospective, and if Congress is determined to keep a carryover basis, what is the point of a moratorium? All it is is a 2-year delay implementing an unworkable law.

Mr. ARONSOHN. If it is unworkable, it should be repealed. If you assume you can make it work, or there is the possibility that you can make it work, then I think a lot can be said for the deferral of the effective date. It gives you the opportunity to go in either direction.

Senator PACKWOOD. What you are saying is that it is unworkable?

Mr. ARONSOHN. Currently it is. I have no doubt that it is.

Senator PACKWOOD. You say it cannot be written in any fashion to be workable, although there may be a prospective date of all property acquired after you put on that prospective date shall be put on a carryover basis. Everybody is at least alerted to keep records from then on.

Mr. ARONSOHN. The problems exceed those of keeping records, though recordkeeping is a difficult problem. There are lots of problems with the fresh start adjustment and with the estate tax adjustment.

For example, under the current statute, there is a provision that purports to tell you how to allocate the death tax adjustment where you have mortgaged real estate or mortgaged property. Apparently the experts decided that this provision would not work, so H.R. 6715 suggests a totally different approach to the same problem.

I personally do not feel that either approach works. However, I also do not think that I am the last fount of all wisdom in this world. I think, given enough time, perhaps we can work out some provision that does work.

Nevertheless, we are now operating under a rule that supposedly applies to people who died last December. We are 10 months into 1977. It does not seem to be desirable to be operating under a law that has problems this severe in it.

Mr. THURM. On that point, Senator Packwood, the National Association of Realtors also agrees that the carryover basis provision should be repealed. If, for some reason, it is not repealed at this time, then a 2-year moratorium would be appropriate, since there is no way of knowing how to apply the law as it now stands.

The regulations have not been issued on the subject. The skeleton of the law is so bare in this case, that without regulations you do not know where to turn.

The bottom line is to repeal it immediately, and if it cannot be repealed immediately, then postpone its effective date.

Senator PACKWOOD. I do not like the carryover basis, and I think we are going to keep it in one way or another. If we do have a 2-year moratorium. I hate to come back 2 years from now and hear the same panel saying it is not workable. If we have not been able to work it out in that stage, Congress will say you have had 2 years; nothing has happened and we are going ahead with our original 1976 date.

If, by chance, you get the time, I think you would be unwise to lobby solely on the basis of repeal and not prepare some alternative suggestions, because if you did not get repeal, you would be stuck with whatever Congress came up with.

Mr. ARONSOHN. We have made some alternative suggestions that might not make it fully workable, but at least would improve it. For example, we did suggest before the House Ways and Means Committee that, in terms of the fresh-start adjustment, the distinction between marketable securities and other property be eliminated.

We think there is a serious problem in valuing real estate, particularly in valuing interests in real estate, that more often than not are not direct ownership, but are stocks in nonpublic corporations and partnership interests. It would ease the problem a great deal if the taxpayer had an option to establish the actual fair market value of that property as of December 31, 1976. We have not simply taken a negative approach here, we have tried to come up with suggestions to improve the act. But the testimony of all of the witnesses who appeared before the Ways and Means Committee that involve problems that go far beyond those with which we are familiar indicate that there are still a tremendous amount of problems that would require some sort of solution.

Senator PACKWOOD. As I indicated earlier, I am surprised to date we did not create more problems with the act than have surfaced, especially with gift and estate taxation, considering the manner in which we rushed it through without any serious hearings as to what the possible effect might be.

Mr. Aronsohn. I do not think most problems surface until people have to grapple with them. Until enough people have died and you have enough estates in administration dealing with this new act, you are not really going to know what some of the problems are.

Senator Packwood. I have no other questions.

Gentlemen, thank you very much.

[The prepared statements of the preceding panel follow:]

Statement of the International Council of Shopping Centers

Summary

A. Carryover basis of property acquired from or passing from a decedent under the 1976 act

1. The carryover basis provisions of the 1976 Act have increased the tax burden upon owners of small businesses, discriminating against small business and favoring large corporations.

2. The 1976 Act has also created an administrative nightmare for taxpayers, adding substantially to the complexity and cost of managing a decedent's estate.

3. The carryover basis provisions are diametrically opposed to the basic goals of tax reform—simplicity, fairness, and efficiency.

a. Simplicity

(1) The carryover basis rule has added greatly to the complexity of the laws which will be manifested in higher professional and administrative costs.

(2) Because most taxpayers did not have notice of the necessity of keeping records of the purchase of various items, few if any records of purchases have been maintained. Many taxpayers acquired assets with the intention of holding them until death and had no need under prior law to maintain records. They acquired such assets in good faith with thoughtful planning and now the ground rules have been suddenly and drastically changed.

b. Fairness

(1) The "fresh start" formula which determines the carryover basis as of December 31, 1976, is based on an erroneous assumption that the appreciation in the value of the property occurs ratably over the period the decedent held the property. A shopping center's value does not increase in a steady continuum.

(2) The arbitrary nature of the "fresh start" formula will encourage heirs of a decedent-owner to dispose of a business by means of a tax-free merger. The affect of the carryover basis provision, thus, is to encourage mergers between small business and larger companies.

(3) The "fresh start" formula fails to account for the actual high inflation rate occurring during the several years preceding December 31, 1976.

(4) The "fresh start" formula also discriminates against owners of property other than marketable securities. Holders of other securities, small business owners and shopping center developers are penalized because they have no public market and because they have created the value in their assets rather than making initial, substantial capital investments.

c. Efficiency

(1) Income tax revenues are generated only if the heirs sell the property acquired from the decedent.

(2) Carryover basis provisions have an incentive which encourages heirs of property acquired from a decedent to hold on to the property unless it can be transferred by means of a tax-free merger.

(3) As a result, investment capital, rather than having mobility may become frozen, thereby limiting the supply of capital required for economic progress and depriving the Treasury of revenue from its accretion.

4. Recommendations:

a. As provided for in S. 1954, introduced by Senator Curtis, the carryover basis provision should be repealed.

b. Alternatively:

(1) As provided for in S. 2228, the carryover basis provisions should be amended to permit assets owned by decedent prior to 1977 to fall within the provisions of the old law. Gains and property previously acquired would

still be subject to income taxation when sold by living owners, and there would be notice so that adequate records could be kept.

(2) The law should be amended to give taxpayers the option of either computing the basis under the "fresh start" formula or establishing a date of death value or basis by an independent appraisal.

(3) As provided for in S. 2227, the carryover basis provisions should be amended to apply prospectively from December 31, 1978; a date sufficiently in the future to permit banks, executors, and other interested parties to comprehend the new rules and plan accordingly.

B. Amortization of real property construction period interest and taxes

1. Although H.R. 6715 clarifies some ambiguities, the bill has at least two remaining ambiguities: the bill does not clearly designate when the construction period begins and does not contain any language concerning a suspension or termination of construction prior to completion.

2. The 1976 Act (Code Section 189) should be clarified to define the construction period as commencing only with the actual physical construction of improvements (such as the sinking of piles or pouring of a foundation)—not with mere land preparation for the purpose of securing financing for construction.

3. Code Section 189 should provide for a suspension in the construction period where circumstances manifest a bona fide interruption of construction by the developer for financial or other reasons.

4. Code Section 189 should also contain a provision which allows the allocation of interest and taxes payable during a construction period between that portion of realty upon which construction is taking place and other portions of the same realty where no construction is occurring. This section should also contain a clarification of the proration method of current year's tax between construction and nonconstruction period, at the beginning and end of a project.

C. Limitation on allowance of partnership losses in case of nonrecourse loans

1. The Committee Report on H.R. 6715 should clarify that the rental of furniture, fixtures and other tangible personal property normally associated with the rental of stores and other facilities in shopping centers be specifically excluded from the ambit of Code Section 465 which apply the "at risk" rule to the leasing of section 1245 property.

2. The Report should also clarify that a partnership clearly engaged only in an activity qualifying for the real property exception under Code Section 704(d), may contract at arm's length with related entities involved in other activities without nullifying the section 704(d) exception.

I. INTRODUCTION

Mr. Chairman and members of the committee, my name is John J. Szymanski, and I am Director of Taxes and Assistant Controller of The Rouse Company (a regional shopping center developer). I am a member of the ICSC Government Affairs Committee and its Tax Legislative Subcommittee. I appear today on behalf of the members of the International Council of Shopping Centers ("ICSC"). The ICSC is a business association of more than 5,000 members. About 60% of our members develop and/or own shopping centers. About 15% are retail companies, the major share of whose stores are operated in shopping centers. Most of our developer-owner members own from two to four shopping centers each, and collectively represent a major share of the estimated 16,000 shopping centers in the United States.

New shopping center construction requires a total annual investment of over $6.6 billion per year for buildings, stores, fixtures, and equipment. It is estimated that shopping centers provide regular employment for more than 5 million sales and store personnel and that several hun .erd thousand more are engaged in the construction end of the business. The rippling affect on employment and related businesses, among them display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable.

We have a significant influence on the total United States economy. Previously, retail trade was concentrated in individual stores and center business districts. But, by 1976, 36.6 percent of all retail trade amounting to $217 billion was conducted in 17,523 shopping centers. It is estimated that in the 1977-78 period 80 percent of total new retail square footage constructed will be in shopping centers.

In the same period 88 percent of new department stores square footage will be constructed in shopping centers.

One of the principal purposes of the Tax Reform Act of 1976 was to reduce the tax burden upon the owners of small business, many of whom are participants in shopping centers. The 1976 Act, however, has increased the tax burden for these taxpayers, discriminating against small business and favoring large corporations.

The 1976 Act has also created an administrative nightmare for taxpayers, adding substantially to the complexity and cost of managing a decedent's estate. I will limit my testimony to three areas of vital concern to the shopping center industry: (1) the carryover basic rule; (2) amortization of real property construction period interest and taxes; and (3) the "at risk" limitation on partnership losses.

II. CARRYOVER BASIS OF PROPERTY ACQUIRED FROM OR PASSING FROM A DECEDENT UNDER THE ACT

A. Prior law

Under prior law, the cost or other basis of property acquired from or passing from a decedent generally was "stepped-up" to its fair market value at the date of death or the alternate valuation date.

B. 1976 act carryover basis provision

1. General

The 1976 Act provides that the basis of most property acquired from or passing from a decedent who dies after December 31, 1976, is to be the same as the decedent's basis immediately before his death (with certain adjustments). The basis of appreciated property is increased by Federal and State death taxes attributable to the appreciation in that property. In addition, the aggregate basis of all carryover basis property may be increased to a minimum of $60,000. A $10,000 exemption is provided for household and personal effects of the decedent. However, the basis of property cannot be increased above the estate tax value by these adjustments.

The carryover basis provision is effective for property acquired from, or passing from, a decedent after December 31, 1976.

2. Transition Rule

a. "Fresh start"

As a transitional rule, the adjusted basis of property which the decedent is treated as having held on December 31, 1976, is increased, for purposes of determining gain (but not loss), to its fair market value on December 31, 1976. In essence, this rule was designed to continue the application of prior law with respect to appreciation in property occurring before January 1, 1977, and to provide everyone with a "fresh start" with respect to the carryover basis rule for property acquired from a decedent.

b. Special valuation rule

In order to avoid the necessity of obtaining an appraisal on all property held on December 31, 1976, the 1976 Act contains a provision which requires that all property, other than a marketable bond or security, be valued under a special valuation method for purposes of this transitional rule. In general. the special rule determines the adjustment by assuming that any appreciation since the acquisition of the property until the date of the decedent's death occurred at the same rate over the entire time that the decedent is treated as holding the property.

The special valuation method must be used for all property other than marketable bonds or securities. Thus, the special valuation method must be used even though the executor or beneficiary of the decedent can establish that the fair market value of the property on December 31, 1976, is other than the value determined under the special valuation method. Under the 1976 Act, the value of marketable bonds or securities for purposes of the transitional rule is to be based on actual market value on December 31, 1976.

Under the special rule, the amount of the increase in basis is equal to the sum of (1) the amount of all depreciation, amortization, or depletion allowed or allowable with respect to the property during the period the decedent is treated as holding the property prior to ' uary 1, 1977, and (2) the portion of the appreciation on the asset since its purchase that is assumed to have occurred during the period that the decedent is treated as holding the property prior to January 1, 1977.

The appreciation treated as occurring before December 31, 1976, is determined by multiplying the total amount of appreciation over the entire period during which the decendent is treated as holding the property by a ratio. The ratio is determined by dividing the number of days that the property is considered to be held by the decedent before January 1, 1977, by the total number of days that the property is considered to be held by the decedent.

The total amount of appreciation is computed by subtracting from the fair market value of the property on the date of the decedent's death a recomputed basis, which is basically equal to the purchase cost of the property.

3. Example of Carryover Basis Provision Applied to Shopping Centers

This complex provision can best be explained by an example of the computations necessary to arrive at the "fresh start" basis. Although the example concerns the owner or developer of a shopping center, its principles are applicable to small businessmen and other parties comprising a shopping center.

Mr. Jones died in 1979 owning a shopping center which cost $500,000 and was worth $2,500,000 at the time of his death. In his will, Mr. Jones devised the property to his son. Mr. Jones held the property for 3,000 days, 500 of which occurred before 1977. Total depreciation allowed or allowable on the property up to the time of his death amounted to $100,000, and of this amount $17,000 was allowed or allowable before 1977. The fair market value of the property on December 31, 1976 was $2,000,000. The adjusted basis of the property immediately before Mr. Jones' death was $400,000. For purposes of determining the son's adjusted basis in the shopping center for purposes of future depreciation or gain on sale, Mr. Joens' basis at death is increased to the December 31, 1976 value as follows:

(*a*) Depreciation allowed or allowable before 1977	$70,000
(*b*) Plus $2,500,000 fair market at death less the $400,000 adjusted basis at death, less the $100,000 total depreciation taken by Mr. Jones up until his death, multipled by the fraction 2,000 over 3,000	1,333,333
(*c*) Pre-1977 appreciation adjustment	1,403,333

The son's basis for the property would therefore equal his father's basis at death of $400,000, plus the pre-1977 appreciation adjustment of $1,403,333 or $1,803,333 (plus adjustments made for Federal and State death taxes and minimum basis). This is the result even though the actual market value on December 31, 1976, was $2,000,000.

C. Problems with the carryover basis provisions

Three of the acknowledged basic goals of tax reform are simplicity, fairness, and efficiency in the tax laws. The carryover basis provisions are diametrically opposed to all three of these goals.

1. Simplicity

The concept of tax simplicity refers to the ease of administration and comprehension of the tax laws. The carryover basis rule has added greatly to the complexity of the laws which will be manifested in higher professional and administrative costs.

As illustrated above, the computation of the appropriate carryover basis which an heir will report upon the sale of property acquired from a decedent will require at least four separate sets of calculations for each item of property. These calculations are further complicated by the requirement of records substantiating the cost of these items.

For the average taxpayer, this will involve many items, perhaps thousands, bought at different times for various prices. Some of the items may have been purchased in groups without a price allocation for each item but for a total unallocated sum.

Because most taxpayers did not have notice of the necessity of keeping such records, few if any records of purchases have been maintained. Many taxpayers acquired assets with the intention of holding them until death and had no need under prior law to maintain records. They acquired such assets in good faith with thoughtful planning and now the ground rules have been suddenly and drastically changed.

Moreover, determining the purchase price of items acquired many years ago, occurs at a time when the individual-purchaser is not available to recall the transaction. In many circumstances it will be difficult even to determine the date on which the decedent acquired the property. This problem is further aggravated in situations where post-acquisition costs are associated with various items of property. Without adequate records the potential for disagreement and litigation between the taxpayer and the federal government is enormous.

Consider the confused situation where an individual purchased property in 1960, added to it again in the form of land and/or building in 1965, then put an addition on the building in 1970. How can one possibly determine the basis under these circumstances under the prescribed "fresh start" formula?

2. *Fairness*

(a) *Erroneous assumptions of ratable appreciation*

The "fresh start" formula which determines the carryover basis of December 31, 1976, arbitrarily prorates appreciation over the period from the date a business first began to the date of death of the owner. The formula is based on an erroneous assumption that the appreciation in the value of the property occurs ratably over the period the decedent held the property. This assumption is invalid and inequitable when applied to property where the actual rate of appreciation prior to January 1, 1977 is greater than the rate of appreciation after January 1, 1977. The example above illustrates this inequitable result.

With respect to a shopping center, the execution of long-term leases prior to the completion of the project substantially enhances the value of the center. As the appreciation rate of the shopping center slows down, the longer the owner keeps the shopping center, the greater the amount of value which will be subject to capital gains tax. For example, if a shopping center is constructed in January, 1975 and long-term leases are executed in March, 1975 and the owner of the shopping center dies in January, 1980, the "fresh start" formula would prorate appreciation evenly over the full period the decedent owned the shopping center even though substantially all of the increase in value occurred before December 31, 1976. This would preclude the heirs of the decedent-owner from a proper stepped-up basis reflecting the more rapid appreciation rate occurring prior to January 1, 1977.

Assume that the shopping center was owned equally by two partners. The heirs of the two partners would be arbitrarily treated differently where one partner dies early in 1977 and the other partner dies many years later, even though there may be very little difference in the value of the shopping center between the two dates of death.

Similarly, the heirs of a decedent who developed a shopping center many years ago would have a significant difference in their tax treatment compared to the heirs of a decedent who developed a shopping center in the 1970's.

(b) *Discrimination against small business*

This inequity will encourage heirs of a decedent-owner to dispose of a shopping center by means of a tax-free merger. Instead of selling for cash and paying a large capital gains tax on the gain resulting from the lower basis, the heirs will look for a tax-free combination with a larger enterprise. The affect of the carryover basis provision, thus, is to encourage mergers between small business and larger companies. Because of the desirability of merger, moreover, the heirs will be in a weaker negotiating position vis-a-vis, a larger company, and the law results in a discrimination in favor of big business at the expense of small business.

(c) *Failure to account for actual inflation rate*

The "fresh start" formula also fails to account for the high rate of inflation occurring during the several years preceding December 31, 1976. This rate was significantly greater than the present or reasonably foreseeable rate of inflation. The formula thus arbitrarily denies an heir the higher step up in basis for pre-January 1, 1977 inflation and unrealistically requires a lower basis for the property.

(d) *Discrimination against owners of property other than marketable securities*

The "fresh start" formula also discriminates against small business owners and holders of property other than publicly traded bonds and securities. The quoted price of listed securities on December 31, 1976 determines the basis on that date, but other property is arbitrarily deemed to be a value determined by a mere proration from the acquisition to the value at date of death. Holders of securities in small businesses, many of whom are tenants in shopping centers, are penalized because they have no public market. This is aggravated by the fact that very small companies have their greatest growth during early years and the rate of appreciation levels off as companies approach their maximum potential and their founders age. Moreover, this formula discriminates against real estate developers, especially shopping center developers who initially create the value of their assets during the development and construction periods of the project—in contrast to taxpayers who make substantial initial capital investments and thus have a relatively higher initial cost basis.

3. *Revenue Raising Efficiency*

Income tax revenues are generated only if the heirs sell the property acquired from the decedent.—According to legislative history, the reduced tax on capital gains was designed to encourage the sale of assets so that capital can flow to new enterprises and move into new industry. The carryover basis provision has an opposite incentive which encourages heirs of property acquired from a decedent to hold on to the property unless it can be transferred by a means of a tax-free merger as discussed above. As a result, investment capital, rather than having the mobility desired by Congress, may become frozen, thereby limiting the supply of capital required for economic progress and depriving the Treasury of revenue from its accretion. This is particularly serious in light of the necessity to encourage capital formulation in industry.

The following example of "negative basis" property illustrates a potential reason for the reluctance of heirs to sell appreciated property acquired from a decedent which is subject to a mortgage or other liability.

Assume that the decedent bought real estate in 1960 for $20,000; the real estate appreciated in value to $150,000. The decedent took out a loan secured by a mortgage in the amount of $100,000 on the property and died when the property—apart from the mortgage—was worth $110,000. Assuming that the "fresh start" adjustment and the addition of the estate taxes on appreciation raise the decedent's $20,000 basis to $70,000 for his daughter to whom he left the property by will. The heir thus acquires property from the decedent with a net worth of $10,000 to her ($110,000 minus $100,000 mortgage). However, if she sells the property, she will have a taxable gain of $40,000 ($110,000 minus $70,000 basis). If she is in the 35 percent tax bracket, the sale costs her a tax of $14,000 (35 percent of $40,000). The tax would be $4,000 more than her economic benefit of $10,000. Consequently, she would incur an economic loss and would not sell the property.

The 1976 Act has enhanced the "lock in effect" of a large gain in the value of an asset. The testator-to-be used to be locked in to a gain, knowing that it would disappear for income tax purposes if he would hold the property until death. The heir is now also locked in. This carryover of basis thus promotes ever increasing concentration among successive generations of a successful wealth-accumulating family, as each heir faces a substantial tax if he disposes of the appreciated property. This provision provides a permanent disincentive to sell appreciated property which becomes greater the longer the property is held.

D. *Recommendations*

Because of the complexity and problems created by the carryover basis provisions, we recommend the adoption of S. 1954, which was introduced by Senator Curtis and which would repeal the carryover basis provisions.

If the adoption of this bill is not possible at this time, a desirable alternative would be to adopt S. 2228, the bill introduced by Senators Harry F. Byrd, Jr. and Robert Dole which would permit assets owned by a decedent prior to 1977 to fall within the provisions of the old law. This would be a great step toward alleviating some of the hardships and gross inequities inherent in the new law.

Gains on property previously acquired would still be subject to income taxation when sold by living owners, and there would be notice so that adequate records could be kept for use where the sale was eventually made by an estate or by heirs.

S. 2228 also contains other worthwhile provisions which would make the law more workable.

We also recommend that the carryover basis provisions remain in the law, be amended to give taxpayers the opportunity of computing a basis under the "fresh start" formula.

If, because of the very complex and substantial problems presented by the carryover basis provisions and the relatively short time for study of these provisions since the enactment of the 1976 Act, the time for immediate action is inadequate, we recommend the adoption of S. 2227, also introduced by Senators Byrd and Dole, which would provide that the carryover basis provisions be amended to apply prospectively from the future date of December 31, 1978. Setting the effective date sufficiently in the future will permit banks, executors, trustees, attorneys, accountants, the Congress and other interested parties to comprehend the new rules and plan accordingly.

III. Amortization of Real Property Construction Period Interest and Taxes

A. Prior law

Prior to the 1976 Act, a cash basis taxpayer could, as a general rule, deduct construction period interest as an expense in the taxable year in which it was paid.

Subject to the rules of apportionment of real property taxes between a seller and a purchaser, the deduction for real property taxes was likewise allowed when paid by a cash basis taxpayer or accrued by an accrual method taxpayer.

The sole exception to the general rules on deductibility of construction period interest and real estate taxes prior to the 1976 Act was provided by Code Section 266. It permits an election to capitalize and add to the basis of unimproved and unproductive real property or real property being developed or improved—including already improved property being improved again—certain items otherwise deductible when paid or accrued.

These items include real property taxes and interest on a purchase money obligation or on money borrowed in connection with the property.

B. New Code Section 189

While Code Section 266 is elective, new Code Section 189 is mandatory, and is applicable to construction period interest and real estate taxes unless Code Section 266 treatment is elected.

Under new Code Section 189 in the case of a taxpayer other than a Subchapter S corporation, real property construction period interest and taxes are to be capitalized in the year in which they are paid or accrued and amortized over a 10-year period. A portion of the amount capitalized may be deducted for the tax year in which paid or accrued. The balance must be amortized over the remaining years in the amortization beginning with the year in which the property is ready to be placed in service or is ready to be held for sale.

Under Code Section 189, construction period interest and real estate taxes must be capitalized in the year paid or accrued and amortized over a period of time—the "amortization period."

The amortization period begins with the year in which the interest and taxes are paid or accrued, so that a portion of the amount capitalized may be deducted in the taxable year in which it was paid or accrued. The balance must be amortized over the remaining years in the amortization period. The remaining years begin, under Code Section 189(c)(1), with the latter of the taxable year after the taxable year in which the interest and taxes are paid or accrued or the taxable year in which the real property is ready to be placed in service or is ready to be held for sale.

The length of the amortization period is phased in gradually according to different schedules for non-residential real property, residential real property other than certain low-income housing, and low-income housing. In all cases, the amortization period is four years in the case of construction period interest and real estate taxes paid or accrued in the first year to which the rules apply. Thereafter, the length of the amortization period increases by one year for the construction period interest and real estate taxes paid or accrued in each succeeding year, until the amortization period reaches ten years.

The entire ten-year amortization period will become fully operative for construction period interest and real estate taxes paid or accrued in taxable years beginning in 1982 in the case of non-residential real property, in taxable years beginning in 1984 in the case of residential real property other than low-income housing, and in taxable years beginning in 1988 in the case of low-income housing Section 189(b).

C. H.R. 6715 clarification and removing ambiguities

H.R. 6715 clarifies that capitalization and amortization of construction, interest, and taxes for non-residential property is required only if the construction period begins on or after the first day of the first taxable year beginning after December 31, 1975.

Although H.R. 6715 clarifies the treatment of the new capitalization and amortization rules for cases in which the construction period for non-residential real estate begins in 1976 and a taxpayer's taxable year begins in 1975, it does not clarify some of the other major enigmatic provisions in new Code Section 189.

D. Recommendations

The bill has at least two remaining ambiguities: it does not clearly designate when the construction period begins and does not contain any language concerning a suspension or termination of construction prior to completion.

1. Clarification of Date on Which Construction Begins

A construction period is vaguely defined as the period beginning on the date construction of the building or other improvement commences and ending on the date on which the property is ready to be placed in service or to be held for sale.

Although the 1976 Act does not precisely define the date on which construction begins, the Joint Committee on Taxation has indicated that land preparation such as clearing and grading begin the construction period. Legislative histories relating to other tax legislation in prior years, however, look to that point when physical construction work of a significant nature—like the digging of footings or the driving of piles into the ground—commenced with respect to the particular building or improvement to be built. Preliminary work such as clearing a site, test drilling to determine soil conditions, or excavation for footings was not considered to be the beginning of construction.

We respectfully submit that the 1976 Act be clarified to define the construction period as commencing only with the actual physical construction of improvements (such as the sinking of piles or pouring of a foundation)—not with mere land preparation and improvements, such as clearing or grading.

This will permit the taxpayer to be able to undertake initial land preparation for the purpose of securing necessary financing for construction and not run the risk that he will be forced to capitalize interest and taxes during a period in which no construction occurs.

In order to secure financing for construction, shopping center developers frequently clear and grade land to demonstrate their intention and the feasibility of their project to potential investors or lenders or to eliminate blighted existing improvements. If a developer is unsuccessful in securing financing, he may be forced to suspend his efforts to build until capital is available.

Under the present law the construction period may be deemed to begin with the initial clearing and grading of the land. Consequently, the taxpayer will be forced to capitalize interest and taxes. If he is unable to secure financing for several years, this capitalization will occur during a period when the taxpayer isn't constructing anything.

2. Provision for Suspension or Termination of Construction Period

New Code Section 189 is also deficient in not suspending the construction period where a taxpayer, having commenced construction, suspends construction for financial or other reasons. Frequently, litigation, the unavailability of sufficient funds or other factors, require a shopping center developer to suspend construction. During the period of suspended construction, the developer normally suffers financially. However, under new Code Section 189 he is also penalized by not being able to deduct currently real estate taxes and mortgage interest which he is required to pay during his period of temporary abandonment of construction. We respectfully submit that Code Section 189 should provide for a suspension in the construction period where circumstances manifest a bona fide interruption of construction by the developer for financial or other reasons.

3. Provision for Construction on a Portion of Real Estate

Moreover, Code Section 189 is presently deficient in that it contains no provisions concerning situations where a taxpayer adds to existing structures or where a taxpayer begins construction on only a portion of a piece of realty. We respectfully recommend (a) the addition of provisions which allow the allocation of interest and taxes payable during a construction period between that portion of realty upon which construction is taking place and other portions of the same realty where no construction is occurring, and (b) a clarification of the proration method of current year's taxes between construction and non-construction period at the beginning and end of the project.

IV. LIMITATION ON ALLOWANCE OF PARTNERSHIP LOSSES IN CASE OF NON-RECOURSE LOANS

A. Prior law

Under prior law, the amount of all debt—recourse or non-recourse—was considered in the same manner as a contribution of money by the partners to the partnership. This created a basis for each partner in his respective partnership interest equal to his actual cash contribution and his percentage "share" of partnership liabilities. In general, this also held true in the case of non-recourse debts of a limited partnership.

B. New code section 704(d)

New Code Section 704(d) now adds an "at risk" limitation on losses deductible by partners (in other than real estate partnerships), thereby effectively limiting the ability to use non-recourse liabilities in a partnership context to create tax shelters.

C. Technical amendments bill

Section 2(o) of the Technical Amendments Bill clarifies some of the ambiguities in the terms "investing" and "principal activity." The bill provides that, for a partnership to qualify, substantially all of the activities of the partnership must involve the holding of real property (other than mineral property) for sale or rental and that passive as well as active rental operations qualify.

D. Recommendations

Although the Amendment is a step in the right direction, something more is required to clarify ambiguities in the 1976 Act. We recommend that the Committee clarify that the exception for real property covers the incidental leasing of Section 1245 property in stores and other buildings, such as restaurants which comprise part of a shopping center or other retail area. The incidental leasing of such property in connection with real estate activity is not covered by Code Section 465 which applies the "at risk" rule to the leasing of Section 1245 property. In its explanation of the 1976 Act the Staff of the Joint Committee on Taxation said:

"Since the at risk rule does not apply to real estate activities, in a situation where section 1245 property is leased as a minor incident of a lease of real property (such as where an unfurnished rental apartment is equipped with a stove or refrigerator), the at risk rules for equipment leasing will not be considered to apply." (See general explanation of the Tax Reform Act of 1976, Staff of Joint Committee on Taxation, p. 81, December 29, 1976.)

It is not clear, however, what amount of activity would be considered a "minor incident of a lease of real property." Accordingly, we recommend that the Committee clarify that the rental of furniture, fixtures, and other tangible personal property normally associated with the rental of stores and other facilities in shopping centers be specifically excluded from the ambit of Code Section 465.

We also agree with the National Realty Committee that your Committee should clarify that a partnership clearly engaged only in an activity qualifying for the real property exception to Code Section 704(d) may contract at arms

length with related entities involved in other activities without nullifying the Section 704(d) exception.

STATEMENT OF THE NATIONAL REALTY COMMITTEE

SUMMARY

I. Carryover basis

A. S. 1954—NRC opposes carryover basis concept introduced by 1976 Tax Reform Act; urges repeal of carryover basis; endorses and recommends favorable consideration of S. 1954.

B. S. 2227—New carryover basis rules have created substantial problems and uncertainty; in previous testimony before House Ways and Means Committee, NRC has urged that effective date be extended to not earlier than December 31, 1978; therefore, NRC endorses and recommends favorable consideration of S. 2227.

C. Technical Corrections Bill:

1. Valuation of real property interests is more severe problem than tangible personal property valuation.
2. Proposed solution contained in Section 3(c)(1) is not applicable to real estate interests and would not solve valuation problems as to real estate interests if applicable.
3. NRC recommends change to permit taxpayer option to use established fair market valuation at cut-off date, as real estate interests do not appreciate ratably.

II. Amortization of Interest and Taxes During Construction of Real Property

A. New Code Section 189 is unclear as to definition of "construction period".

B. Proposed Section 2(e) of Technical Corrections Bill does not clarify this ambiguity.

C. NRC recommends change to establish that construction period commences with start of actual physical construction of improvements.

D. NRC recommends also that construction period terminate or be suspended when taxpayer abandons present intention to complete construction.

III. Real Estate Exception to Partnership "at risk" Rule

A. Proposed Section 2(o) of Technical Corrections Bill intended to clarify certain ambiguities in Code Section 704(d); it will not clarify current ambiguities.

B. NRC recommends that the real property exception to Code Section 704(d) be simplified by extending such exception to any non-recourse debt secured by an interest in real property, to the extent of the fair market value thereof.

STATEMENT

The National Realty Committee, Inc., a non-profit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States, offers the following statement concerning certain aspects of S. 1954, S. 2227, S. 2228 and H.R. 6715 (the Technical Corrections Bill of 1977), for consideration and action by the Subcommittee on Taxation and Debt Management of the Committee on Finance of the United States Senate.

Initially, we wish to express our concern and that of the real estate industry in general with respect to three particular issues: the new provisions for a carryover basis on death, amortization of construction period items and the application of the partnership "at risk" rules to investments involving real estate. Each of these issues is affected to some degree by provisions of the proposed Technical Corrections Act as passed by the House of Representatives. In addition, the carryover basis issue is the subject of S. 1954, S. 2227 and S. 2228. Our comments and suggestions concerning these issues are set forth below, and are presented by subject area.

Carryover basis

A

The National Realty Committee opposes the carryover basis concept introduced by the 1976 Tax Reform Act. Therefore, we are pleased to endorse and urge this Committee's favorable consideration of S. 1954, which would repeal the carryover basis rules and return to the pre-1976 law under which the cost or basis of property passing from a decedent generally was "stepped up" to its fair market value at the date of death or the alternate valuation date.

We are particularly concerned with the fact that this entirely new concept, constituting a radical departure from prior law, became a part of the 1976 Tax Reform Act as a result of the Conference Committee deliberations, with an inadequate time for study and comment prior to enactment of this portion of the 1976 Act. As a matter of tax policy, we believe that the carryover basis rules will prove to be detrimental to capital formation and investment which is essential to the continued strength and growth of the nation's economy.

B

In the event that this Committee, or the full Congress, elects not to act to repeal the carryover basis rules, we would urge your prompt and favorable consideration of S. 2227, which would extend the effective date of the carryover basis rules from December 31, 1976, to December 31, 1978.

In testimony before, and statements filed with, the House Ways and Means Committee during the last three months, the National Realty Committee consistently has urged that the effective date of these rules be extended from December 31, 1976 to a date sufficiently in the future, not earlier than December 31, 1978, as would permit all interested parties to thoroughly understand the new rules and to plan their affairs based upon some generally accepted understanding as to how these new rules will work, and as would also permit time for a review of the carryover basis rules as part of the upcoming Congressional study of the President's tax reform proposals.

As we are certain this Committee knows on the basis of other testimony presented to it, utter confusion currently exists over many aspects of the carryover basis rules, including the proper application of such rules to mortgaged property and property held by nonpublic partnerships and corporations. In initially presenting our suggestion of postponement of the effective date of the carryover basis rules to the House Ways and Means Committee this past August, the National Realty Committee was primarily concerned that the legislation, as enacted, was seriously deficient in many respects and that the new provisions would be unworkable in the absence of further congressional refinement. Since that time, we understand that recommendations have been made to the President that he consider adopting an entirely new approach in this area.

A period for reflection would not only permit the possibility of creating solutions for currently unanswered problems, but might also, in case the Congress decides to enact a different approach as part of the President's upcoming tax reform program, avoid the utterly useless complexity that would be involved in imposing three entirely different sets of rules to decedents' estates over a very limited time period.

At the moment, estates of decedents who have died prior to January 1, 1977, receive treatment under the basis rules which were in existence for a period of more than 50 years preceding the enactment of the Tax Reform Act of 1976. If Congress, as part of its review of the President's forthcoming tax reform proposals, enacts any changes in the carryover basis rules, replaces such rules entirely by providing for realization of gain at death, or adopts some other alternative, a retroactive application of any such changes would require the massive filings of amended tax returns. On the other hand, if any such changes were made prospective only, government tax administrators and private tax practitioners would have to deal with a set of complex problems relating to the interim period and at the same time struggle with the inevitable uncertainties of yet another new system.

If no changes are enacted in this area over the next several years, a postponement of the December 31, 1976 effective date for the carryover basis provisions will at least permit Congress time to legislate a thoughtful carryover basis provision that will be more comprehensive and workable than the general concepts enacted into law in the closing days of the 1976 Tax Reform Act debates.

The fact is that the current Code provisions dealing with carryover basis are technically deficient and substantially less than comprehensive. A statute that purports to introduce a totally new concept for determining the income tax basis of property owned by all decedents dying after December 31, 1976, but which provides that the basis of an inherited partnership interest owned prior to that date, or similar interest in a nonpublic corporation, is to be determined in accordance with Regulations to be prescribed by the Secretary, simply reflects an abandonment by Congress of its responsibility to legislate.

As of the current date, October 28, 1977, there are still no Treasury Regulations with respect to important provisions enacted approximately 8 years ago as part of the Tax Reform Act of 1969. It is not likely that anyone administering the carryover basis provisions enacted in 1976, or attempting to discharge his responsibilities as a taxpayer under such provisions, will receive any substantial enlightenment from any Regulations issued with respect to these questions in the near future.

The open questions are material and serious. Congress has given neither the Treasury nor the taxpaying public any hint in the statute or legislative history as to the proper resolution of these problems.

For example, assume that two individuals organized either a partnership or a corporation in 1956. Assume further that the partnership or corporation constructed several additional buildings during the period between 1966 and December 31, 1976 and during this period sold one or more buildings. Assume further that the partnership or corporation is currently constructing an additional building.

If a partner or shareholder dies during 1977, how are the "fresh start" provisions of Code § 1023(h)(2) to be applied? How would they be applied to a partnership owning a corner grocery store or a family farm?

What would the result be if any building, store or farm were subject at the time of death to a mortgage liability which exceeded the decedent's basis in the property, or if the decedent's interest was in a partnership where the decedent's share of partnership liabilities exceeded the basis for his partnership interest?

The rules contained in Code § 1023(g)(4) relating to mortgages have created such confusion that § 3(c)(2) of the proposed Technical Corrections Act of 1977 as passed by the House proposes to eliminate Code § 1023(g)(4) entirely and to amend Code § 1023(g)(1). Comments presented to the House Ways and Means Committee from others during the hearings on the Technical Corrections Act indicate that the proposed correction will not obviate the confusion.

We are not in any position at this time to even suggest possible solutions to all of the problems involving the application of the carryover basis rules to mortgaged real estate. Delay in the effective date would afford Congress the opportunity to identify and resolve these problems.

We note that the House of Representatives has just passed H.R. 9251, the "Tax Treatment Extension Act", extending the effective dates of certain provisions of the 1976 Tax Reform Act, including Code § 911. The carryover basis rules affect a substantially greater number of taxpayers throughout the country than Code § 911, which deals with earned income from sources without the United States.

Extension of the effective date with respect to carryover basis would not affect the estate and gift tax reforms, such as unification of rates, substitution of credits and the like, enacted as part of the 1976 Tax Reform Act.

Extension of the effective date of the carryover basis provisions simply means an extension of the date of applicability to permit Congress to either rationally solve the problems left by the current carryover basis provisions or to move on to an improved solution to the problems perceived by Congress in this area.

If this extension proposal, provided for by S. 2227, is accepted by this Committee and rapidly enacted by Congress, any problems that may result from such extension will be minimal. The only taxpayers who could be affected would be estates or legatees of decedents dying after December 31, 1976, who have already sold property inherited from the decedent. In most cases, such taxpayers would not yet have even filed income tax returns. Of course, the longer any extension of the effective date is delayed, the more complex the problems will become when Congress takes any action that would result in any substantial change in the current rules.

Considering the unworkable nature of the current rules as they stand, as testified to by many witnesses before this Committee, some substantial change in these rules appears to be inevitable. Under these circumstances, rapid enactment of a provision extending the effective date for application of the carryover basis rules would save the nation a thoroughly needless trauma, the cost of which will surely exceed the de minimis revenue loss which may result to the Government from any such extension.

C

Finally, there is a particular problem of equity and fairness presented by the new carryover basis rules in their application to the valuation of real property interests for purposes of the "fresh start" adjustment. Section 3(c)(1) of the proposed Technical Corrections Act as passed by the House provides a new formula to determine a fresh start adjustment with respect to tangible personal property. The explanation for this proposal provided by the Statement of the Joint Committee on Taxation is that "it is particularly difficult to ascertain the fresh start adjustment in many cases because the executor or heirs may not be able to determine the basis of the property or even the approximate date on which the decedent had purchased the property."

We respectfully suggest that the problems affecting owners of real property and holders of intangible interests in real property, such as stock in nonpublic corporations and interests in nonpublic partnerships owning real estate, are even more severe than those faced by owners of tangible personal property.

Furthermore, we do not believe that the proposed solution to the problems contained in Technical Corrections Bill Section 3(c)(1) is the appropriate solution to these problems. Instead, we believe that it would be appropriate for taxpayers to have the option of utilizing actual fair market values in all cases where the heirs of a decedent are prepared to accept the burden of proving such actual fair market values.

We urge that taxpayers be granted the same rights with respect to property other than marketable securities as those accorded to taxpayers with respect to marketable securities by permitting an optional fresh start adjustment based upon actual cut-off date (whether that date be December 31, 1976, December 31, 1978, or some other date) fair market value as established by the taxpayer.

Our more detailed reasons for this proposal follow.

The new carryover basis rules of Internal Revenue Code Section 1023 contain a "fresh-start" provision designed to give recipients of appreciated property from a decedent a fair market value basis for the inherited property as of December 31, 1976 (the "cut-off date"). Congress adopted a formula for computing the "fresh-start" basis of property other than marketable bonds and securities that assumes that such property appreciates ratably over time. Under the formula, the decedent's basis at death is increased by the portion of the excess of the fair market value of the property on the date of death over its adjusted basis on that date equal to the period of time the decedent held the property at December 31, 1976 as compared to the total period of time he held the property. The justification for the use of such a formula is that it will avoid the administrative inconvenience of obtaining appraisals of all such property held as of December 31, 1976.

In fact, most such property does not appreciate ratably. As a result, the required use of this formula will produce gross inequities in result to executors and legatees in many instances. We believe that the equity of recognizing fair market value at December 31, 1976, as the "fresh-start" basis is far more important than, and must prevail over, mere administrative convenience. In addition to significant inequity, the required use of this formula will create difficult legal and factual questions, impose onerous administrative burdens on executors and unfairly subject them to risks of fine and liability to heirs. It is the position of the National Realty Committee that these problems and injustices can be avoided by providing executors with the option to increase the basis for this appreciated property at death to its fair market value on the cut-off date, provided the executor can reasonably sustain the burden of proof as to value at that date.

We have said that the mandated application of the formula approach may work substantial injustices in those many situations where property does not appreciate ratably. For example, substantially all of the appreciation in the value of a shopping center typically will arise upon the execution of valuable long-term leases. The holding period for a shopping center prior to full rent-up typically is short compared to the useful life of the property. Assume, for example, a decedent had constructed a shopping center during 1976, executing valuable leases on the stores by calendar-year end. If the date of death occurs several years thereafter, the formula approach would fail to recognize, and therefore largely deny his heirs, an increase in tax basis for appreciation that was economically and properly attributable to the pre-1977 period.

The formula approach may distort the allocation of "real" appreciation in property between periods before and after the cut-off date; it also fails to take account of the fact that the rate of inflation for a substantial period of years ending shortly before the cut-off date was materially higher than the present or reasonably foreseeable inflation rate.

Under the formula approach, post-cut-off date declines in the rate of inflation will have the effect of denying a decedent's heirs a step-up in basis for pre-cut-off date inflationary appreciation. Recognition of true fair market value at the cut-off date, on the other hand, will properly allocate both "real" and inflationary appreciation to the periods in which they economically occurred.

In order to apply the formula approach, the executor must first determine the decedent's basis for the property at death, or if unknown, the value at the date of acquisition. This information will often be extremely difficult, if not impossible, to obtain, particularly since taxpayers never before had reason to maintain information with respect to the tax bases, or the dates of acquisition, of their property in a form accessible to their executors. This may not only raise difficult factual questions, but may also raise legal questions surrounding the effect on the decedent's basis of transactions during his lifetime with respect to which he had sole knowledge. For example, it is not uncommon for a decedent to have owned a personal residence for many years and to have made substantial capital improvements in the property from time to time. If the taxpayer planned to live in his house until death, he had no reason to accumulate this information in pre-cut-off years or to make it accessible to others.

The need for this information is, of course, inherent in the new carryover-basis system; however, taxpayers who acquire property after the enactment of the 1976 Act, and their accountants, are at least put on notice that their executors will need this information at death.

The problem of lack of notice and accessibility of information are exacerbated where the decedent owns a partnership interest or stock in a Subchapter S corporation. Taxpayers themselves rarely maintained information with respect to the basis of the property owned by these entities, and there may be serious questions as to the right of an executor to secure this information.

The Code imposes a duty on executors to provide the Internal Revenue Service with information concerning the carryover basis of property. An executor may be fined for failure to produce such information, unless he has done everything reasonable to obtain the information but without success. The standard of reasonableness may be difficult to apply to the production of information for years before decedents and prospective executors were put on notice as to its need. Moreover, executors will be aware that a failure to produce such information to the Internal Revenue Service may not only subject them to fine, but may also subject them to possible liability to the decedent's heirs for any increase in tax liability that may be incurred as a result of this "unreasonable" failure to produce such information.

The carryover-basis system, in general, is a radically new system, producing new and substantial record-keeping responsibilities. For these and other reasons, Congress determined to apply it prospectively by providing a "fresh-start". We submit that the formula approach to a "fresh-start" basis contains most of the hardships, injustices and unfair burdens inherent in a retroactive application of the carryover basis concept. The clear congressional intention of prospective application, for the purpose of achieving equity and fairness, can only be implemented properly by providing executors with the option of calculating tax basis on cut-off date fair market value.

Amortization of interest and taxes during construction of real property

Section 2(e) of the proposed Technical Corrections Act as passed by the House would clarify the treatment of the new capitalization and amortization rules of Code Section 189 in cases in which the construction period for non-residential real estate begins in 1976 for a taxpayer whose taxable year begins in 1975.

While this provision in the Technical Corrections Bill clears up a minor ambiguity in new Code Section 189, it does not deal at all with major ambiguities which exist in this new Code Section and which have not yet been dealt with by either the statute or any Treasury regulations.

Section 2(e) of the Technical Corrections Bill is intended to apply "if the construction period begins" on or after a particular date. Currently, the determination of when the construction period begins is unclear.

Under new Code Section 189, the construction period is defined as beginning upon the commencement of the construction of the building or other improvement and ending when the constructed property is ready to be placed in service or held for sale. The Joint Committee on Taxation explanation of the events that will cause the commencement of the construction period indicates that "land preparation and improvements, such as clearing, grading, excavating and filling" start the period. There is no provision for the suspension or termination of the period once commenced, prior to completion of construction.

It is the position of the National Realty Committee that the construction period should be deemed to commence for this purpose only with the start of the actual physical construction of the improvements, and not with land preparation and improvement, and that the construction period should terminate or be suspended in the event the taxpayer abandons his present intention to complete construction.

According to the Joint Committee's explanation, Congress adopted Code Section 189 in order to discourage tax-motivated, rather than economically motivated, real estate construction, which can cause distortions in real estate values and construction costs that produce unsound investments. We believe that to be a completely valid objective; however, we submit that Code Section 189, as enacted and explained, is overly broad and may inappropriately constrain the conduct of economically motivated real estate construction.

Taxpayers owning land and seeking debt or equity financing necessary for the construction frequently prepare land for construction in order to show good faith to prospective lenders and investors. If a taxpayer cannot secure the needed financing, he will abandon his present intention to construct until such time as he can secure the needed capital. Under Section 189, as enacted and explained, such a taxpayer will be deemed to have commenced the construction period upon the undertaking of preliminary land preparation, and will be required to capitalize interest and taxes, conceivably over a period of years during which no construction is taking place, even though the land preparation cost may be insignificant in relation to the actual cost of land to the taxpayer. There would be little erosion of the Code Section 189 provision, and no erosion whatsoever if its underlying intent, by defining the commencement of construction as the start of actual physical work on the construction, such as the sinking of piles or the pouring of a foundation. Typically, if immediate construction is intended, there will only be a short delay between land preparation and actual physical construction, during which period only a small portion, if any, of indebtedness or real estate taxes will be attributed to construction. At the same time, taxpayers will continue to be able to undertake preliminary land preparation for the purpose of securing construction capital.

Similarly, frequently a taxpayer will acquire a number of building sites, intending immediate construction on less than all of such sites. Such a taxpayer may find it more economical to do the land preparation work on all the sites, even though he only has an indefinite intention to construct on some in the future. Taxpayers in this situation may well be forced to avoid the more economical approach of preparing the land on all sites at the same time in order to avoid capitalizing interest and taxes with respect to building sites on which the taxpayer has no present intention to construct.

The rule which we propose is similar to that adopted by the Treasury Department in its regulations relating to the credit for the purchase of a new principal residence after March 12, 1975 and before January 1, 1977, i.e., Treas. Regs. § 1.44–2(a) issued December 1, 1975.

Present Code Section 189, as explained, is similarly overbroad in not suspending the construction period where a taxpayer, having commenced construction, abandons construction for economic reasons. Thus, a taxpayer who has commenced construction but who is forced to interrupt because of the unavailability of sufficient funds, litigation contesting his right to construct or other factors beyond his control, will not only suffer the substantial economic detriment which always results from the interruption of a planned construction program, but in addition is subject to being penalized under the tax laws through inability to currently deduct real estate taxes and any mortgage interest being paid to carry the property through this difficult period of time.

It would, therefore, be appropriate in our view to provide in the statute for an interruption in the "construction period" where the facts demonstrate a bona fide, albeit temporary, abandonment of construction.

Because the Code Section 189 approach is to capitalize interest and taxes attributable to construction periods, rather than interest and taxes attributable to construction, the provision not only covers situations outside the congressional purpose as discussed above, but also creates a variety of allocation problems. For example, the provision offers no guidance as to the result where a taxpayer improves or makes additions to existing structures or where a taxpayer commences construction on only a portion of a single land tract. We believe that these problems are serious enough to require statutory attention. The language of Code Section 189 should, in our view, be broadened to specifically permit, pursuant to appropriate Treasury regulations, allocations of interest and taxes payable during a "construction period" between that portion of any property which is actually undergoing construction or reconstruction and other portions with respect to which either no construction has commenced, in the case of vacant land adjoining the construction site for example, or where construction has already been completed, as in the case of the addition of an extension, enlargement, or rehabilitation of an existing structure.

Real estate exception to partnership "at risk" rule

Section 2(q) of the Technical Corrections Bill would amend Code Section 704(d) by substituting certain language in the exception contained in Section 704(d) for "any partnership, the principal activity of which involves real property (other than mineral property)." (Language from Conference Report to the Tax Reform Act of 1976.) The problems which have arisen under the language currently used in Section 704(d) have centered around the ambiguities in the term "principal activity" and the word "investing", the latter being used in the statutory language while the Conference Committee Report utilized the word "involves".

The Bill attempts to clarify these ambiguities by providing that, for a partnership to qualify for this exception "substantially all of the activites of [the partnership must] relate to the holding of real property (other than mineral property) for sale or rental." We are concerned that the substitution of the proposed new language for the existing phraseology in Section 704(d) will not clarify the current ambiguities.

Of particular concern to us is the ambiguity implicit in both the existing statutory language and the substitute language proposed in the Technical Corrections Bill with respect to treatment of personal property leased as an incident to the ownership or operation of real property, such as, the leasing of furniture, fixtures and kitchen equipment in hotels, motels and apartments.

The proposed language changes suggested in Section 2(q) of the Bill will not eliminate this problem.

Moreover, we are concerned that the use of any concept that makes the existence of the real property exception to Section 704(d) depend upon the dominance of real-property activities in the partnership not only will perpetuate ambiguities but will also deny the benefits of the exception to many partnerships not engaged in the kinds of abuses that motivated Congress to amend Section 704(d) as part of the 1976 Tax Reform Act. The purpose underlying the 1976 amendments to Section 704(d) was prevention of the use of the partnership vehicle to carry on tax shelter transactions involving nonrecourse financing and other forms of limitation of risk. The real estate exception included in the Section 704(d) amendment reflects congressional recognition of the historic use of nonrecourse financing as a customary, non-tax motivated method of financing real estate transactions, as contrasted with the rather recent utilization of various forms of nonrecourse financing in connection with leveraged oil and mineral transactions, purchases of films, books and records, and other acquisitions structured with nonrecourse debt for the primary purpose of securing tax advantages.

In the light of this purpose, it is not necessary to limit the real estate exception to Section 704(d) to instances in which "substantially all" of the partnership's activities are limited to the ownership of real property. The legitimate use of traditional nonrecourse financing of real property by a partnership should be permitted without limit even where the partnership engages in other business activities. For example, we do not believe that it is consistent with the congressional purpose to deny the real property exception to a partnership engaged in a manufacturing business in its nonrecourse-financed factory while allowing the benefits of the exception to a similar partnership that chose to lease its factory to another instead.

The National Realty Committee therefore proposes that the language added to Section 704(d) by the 1976 Tax Reform Act be deleted and the following language substituted:

"For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability, other than a liability secured by an interest in real property (other than mineral property). The preceding sentence shall not apply with respect to any activity to the extent that section 465 (relating to limiting deductions to amounts at risk in case of certain activities) applies."

We recognize that while the proposed broadening of the exception for real property substantially increases the clarity of Section 704(d), this liberalized language, on its face, may arguably expand a potential for abuse currently implicit in the statutory framework of Section 704(d). Unlike Section 465, the application of the "at risk" concept of Section 704(d) does not depend on the conduct of a particular partnership "activity". Accordingly, as currently drafted, Section 704(d) appears to permit a partner to create "at risk" tax basis that allows the flow-through of partnership losses by contributing cash or other high-basis property or by incurring personal liability on partnership indebtedness, whether or not the contributed property or personal liability is economically at risk in the loss producing "activity".

If Congress desires, it may therefore be appropriate in the legislative history explaining this amendment to make it clear that Congress does not intend that the real property exception to Section 704(d) be utilized to permit the pass-through to partners of losses attributable to property, other than non-mineral real property, financed with nonrecourse debt, where the principal purpose for the acquisition by the partnership of either the real property, or such other property, is the evasion or avoidance of Section 704(d).[1]

Despite the foregoing, if the Congress desires to preserve the "principal activity" or "substantially all" test, or substitute some other activity test, in defining the real property exception to Section 704(d): the National Realty Committee urges that the accompanying legislative history make clear that the incidental and subsidiary activities conducted in connection with the operation of a hotel, motel or apartment house by a partnership will not cause the loss of the real property exception.

Statement of Gil Thurm, Staff Legislative Counsel and Director of Tax Programs, the National Association of Realtors

The National Association of Realtors is comprised of more than 1,750 local boards of Realtors located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is approximately 500,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the U.S. concerned with all facets of the real estate industry. Principal officers are: Harry G. Elmstrom, President, Ballston Spa, New York; Tom Grant, Jr., Vice President, Tulsa, Oklahoma; and H. Jackson Pontius, Executive Vice President. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 925 Fifteenth Street, N.W., Washington, D.C. 20005. Telephone 202/637-6800.

Mr. Chairman and members of the subcommittee, my name is Gil Thurm, and I am the Staff Legislative Counsel and Director of Tax Programs for the National Association of Realtors. We appreciate this opportunity to testify before this Subcommittee on legislation relating to the estate tax carryover basis provision enacted as a part of the Tax Reform Act of 1976.

The National Association of Realtors is comprised of 50 state Associations, and more than 1,750 local boards of Realtors located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is in excess of 500,000 persons actively engaged in sales, brokerage, management,

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[1] The accompanying legislative history may also point out that the real property exception would continue to be subject to existing law which provides that no partner may include in his tax basis for his partnership interest his share of nonrecourse indebtedness to the extent such indebtedness exceeds the fair market value of the property subject to such liability, and that where real property and other property are subject to a single nonrecourse indebtedness, such indebtedness should be allocated between the real property and the other property on the basis of their relative fair market values.

counseling, and appraisal of residential, commercial, industrial, recreational, and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction, and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Before the enactment of the Tax Reform Act of 1976, the basis of inherited property was "stepped-up" or increased to the fair market value at the date of the decedent's death. This former rule was drastically changed by the Tax Reform Act of 1976. Section 1023 of the Internal Revenue Code of 1954, added by Section 2005 of the Tax Reform Act of 1976, requires the recipient of inherited property to carry over the decedent's basis—there is no longer a step-up to fair market value at the date of death.

To ease the impact of this change in the law, the statute provides a "fresh start" as of December 31, 1976. That is, the "carryover basis" is increased to reflect pre-1977 appreciation in the value of property. Marketable bonds and securities are valued according to a stock exchange listing as of December 31, 1976 to determine the amount of the increase. Appreciation in the value of basically all other property, including real estate, is determined by an artificial allocation in accordance with the number of days the property was held before 1977 and the total number of days it was held before the decedent's death. The effective date of this major change in the law was December 31, 1976.

A number of bills have been introduced in both the Senate and the House to repeal and alleviate this carryover basis rule because of its complexity and because of the hardships that result from the rule. The National Association of Realtors urges the Subcommittee to support those bills designed to repeal this onerous provision, such as S. 1954 which was introduced by Senator Curtis.

Short of outright repeal of the carryover basis rule, we strongly urge the Subcommittee to support a postponement of the effective date of this troublesome and complex provision until 90 days after final regulations are issued by the Treasury Department for this provision, but in any event, not before December 31, 1978. In that regard, the National Association of Realtors supports S. 2227, introduced by Senator Byrd, to postpone the effective date of the rule to the end of 1978.

It is important that the effective date be postponed since a significant number of major questions are arising with regard to the application of the carryover basis rule and the "fresh start" adjustment. These rules are applicable to heirs and executors of persons dying after December 1, 1976. Yet there is little or no authoritative guidance for the heirs and executors concerning implementation of these new rules. It is clear that Treasury regulations will not be available in time to answer the many questions on this subject which started to appear at the beginning of this year and which are continuing to be raised at this very time.

Our Association also supports the "grandfather provision" of S. 2228, introduced by Senator Byrd and Senator Dole, which eliminates from the applicability of carryover basis all assets held by a decedent on December 31, 1976.

In light of the President's recent announcement that he will delay sending his tax reform proposals to Congress until next year, it becomes even more important for this matter to be addressed and corrected now.

We also urge that this Subcommittee support removal of the discriminatory aspect of the "fresh start" provision which imposes one rule for taxpayers with respect to marketable securities and a different rule for other property, including real property. As noted above, marketable bonds and securities are valued by determining the listed price of such securities on a stock exchange at December 31, 1976. On the other hand, the value of other property such as real estate is valued by use of an artificial allocation formula which assumes that the property appreciated evenly over the period it was owned. Even if the taxpayer produces an independent appraisal of the value of the property as of December 31, 1976, the statute requires that the existence of the appraisal be disregarded and that only the artificial allocation would apply.

The National Association of Realtors respectfully submits that this discrimination between types of property for purposes of the "fresh start" rule is not justified. Real property does not typically appreciate evenly over its holding period. By assuming ratable appreciation before and after December 31, 1976, this rule imposes a particularly harsh burden upon taxpayers with improved real property such as multi-family rental housing and commercial properties such as shopping centers. There generally is a large increase in the value of the land shortly after it is fully improved. This increase in value is usually slower in later years. It is because of these economic realities that the artificial allocation formula under the "fresh start" rule results in unsound and unfair value determinations.

Equity and economic reality require that taxpayers be given the opportunity to present independent appraisals to prove fair market value for purposes of the "fresh start" rule, or, in those cases where the cost of the appraisal might be disproportionate to the value involved, that they be permitted to use the appraisal on the basis of which real property taxes were paid to the local government (adjusted, of course, to full value if the local governments procedure was to use a fraction of full value). The National Association of Realtors urges that the statute be amended to give taxpayers the opportunity to use such appraisals.

Thank you for this opportunity to present our views.

Senator PACKWOOD. Now, if we might take Mr. Stewart and Mr. Tierney.

STATEMENT OF GEORGE STEWART, TREASURER, JOHNS HOPKINS UNIVERSITY

Mr. STEWART. My name is George Stewart and I am treasurer of Johns Hopkins University. I appear on behalf of my institution and a number of colleges and universities.

Exempt charitable and educational institutions are engaged in the practice of lending securities, stocks and bonds, from their investment portfolios to various brokerage houses to enable the brokers to make delivery of such securities to cover either a short sale or a failure to receive securities.

In these transactions, the broker receiving the certificates posts cash collateral or, in some cases, U.S. Treasury bonds, in the amount equal to or exceeding the then fair market value of the particular securities being borrowed.

Senator PACKWOOD. At no risk.

Mr. STEWART. That is right. These arrangements are of two types: in one, the collateral is available to the institution during the period of the loan. If the collateral is bond, the institution is entitled to the interest earned thereon during that period of time. If the collateral is cash, the institution may invest the assets as it deems appropriate and retain any earnings derived therefrom. Normally the collateral is invested in such a way as to generate income in the form of interest.

Senator PACKWOOD. For how long of a period are these loans of securities?

Mr. STEWART. The average is 2 weeks or less.

Senator PACKWOOD. What is the going rate that an institution like yours would charge for that period?

Mr. STEWART. Generally we can earn the going short-term interest rate. As you know, today that is a little over 6 percent. Generally, however, we earn less than that because the procedure that I am describing where sometimes——

Senator PACKWOOD. Do you make these loans because there are simply not enough stock certificates and stock around for brokers to fulfill their commitments, so they come and borrow the stock from you on a very short term—100 percent collateralized basis and you very soon get the stock back?

Mr. STEWART. That is right. They are in need of these securities on very short notice and do return them as soon as they find their securities.

Under either arrangement—the second type being another type of transaction where the institution is paid a negotiated fee rather than receiving cash and earning interest itself—under either of these arrangements, the institution or the broker can terminate the lending relationship upon notice and, in such instances, the broker becomes obliged to return the same number of shares of the securities borrowed to the institution which retained the beneficial interest therein and the institution becomes obliged to return the collateral.

In event of default on the part of the broker, the lending institution is required to use the collateral to purchase replacement securities and has a claim against the borrowing broker for any deficiency. Any excess funds derived from the process of seeking replacement securities must be returned to the broker.

Thus, the institution's portfolio position cannot be improved by virtue of any default by a broker-borrower. Any dividend or interest which comes due during the course of a lending period must be paid by the borrowing broker to the lending institution.

In a number of instances going back over a period of 3 or more years, questions have been raised as to whether the lending of securities by the institution is a trade or business and, if so, whether the fee paid or the interest earned on the collateral and the interim dividend and/or interest payments made by the broker constitute unrelated business income taxable under section 513(a) subject to the modifications of section 512(b).

In the meantime, any exempt institutions which could make their securities available to brokers and, thus, increase the stability of the marketplace have refused to do so until the issue is disposed of by the Internal Revenue Service.

Senator PACKWOOD. The issue is whether this is related or unrelated business income, taxable or not taxable?

Mr. STEWART. Exactly.

Senator PACKWOOD. You are not really in the common business of selling stocks and bonds. You are simply a backup reservoir for those who are involved in that business so that they can fulfill their commitments.

Mr. STEWART. Yes. As you may be aware, until some years ago, generally the broker-dealers were able to accommodate one another. As the volume of trading expanded, they had to seek other sources and come generally to institutions with large portfolios.

Whether the broker is entitled to the interest, the Internal Revenue Service has suggested that the transaction is really a borrowing of the collateral by the lender and the securities are really collateral from the lender's loan. In such case, the contention is made that there is an acquisition indebtedness giving rise to the treatment of the interest earned on the collateral as being unrelated debt-financed income.

However, there seems to be common agreement that this kind of transaction is a passive use of investment assets of a nature which Congress did not intend.

Senator PACKWOOD. I will have to call your portion of this to a close because of the time limit. I understand the issue very clearly. I do not agree with the Internal Revenue Service. I agree with your position.

[The prepared statement of Mr. Stewart follows:]

STATEMENT OF GEORGE STEWART, JOHNS HOPKINS UNIVERSITY

My name is George Stewart and I am Treasurer of Johns Hopkins University. I appear on behalf of my institution and a number of colleges and universities.

Exempt charitable and educational institutions, including colleges and universities, have engaged in the practice of lending securities (stocks and bonds) from their investment portfolios to various brokerage houses to enable the brokers to make delivery of such securities to cover either a short sale or a failure to receive securities. In these transactions, the broker receiving the certificates posts cash collateral (or in some cases U.S. Treasury bonds) in an amount equivalent to or exceeding the then fair market value of the particular securities being borrowed. These arrangements are generally of two types:

(a) In one, the collateral is available to the institution during the period of the loan. If the collateral is bonds, the institution is entitled to the interest earned thereon. If the collateral is cash, the institution may invest the assets as it deems appropriate and retain any earnings derived therefrom. Normally, the collateral is invested in such a way as to generate income in the form of interest.

(b) In another type of transaction, the institution is paid a negotiated fee to compensate it for the borrowing of the securities and the income on the collateral.

Under either arrangement, the institution or the broker can terminate the lending relationship upon notice. In such instance, the broker becomes obliged to return the same number of shares of the securities borrowed to the institution which has retained the beneficial interest therein and the institution becomes obliged to return the collateral to the broker.

In the event of default on the part of the broker, the lending institution is required to use the collateral to purchase replacement securities and has a claim against the borrowing broker for any deficiency. Any excess funds derived from the process of seeking replacement securities must be returned to the broker. Thus, the institution's portfolio position cannot be improved by virtue of any default by a broker-borrower. Any dividend or interest which comes due during the course of the lending period must be paid by the borrowing broker to the lending institution.

In a number of instances going back over a period of three or more years, questions have been raised as to whether the lending of the securities by the institution is a trade or business and, if so, whether the fee paid or the interest earned on the collateral and the interim dividend and/or interest payments made by the broker constitute unrelated business income taxable under Section 513 (a) subject to the modifications of Section 512(b). In the meantime, many exempt institutions which could make their securities available to brokers and, thus, increase the stability of the marketplace have refused to do so until the issue has been disposed of by the Internal Revenue Service.

Where the broker is entitled to the interest on the cash collateral, representatives of the Service have suggested that the transaction is really a borrowing of the collateral by the lender and "the lent securities are really collateral for the lender's loan." In such case, the contention is made that there is an acquisition indebtedness giving rise to the treatment of the interest earned on the collateral as unrelated debt-financing income. However, there seems to be common agreement that this kind of transaction is a passive use of investment assets of a nature which Congress did not intend to be taxed. As was noted in the Senate Finance Committee report with respect to this matter:

"Dividends, interest, royalties, most rents, capital gains and losses and *similar items* are excluded from the base of the tax on unrelated income because your committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income." (Senate Report 2375, 81st Cong., 2nd Sess. (1950), pages 30–31.) (Italic supplied.)

And that such income did not arise "from active business enterprises which are unrelated to the exempt purposes of the organizations." (Senate Report, *supra*, page 27.)

Moreover, as the Securities and Exchange Commission has made clear in letters to the Internal Revenue Service, the availability of securities for lending in this fashion fulfills a significant public function in assuring the stability of the marketplace by providing securities for delivery by brokers to customers.

Near the end of the session in 1976, the Finance Committee approved the addition of a similar bill (S. 3811) to H.R. 7929. The proposal was supported by the Treasury Department which advised the Office of Management and Budget that it had no objection to its position. At this session, in response to the Chairman's request, the then Chief of the Joint Committee on Internal Revenue Taxation indicated that the staff saw no reason why the bill should not be supported. The sponsor further indicated that, in addition, the Securities and Exchange Commission supported the amendment.

On behalf of a number of colleges and universities, some of which have engaged in securities lending and others of which would do so if the threat of the unrelated trade or business challenge were removed and in the interest of other exempt organizations similarly situated, I would urge that the proposed bill be approved by the subcommittee on the grounds that the lending of securities is the kind of passive use of investment assets which Congress did not not intend to subject to tax and, further, that such lending serves a clear public purpose as indicated by the Securities and Exchange Commission.

Because of the short notice which we received with respect to my appearance before this Committee, I would like to reserve the right to submit a more detailed statement for inclusion in the record if that should seem appropriate or necessary.

Senator PACKWOOD. Mr. Tierney.

STATEMENT OF WILLIAM J. TIERNEY, VICE PRESIDENT, SALOMON BROS.

Mr. TIERNEY. Mr. Chairman, my name is William J. Tierney. I am vice president of Salomon Bros.

Senator PACKWOOD. You would be on the other side of this?

Mr. TIERNEY. Yes.

I appreciate the opportunity to be before you in respect to the bill introduced by Senator Packwood that would provide that income derived by exempt organizations from lending of securities in their portfolios should be treated in the same manner as dividends and interest, and hence exempt from tax.

I shall endeavor to explain what securities lending is, what function it serves, and why the SEC has taken the position that increased availability of securities for lending would have a most salutary effect.

My oral statement will be as brief as possible. I am most anxious to conserve the committee's time, and therefore I would like to file copies of letters written by the Chairman of the SEC and certain material previously prepared by Salomon Bros. with respect to loans of securities for the record, marked "appendix A" and "appendix B"; they are attached to this statement.

Let us turn first to what is meant by a securities loan, and the circumstances under which it becomes necessary for a broker-dealer to borrow certificates representing securities. When a broker-dealer sells a security for its customer, it settles the transaction by receiving the security from the customer and redelivering it to a clearing facility or directly to the buyer.

On the other hand, when a broker-dealer purchases a security as agent for a customer, it receives the security from the clearing facility or directly from the seller, or its agent, and redelivers it to the customer.

In either event, if the broker-dealer fails to receive the physical certificates evidencing the security, it will be unable to make a timely delivery unless it is able to "borrow" a block of identical securities from another holder.

Fails to receive may also occur when the seller has sold "short", that is, when a security which is not owned by the seller is sold to a third party.

If the broker-dealer can effect a borrowing of physical certificates, he uses the borrowed certificates to make delivery, and thereby avoids creating an incompleted transaction.

When the original security is received, the borrowed certificates are returned. Despite efforts to eliminate the necessity for physical delivery or certificates by means of clearing facilities and depositories, such delivery is still the principal means of consummating transactions of corporate securities.

Consequently, the SEC has concluded that the borrowing of securities can improve the efficiency of clearance and settlement functions.

The proposed bill contemplates that the terms of securities loans entered into by exempt organizations would comply with the requirements imposed by the SEC on regulated investment companies which lend securities.

Under these requirements a broker-dealer must post collateral with a value equal to that of the securities borrowed; adjustments of collateral are required on a daily basis so that the lender is always fully secured.

In addition, the lender has the right to terminate the loan at any time upon notice of no more than 5 business days, whereupon the broker-dealer is required to return certificates for the borrowed securities.

The 5-day notice is fixed in light of the fact that an institution which sells securities will have 5 days following the trade date within which to make timely settlement by delivery of physical certificates returned by the broker-dealer.

The lender therefore continues to be in full control of its portfolio, and may sell although certificates for such securities may have been loaned to a broker.

Compensation received by lenders of securities may take several forms. Certain borrowers furnish short-term, marketable securities as collateral and pay a fee, or permit the lender to retail all or a portion of the income on such securities.

Others furnish cash as collateral; in such cases, the lender may retain some or all of the interest or dividends attributable to investments made with the cash.

If a loan of securities extends over a record date the borrower is required to pay the lender an amount equal to the dividends or interest which the lender would have received if the borrowed securities had been registered in its name on the record date.

The lending of securities along the lines which I have just described has been approved by various government agencies with jurisdiction over a variety of institutional investors.

For example, the SEC has granted such authorization to registered investment companies, and the Comptroller of the Currency has taken similar action with respect to pension funds and other accounts managed by the trust departments of national banks.

The lender with the largest volume of securities loans at present is the Federal Reserve Board. However, pension trusts and exempt institutions, which hold a substantial percentage of common stocks and corporate bonds, have generally been unwilling to lend securities due to the existing uncertainty regarding the classification of such income for tax purposes.

The lending of securities is a passive adjunct to normal portfolio management activities. Each judgment to buy, sell or hold a security continues to be made solely on the merits of the security as an investment, and without regard to the fact that the certificates for such security had been, or might conceivably be, loaned to a broker.

This is due to the fact that brokers' needs for certificates of any particular security are unpredictable. Therefore, whether a security might be borrowed, and the likely duration of such loan could not be determined in advance.

Moreover, experience has shown that most securities loans entered into by a broker-dealer are outstanding for only a brief period of time, generally measured in days or weeks, rather than months.

The modest return from lending securities would have no impact on investment portfolio decisions.

However, such income would enable educational institutions, pension funds and other exempt entities to increase their current portfolio yield through fully secured transactions as an adjunct to routine portfolio management.

The bill would recognize the passive nature of income derived from such loans, and treat it for tax purposes in the same manner as interest, dividends and rental income.

In summary, we respectfully urge the committee to give favorable consideration to the bill introduced by the Honorable Senator Packwood. It is in the public interest, and clarifies the character of payments on securities loans in a manner entirely consistent with the spirit and letter of existing Internal Revenue Code provisions which recognize that income from passive investments should be a tax-free source of revenue for educational and charitable entities and pension trusts.

Senator PACKWOOD. Thank you. I have no questions. I appreciate your coming down.

[The prepared statement of Mr. Tierney follows:]

STATEMENT OF WILLIAM JOSEPH TIERNEY, JR., VICE PRESIDENT—OPERATIONS, SALOMON BROTHERS

Mr. Chairman and members of the committee, my name is William J. Tierney, Jr. I am Vice President—Operations of Salomon Brothers. I have served in this capacity for approximately seven years, and have had extensive experience in supervising the borrowing of securities on behalf of one of the largest broker-dealers in the nation. I greatly appreciate the opportunity to appear before you with respect to the bill introduced by Senator Packwood (for himself and Senator Ribicoff) which would provide that income derived by exempt organizations from lending of securities in their portfolios should be treated in the same manner as dividends and interest, and hence exempt from tax. I shall endeavor to explain what securities lending is, what function it serves, and why the SEC has taken the position that increased availability of securities for lending would have a most salutary effect.

My oral statement will be as brief as possible. I am most anxious to conserve the Committee's time, and therefore I would like to file copies of letters written by the Chairman of the SEC and certain material previously prepared by Salomon Brothers with respect to loans of securities for the record, marked "Appendix A" and "Appendix B"; they are attached to this statement.

Let us turn first to what is meant by a securities loan, and the circumstances under which it becomes necessary for a broker-dealer to borrow certificates representing securities. When a broker-dealer sells a security for its customer, it settles the transaction by receiving the security from the customer and re-delivering it to a clearing facility or directly to the buyer. On the other hand, when a broker-dealer purchases a security as agent for a customer, it receives the security from the clearing facility or directly from the seller, or its agent, and redelivers it to the customer. In either event, if the broker-dealer fails to receive the physical certificates evidencing the security, it will be unable to make a timely delivery unless it is able to "borrow" a block of identical securities from another holder. Fails to receive may also occur when the seller has sold "short", i.e., when a security which is not owned by the seller is sold to a third party. If the broker-dealer can effect a borrowing of physical certificates, he uses the borrowed certificates to make delivery, and thereby avoids creating an incompleted transaction. When the original security is received, the borrowed certificates are returned. Despite efforts to eliminate the necessity for physical delivery of certificates by means of clearing facilities and depositories, such delivery is still the principal means of consummating transactions of corporate securities. Consequently, the SEC has concluded that the borrowing of securities can improve the efficiency of clearance and settlement functions.

The proposed bill contemplates that the terms of securities loans entered into by exempt organizations would comply with the requirements imposed by the SEC on regulated investment companies which lend securities. Under these requirements a broker-dealer must post collateral with a value equal to that of the securities borrowed: adjustments of collateral are required on a daily basis so that the lender is always fully secured. In addition, the lender has the right to terminate the loan at any time upon notice of no more than 5 business days, whereupon the broker-dealer is required to return certificates for the borrowed securities. The 5 day notice is fixed in light of the fact that an institution which sells securities will have 5 days following the trade date within which to make timely settlement by delivery of physical certificates returned by the broker-dealer. The lender therefore continues to be in full control of its portfolio, and may sell although certificates for such securities may have been loaned to a broker.

Compensation received by lenders of securities may take several forms. Certain borrowers furnish short-term, marketable securities as collateral and pay a fee, or permit the lender to retain all or a portion of the income on such securities. Others furnish cash as collateral; in such cases, the lender may retain some or all of any interest or dividends attributable to investments made with the cash. If a loan of securities extends over a record date the borrower is required to pay the lender an amount equal to the dividends or interest which the lender would have received if the borrowed securities had been registered in its name on the record date.

The lending of securities along the lines which I have just described has been approved by various government agencies with jurisdiction over a variety of institutional investors. For example, the SEC has granted such authorization to registered investment companies, and the Comptroller of the Currency has taken similar action with respect to pension funds and other accounts managed by the trust departments of national banks. The lender with the largest volume of securities loans at present is the Federal Reserve Board. However, pension trusts and exempt institutions, which hold a substantial percentage of common stocks and corporate bonds, have generally been unwilling to lend securities due to the existing uncertainty regarding the classification of such income for tax purposes.

The lending of securities is a passive adjunct to normal portfolio management activities. Each judgment to buy, sell or hold a security continues to be made solely on the merits of the security as an investment, and without regard to the fact that the certificates for such security had been, or might conceivably be, loaned to a broker. This is due to the fact that brokers' needs for certificates of any particular security are unpredictable. Therefore, whether a security might be borrowed, and the likely duration of such loan could not be determined in advance. Moreover, experience has shown that most securities loans entered into by a broker-dealer are outstanding for only a brief period of time, generally measured in days or weeks, rather than months. The modest return from lending securities would have no impact on investment portfolio decisions.[1]

However, such income would enable educational institutions, pension funds and other exempt entities to increase their current portfolio yield through fully secured transactions as an adjunct to routine portfolio management. The bill would recognize the passive nature of income derived from such loans, and treat it for tax purposes in the same manner as interest, dividends and rental income.

In summary, we respectfully urge the Committee to give favorable consideration to the bill introduced by the Honorable Senator Packwood. It is in the public interest, and clarifies the character of payments on securities loans in a manner entirely consistent with the spirit and letter of existing Internal Revenue Code provisions which recognize that income from passive investments should be a tax-free source of revenue fo- educational and charitable entities and pension trusts.

APPENDIX A

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Re Availability of corporate securities for lending to facilitate settlement of securities transactions.

Hon. DONALD C. ALEXANDER,
Commissioner of Internal Revenue Service,
Department of the Treasury,
Washington, D.C.

DEAR MR. ALEXANDER: The availability of securities for lending to facilitate the the settlement of securities transactions is a matter of some concern to the securities industry. Because current and future tax policies may have some bearing on this matter, I am taking this opportunity to apprise you of the situation and its ramifications.

When a broker-dealer sells a security as agent for a customer, it settles the transaction by receiving the security from the customer and redelivering it to the appropriate clearing facility or directly to the buyer. On the other hand, when a broker-dealer purchases a security as agent for a customer, it receives the security from the clearing facility or directly from the seller, or its agent, and redelivers it to the customer, in general, after transferring the security into the customer's name. In either event, if the broker-dealer fails to receive the security, it likely will not be able to deliver it, unless other identical securities of the same issuer are readily available for borrowing. Similar situations occur when the broker-dealer is acting as principal rather than as agent.

These situations may arise from a variety of circumstances, including, among others: the customer's securities are in "legal form" and must first be transferred into "good deliverable form"; the customer has not sold his entire holdings

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[1] The amount which institutions receive as compensation for lending a security is related to the broker's loan rate on commercial bank borrowings during the term of the loan. At present, major institutional lenders earn a yield of about 3 percent on loans of equity securities, approximately 2 percent on loans of corporate bonds, and ½ to ¾ of 1 percent on loans of U.S. Government bonds. If a loan of securities were outstanding for two months (a period which is longer than the vast majority of cases) and the compensation received by the lender were 3 percent on an annual basis, the lender's actual yield for that loan would be 0.5 percent of the value of the security. It is obvious that such a modest return could not cause an institution to acquire a security, and could not act as a disincentive in the event that a sale would otherwise be deemed advisable in light of market conditions or the outlook for the issuer.

and must have the certificates broken down into smaller denominations for delivery; or the seller has sold the securities short. One of the most common reasons, however, is that the seller or his broker-dealer has itself failed to receive the security from a previous seller. (For example, customer X of Broker A sells to Marketmaker B, who sells to Trader C, who sells to Broker D for its customer Y; if customer X fails to deliver to Broker A, as a consequence, four additional incomplete transactions may be created.) It was the realization of this possibility of an initial failure to complete a transaction to create a continuous chain of incompleted transactions that was one of the primary causes of the securities processing crisis of the late 1960's and early 1970's.[1]

Over the last few years the Securities and Exchange Commission and the securities industry self-regulatory organizations (the stock exchanges and the National Association of Securities Dealers, Inc.) have instituted a number of reforms designed to improve the processing of securities transactions and thus to reduce incompleted transactions. The level of incompleted transactions between broker-dealers may be reduced through the use of sophisticated clearing facilities by netting transactions among participants and thereby reducing the number of securities movements which are necessary to complete transactions among participants and thereby reducing the number of securities movements which are necessary to complete transactions and eliminating chains of incompleted transactions.[2]

Such clearing facilities or depositories, however, cannot reduce the level of incompleted transactions where the parties to such transactions are not members of these clearing facilities or depositories but rather are customers of broker-dealers or, the particular securities are not cleared through any clearing facility or included in a depository. Thus, many such incompleted transactions are unavoidable. Even so, if the broker-dealer obligated to deliver a security can borrow an identical security from another holder, and use the borrowed security to make delivery, at least a chain of incompleted transactions may be avoided. And, when the original security is received, the borrowed security can be returned.

Consequently, the Commission believes that the borrowing of securities to settle securities transactions can, depending upon the circumstances, be a useful and desirable technique to improve the securities processing mechanism and reduce incompleted transactions. The rules promulgated by the Board of Governors of the Federal Reserve System appear to foster such an approach, since those rules permit broker-dealers to borrow securities for the purpose of making deliveries of such securities, without regard to the margin limitations otherwise imposed by Regulation T.[3]

The borrowing of securities by broker-dealers to complete deliveries, to avoid "fails" and to cover short sales is thus quite extensive. The New York Stock Exchange reports, for example, that, at the end of December, 1973, its members had outstanding borrowings of securities of approximately $1 billion.

A principal obstacle to increasing the borrowing of securities appears to be the limited supply of such securities available for loan. A portion of the securities currently borrowed are securities in customer's margin accounts and the supply, we are advised, is not adequate to meet demand because a large percentage of common stocks and most corporate bonds are held by institutional investors, primarily pension funds, investment companies and insurance companies.

We understand that, with the very recent exception of insurance companies, these institutional investors have not been lenders of securities because of their doubts about the tax status of the payments that would be made to them. These payments include not only the borrowing fee, but also any payments made in lieu of dividends, interest and other distributions by the issuer of the securities.[4] The characterization of those payments for income tax purposes may be determinative of whether it is profitable for various types of institutional investors to make securities loans. If the source of such borrowings is inhibited or eliminated

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[1] See, Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92–231, 92d Cong., 1st Sess. (1971).

[2] Depositories also reduce securities movements by holding large amounts of securities and effecting delivery between participants solely by book entry and without the necessity for actual receipt and delivery of certificates by the participants.

[3] See 12 CFR 220.6(h).

[4] Since the broker-dealer has redelivered the security to its purchaser and is not the holder of record, it is not in a position to flow through the actual distribution to the lender and can only make a payment in lieu of it.

because institutional investors will incur adverse tax consequences if they lend their securities, both the level of incompleted transactions could increase and the ability to effect short sales could be reduced. On the other hand, to the extent an increased amount of borrowable securities is available, it is quite possible that the current level of incompleted transactions could be further reduced.

We are advised that a number of such investors may have filed, or may be about to file, requests for revenue rulings to resolve the question with respect to the proper classification of such payments. These requests involve complicated provisions of the Internal Revenue Code and of tax policy as to which the Commission, of course, does not have any expertise. If, however, favorable revenue rulings are issued, thereby encouraging institutional investors to lend their securities, based on the current volume of fails, knowledgeable members of the brokerage industry estimate that substantial additional borrowings could take place, significantly reducing "fails" in the securities markets. This would improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry, which needs to operate as efficiently as it can in order to discharge its resonsibilities.

We hope that this background information will be useful to the Internal Revenue Service in considering any requests for rulings you have received or may receive on this important subject.

Sincerely yours,

RAY GARRETT, Jr., *Chairman.*

SECURITIES AND EXCHANGE COMMISSION.
Washington, D.C., March 19, 1975.

Re Availability of corporate securities for lending to facilitate settlement of securities transactions.

HON. DONALD C. ALEXANDER,
Commissioner of Internal Revenue Service,
Department of the Treasury,
Washington, D.C.

DEAR MR. ALEXANDER: Last year, the Commission determined that I should write to you to advise you of its views with respect to the availability of corporate securities for lending to facilitate the settlement of securities transactions. At that time, we were aware that some institutional investors were contemplating requesting revenue rulings to clarify the tax status of the payments that would be made to them if they were to lend securities. Since that time, we understand that requests have been made for revenue rulings by at least some institutional investors who, in the absence of a favorable ruling, have indicated their reluctance to become lenders of securities.

As I indicated to you in my prior letter, the Commission, of course, is not purporting to express any opinion on matters of tax policy or any interpretation of the Internal Revenue Code. We do believe, however, that favorable rulings could result in substantial additional borrowings, significantly reducing "fails" in the securities markets and, concomitantly, could improve the efficiency of the clearance and settlement functions in these markets with resulting savings for the securities industry. Since the time of my first letter, the aggregate dollar value of "fails" has decreased, due to the important strides that have been made over the last five years by the Commission and the securities industry to maintain regulatory control over this situation. Nevertheless, the very recent increase in trading activity we have been witnessing has been accompanied by an increase in the dollar value of fails generally; a favorable tax ruling would permit these fails to be reduced by the lending of securities, augmenting continuing regulatory efforts. Indeed, since our last letter, the dollar value of fails in the corporate bond area has increased by at least ten percent, and this particularly is an area where the corporate lending of securities could prove most salutary.

In light of our interest in this matter, the Commission would appreciate it if you could apprise us of the current status of any requests you have received on this matter. Naturally, if we can be of any assistance to you in your consideration of this matter, you should feel free to call upon us.

Sincerely yours,

RAY GARRETT, Jr., *Chairman.*

Appendix B

Prepared Statement of Salomon Brothers

THE IMPORTANCE OF FAVORABLE TAX TREATMENT FOR LOANS OF SECURITIES BY INSTITUTIONAL INVESTORS

Despite efforts to eliminate the necessity for physical delivery of corporate stock and bond certificates, such delivery is still the principal means of consummating transactions in such corporate securities.[1] For example, in a transaction involving a seller, a buyer and a different broker for each, the seller's broker must deliver certificates for the security that is the subject of the transaction against payment to the buyer's broker within five business days after the trade date. If for any reason the seller's broker fails to receive the security from its customer, it will be unable to complete the transaction. Because securities transactions generally involve multiple transfers of securities, a break in the chain at any point in a securities transaction may result in a number of fails to deliver and fails to receive unless identical securities are available.

A broker-dealer's "failure to receive" securities can be the result of a number of different circumstances. For example, a significant reason for fails is that securities must be delivered in the exact amount being sold in order to complete a transaction. In many instances, where the seller has sold less than his entire position in a particular security, the seller must exchange the security into different denominations so that he can make appropriate delivery. The mechanical steps involved in retrieving the securities from wherever they are being held for safekeeping and delivering them to the transfer agent (and registrar) for exchange and subsequently delivering them to the broker-dealer involve necessary, but unavoidable, delay. Fails may also occur when the seller has sold short, i.e., when a security which is not owned by the seller is sold to a third party.

The Securities and Exchange Commission has been formulating and implementing a comprehensive program to avoid a repetition of the securities processing crisis of 1968–1971. As part of its program the Commission has instituted a number of reforms, such as mandatory buy-in requirements, designed to reduce the number of initial fails-to-receive. But many such fails are unavoidable. The next best alternative is to insure at least that the fail-to-receive does not set off a chain reaction. This can be done if the broker-dealer owing the security can borrow an identical security from another holder and use it to make the delivery to the broker-dealer on the other side. Then, when the original security is finally delivered, the broker-dealer can use it to pay off the loan.

The Commission encourages the borrowing of securities to keep unavoidable fails-to-receive from spreading further. The Federal Reserve Board pursues a comparable policy. It specifically permits securities borrowing in its margin regulations[2] to enable brokers and dealers to make deliveries in the case of short sales and fails-to-receive and directly facilitates the lending of securities to cover fails by lending its own portfolio securities through the Federal Reserve Bank of New York. This policy has also been followed by the various self-regulatory organizations within the securities industry. The New York Stock Exchange, for example, requires its members to be in a position to cover a short sale before it is entered into and specifically permits borrowings to cover such a position. In a recent Educational Circular, the New York Stock Exchange advised member firms that:

"Orders to sell short should not be executed or entered into without reasonable assurance that delivery can be made on the settlement date. Such assurance preferably should be through prior arrangement to borrow. Other reasonable assurance includes knowledge that the security is available for borrowing."

As a result of these efforts the value of securities borrowed by broker-dealers has become very significant. According to the New York Stock Exchange, in December 1973, its member firms had average outstanding borrowings of securi-

[1] A central depository has been established by the New York Stock Exchange for those securities deposited in it, and transfers of such securities can take place among depositors without the physical transfer or delivery of certificates. For a variety of reasons, however, a large number of tansactions are not settled within the system.

[2] Since the lender of securities may use the collateral directly or indirectly to purchase or carry securities, an exemption is necessary.

ties in excess of $1 billion against cash collateral. Substantial borrowings are also made against the pledge of U.S. Government securities. However, this is still only a fraction of the potential need for securities borrowing. During the same month the New York Stock Exchange reported that its members were failing to deliver some $3 billion in securities to their customers and $1.5 billion to each other. It seems apparent that the securities markets are still plagued by fails-to-deliver that could be avoided by borrowing.

Although securities are currently borrowed by broker-dealers from savings banks, savings and loan associations, other broker-dealers and insurance companies, certain large institutions, particularly pension funds managed by commercial banks and investment companies, have been unwilling to lend their securities. Since such institutions currently hold a large percentage of the common stocks and corporate bonds held by institutional investors and, for the reasons set forth below, are unwilling to lend securities to broker-dealers, the supply of securities currently available for loan is greatly restricted.

This lack of supply has made it uneconomical in most cases for broker-dealers to borrow the corporate securities that are available. The scarcity of the securities has resulted in a cost of borrowing that usually leaves no economic incentive for the broker-dealer to make a loan. A typical arrangement is for the broker-dealer to deposit cash collateral for the loan at least equal to the market value of the securities. The lender invests the cash in the money market and generally retains the entire return. The broker-dealer borrows the cash collateral from a commercial bank at the brokers' loan rate, so there is no advantage to it in borrowing the securities in order to obtain the return of the same amount of cash when it delivers them. As a result, broker-dealers have tended to borrow securities only when required or encouraged to do so by regulation or as part of reciprocal arrangements among broker-dealers for the mutual borrowing of customers' margin securities.

The borrowing of U.S. Government securities is usually conducted on an entirely different basis. Instead of depositing cash collateral, the broker-dealer pledges other U.S. Government securities and pays the lender a negotiated fee. Because there is a sufficient supply of these securities available for loan, free market forces have resulted in a fee that is only a fraction of the brokers' loan rate. Under these arrangements the broker-dealer has a strong economic incentive to borrow the securities in order to obtain the proceeds from its buyer at a cost that is substantially less than the brokers' loan rate. The broker-dealer can then use this cash to pay off some of its outstanding bank loans and thus reduce its overall financing costs. If institutional investors were generally willing to lend their portfolios of corporate securities, similar market forces should reduce the cost of borrowing such securities.

Various government agencies with regulatory jurisdiction over institutional investors have recently taken steps to enable them to lend their securities. For example, the Securities and Exchange Commission has granted such authorization to registered investment companies, and the Comptroller of the Currency has taken similar action with respect to pension funds and other accounts managed by the trust departments of national banks. The one major obstacle remaining to extensive lending activities by most institutional investors is doubt about the tax status of the payments that would be made to them by the broker-dealers that borrowed the securities. These payments include not only the borrowing fee, but also any payments made in lieu of dividends, interests and other distributions by the issuer of the securities.[3] In the case of some institutional investors that are either tax exempt or are non-taxable as conduits, the issue is principally whether these payments are taxable. We are told by such institutions that if such income is taxable, it would not only reduce or eliminate the return from lending securities[4] but would also require the filing of detailed tax returns by them; moreover, in the case of some institutional investors such as foundations the payments, if sufficiently large, could jeopardize their current tax status.

Appendix

If payments made during the loan period to an otherwise tax-exempt lender are taxed, no such lender will allow a loan of securities to extend over the date interest or a dividend is payable. To allow a loan to extend over the payment

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[3] Since the broker-dealer has redelivered the security to its purchaser and is not the holder of record, it is not in a position to flow through the actual distribution to the lender and can only make a payment in lieu of it.

[4] See Appendix for an explanation of the economic factors underlying this statement.

date would decrease the after-tax yield on such payments by 48 percent, and such a decrease would generally not be compensated for by the borrowing fee received for the whole loan period.

At present, the average securities loan remains outstanding for approximately one month. If, for example, the borrowing fee on securities loans where 5 percent per annum, the after-tax yield on the borrowing fee for a one month loan would be approximately 0.2 percent of the value of the securities:

	Percent
5 percent annual rate for 1-month yields	0.4
48 percent on borrowing fee reduces yield by	.2
Net yield	.2

Unless a stock, paying dividends quarterly, yielded significantly less than 2 percent per annum, the borrowing fee would not compensate for the after-tax yield lost due to the tax upon the payments in respect of dividends.

$100,000 of stock yielding 2 percent annually

Stock not on loan:	
Quarterly dividend (not taxed)	$500
Stock on loan at 5 percent for 1 month:	
Quarterly dividend	500
Borrowing fee	417
Total before taxes	917
Tax (48 percent)	440
Net after taxes	477

The same principle is applicable to corporate bonds, and since such bonds yield substantially more than 2 percent, no bonds would remain on loan over an interest payment date. If tax-exempt lenders generally were to insist upon the return of their securities before a dividend or interest payment date, the benefits to the securities markets from the increased securities loans during the balance of the year would be more than offset by the confusion which would occur near the time of a dividend or interest payment date.

Senator PACKWOOD. Next we will take a panel consisting of Roger Hitzhusen, Mr. McMillan, and Mr. Larson.

STATEMENT OF ROBERT L. HITZHUSEN, ASSISTANT DIRECTOR, NATIONAL AFFAIRS, AMERICAN FARM BUREAU

Mr. HITZHUSEN. I appreciate your attempt in pronouncing my name. Many people have trouble with it.

I am Robert Hitzhusen, assistant director for national affairs, American Farm Bureau. The Farm Bureau appreciates this opportunity to present our views on the carryover basis of the Tax Reform Act of 1976. The Farm Bureau members have been actively involved in the past several years in seeking reform of the Federal estate and gift tax law. Some measure of gift and estate tax relief was achieved in the Tax Reform Act of 1976. However, much of this relief will be offset in the years to come by the greatly increased capital gains liabilities created by the carryover basis provision.

This provision is the most objectionable provision of the Tax Reform Act of 1976 to farm and ranch families. Our members voiced their strong opposition to this provision by adopting the following policy for 1977: "We urge repeal of the capital gains carryover basis provision of the Tax Reform Act of 1976." Opposition to this provision reflects first, the complexity involved in applying the carryover basis and second, the adverse effects which the provision produces.

The complexity of applying the carryover basis provision has been described to us at length by several tax practitioners. The provision provides that gains occurring prior to December 31, 1976, will not be subject to the new carryover basis rule.

In the case of property other than marketable stocks and bonds, however, gains occurring prior to December 31, 1976, are to be determined by prorating total realized gains on the basis of the number of days in the holding period before December 31, 1976, and the number that occurred after that date.

This means that records, methods, and formulas are required to determine the decedent's basis for each piece of property other than marketable securities in the estate.

It is not uncommon for farms to be built up over several years with the acquisition of several small pieces of property at different times and at different prices.

In addition, many material improvements may have been added to each purchased property which further complicates the determination of the decedent's basis.

It is not uncommon for a farmer and rancher to have many separate pieces of machinery each requiring a separate basis calculation.

Livestock, particularly livestock raised on the farm or obtained in exchange for raised livestock, further complicates the process.

Few farmers other than the very few with complete, computerized records will have the information needed to support an accurate computation, especially for property acquired many years ago.

Aside from the administrative complexities, we believe the carryover basis will have a particularly adverse effect on farm and ranch families. Many farm families receive extremely low returns on invested capital—historically, about 3 percent—with the hope that these low returns can at least partially be offset by increases in the value of their assets.

The appreciation of assets has been farm families' best protection from inflation and has provided them with some assurance of adequate resources for retirement. This has been an important fact when the Consumer Price Index increased over 300 percent from 1940 to 1976.

Since carryover basis affects capital appreciation it affects income tax liability rather than estate and gift taxes. Federal tax laws do not distinguish between appreciation due to inflation and appreciation which represents an increase in the real value of an asset. Consequently, in the case of assets held over a long period of time, the tax on capital gains becomes a tax on capital to the extent that capital values are increased by inflation.

The tax on capital gains hits farmers and ranchers particularly hard because of the long holding periods typical of farm assets.

In summary, because of the complexities of the carryover basis and its adverse impact on farm and ranch families and other closely held businesses we urge this committee to favorably report legislation to repeal this provision of the Tax Reform Act of 1976.

Senator Packwood, I would ask that the entire statement be inserted, since I skipped over some of it.

Senator PACKWOOD. Your entire statement will be inserted.

STATEMENT OF C. W. McMILLAN, VICE PRESIDENT, GOVERNMENT AFFAIRS, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. McMILLAN. I am C. W. McMillan, vice president for government affairs of the National Cattlemen's Association. I am not only speaking on their behalf today but the Ad Hoc Agricultural Tax Committee which includes, in addition to the National Cattlemen, the American Horse Council, the National Association of Wheat Growers, the National Cotton Council of America, the National Livestock Tax Committee, the National Milk Producers Federation and the National Wool Growers Association.

I do have several letters from some of these organizations addressed to Senator Byrd, chairman of the subcommittee. I would appreciate their being included as a part of the hearing record.

Senator PACKWOOD. They will be included.

[The material to be furnished follows:]

NATIONAL COTTON COUNCIL OF AMERICA,
Washington, D.C., October 27, 1977.

Hon. RUSSELL LONG,
Chairman, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The National Cotton Council is the central organization of the U.S. cotton industry. Our delegate body is representative of all seven segments of the raw cotton industry—producers, ginners, warehousemen, crushers, merchants, cooperatives and manufacturers.

The Council favors repeal of the carryover basis provision of the 1976 Tax Reform Act. The complexity of compiling the necessary information in order to compute the income tax basis plus the forced liquidation of many family farm businesses in order to meet the tax obligation underlines the need for repeal. Our views on this subject are amplified in the statement filed by the Ad Hoc Agricultural Tax Committee.

We appreciate this opportunity to present our views and ask that this letter be made a part of the hearing record on this subject.

Sincerely,

ALBERT R. RUSSELL,
Executive Vice President.

NATIONAL ASSOCIATION OF WHEAT GROWERS,
Washington, D.C., October 27, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Senate Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Tax Reform Act of 1976 brought needed changes in Federal estate and gift tax law which were long overdue, but the Act also established the "carryover basis" provision which imposes significant hardships on all size agricultural estates. The effect of the provision is to compound tax liability problems for estates forced to sell property for estate tax or other purposes.

The law establishing the "carryover basis" is scarcely twelve months old, but the complexities and inequities inherent in the provision have become very apparent. Equally apparent is the fact that estates not subject to Federal estate taxes due to various credits and deductions may still have to pay higher income taxes if property is sold by the estate or the heirs. The burden created by this treatment could force liquidation of a family farm or its reduction to an uneconomic size which would lead to its ultimate failure.

The National Association of Wheat Growers supports repeal of the "carryover basis" provision, and it fully endorses testimony scheduled for presentation to your subcommittee in behalf of the Ad Hoc Agricultural Tax Commitee on this matter.

Sincerely,

DON HOWE, *President.*

NATIONAL MILK PRODUCERS FEDERATION,
Washington, D.C., October 26, 1977.

Hon. HARRY F. BYRD,
Chairman, Taxation and Debt Management General Subcommittee, Senate Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The National Milk Producers Federation represents the dairy farmers of the nation through their cooperatives. We are deeply disturbed over the impact of the carryover basis in the estate tax law on estates consisting largely of dairy farm operations.

We have, therefore, joined with others in the Ad Hoc Agricultural Tax Committee in presenting detailed views to your Committee urging repeal of this carryover basis.

Sincerely,

PATRICK B. HEALY, *Secretary.*

Mr. MCMILLAN. Also, I would appreciate my entire statement's being included because my intent is just to hit the high points.

Senator PACKWOOD. It will be included.

Mr. MCMILLAN. Thank you.

During the consideration of the Tax Reform Act of 1976 the National Cattlemen and American Farm Bureau Federation and others on the Ad Hoc Agricultural Tax Committee foresaw many of the complications and problems related to the carryover basis that we will be addressing ourselves to today.

Since that time, in spite of our efforts, there seems to be a groundswell of opposition. I guess that saying that appears on the front of the statue down at the Archives "What is past is prologue" is just as true today as it ever was.

Because of the complexity, the carryover basis will be extremely difficult to comply with as well as to administer. Moreover, the carryover basis will increase the tax burden and compound illiquidity of the estates of farmers and ranchers and other business operators that will have to sell property in order to raise sufficient cash to pay death taxes and administration expenses.

In addition, it will allow a new tax liability held by estates, even where there is no estate tax liability. For example, if a modest estate that has no estate tax liability has to sell property to divide the estate among the heirs, they incur a large capital gains tax. Contrary to many businesses, generally agriculture is not one that has much liquidity. In other words, there is not much liquidity available to pay death taxes and administration expenses on the death of a farmer-rancher, largely because the amount of the land owned by the decedent has to be considered.

When this occurs, the rancher's estate may be required to sell some of the land to pay death taxes even when the impact of such taxes may be ameliorated by the special farm use valuation and extended payment contained in the Tax Reform Act.

Such sale of such farmland will increase the total tax liability of the estate since the estate will have a capital gains tax to pay on the appreciation built into the land plus a Federal estate tax on the land's value.

The estates of many farmers and ranchers will not be able to bear this double tax burden which could mean the liquidation of the family farm or ranch.

With the need to maintain a sound and productive agricultural system and to provide the country with adequate supplies of food and fiber, the carryover basis would strike a lethal blow to this desired goal.

As to the complexities, for the record I have—and I apologize that it is not attached to the statement—an exhibit which I would appreciate being included in the hearing record which is an outline entitled "Computation of Carryover Basis." It was drafted by Mr. William R. McDonald, attorney and trust officer with the First National Bank of Denver, Colo.

[The exhibit referred to follows:]

EXHIBIT A

C-1

COMPUTATION OF CARRYOVER BASIS

(As of May 15, 1977) (1)

William R. McDonald

Trust Officer

First of Denver

Complete this form for all items except excluded personal goods, life insurance, and transferred property disposed of prior to death.

I. Computation of Fresh Start Basis (2)

(If traded security complete lines 1 and 5, enter 12/31/76 value on line 10, skip lines 2-4 & 6-9)

1. Estate Tax value of asset. (If income in respect of decedent, Sec. 72 annuity, or certain stock options, enter decedent's adjusted basis here and on lines 10 and 26. Skip lines 2-9 and 11-25). ____________
2. Date of death value of asset (2031 or 2032 A if elected; not 2032). ____________
3. Decedent's cost or acquired basis. ____________
4. Total depreciation, depletion or amortization for total holding period. ____________
5. Decedent's adjusted basis at death (line 3 minus line 4). ____________
6. Net appreciation of asset during total holding period (line 2 minus lines 4 and 5). ____________
7. Pre-1977 holding period (days) / Total holding period (days) ____________ (%)
8. Assumed pre-1977 net appreciation (line 6 times line 7). ____________
9. Actual pre-1977 depreciation, etc. ____________
10. Fresh start basis (total lines 5, 8 and 9). (Not to exceed line 1, except traded security) ____________
11. Remaining allocable appreciation (line 1 minus line 10). ____________

II. Computation of Property Subject to Tax.

12. Non-recourse mortgage on property at date of death (If none, enter amount on line 11 on line 14) ____________

13. Amount of asset subject to tax (line 1 minus line 12). ____________
14. Remaining appreciation subject to tax considering mortgage (line 13 minus line 10). ____________
15. Net value of asset for Federal estate tax purposes. ____________
16. Amount of asset qualifying for marital or charitable deduction. ____________
17. Amount of transfer subject to tax (line 15 minus line 16). ____________
18. Percent of transfer subject to tax (line 17 divided by line 15). ________(%)
19. Amount of transfer subject to tax attributable to basis of asset (line 18 times line 10). ____________
20. Remaining appreciation subject to tax considering deduction (line 18 times line 11). ____________

III. Adjustment for Taxes Paid by Estate. (3)

21. Maximum adjustment for taxes (lesser of lines 11, 14 or 20). ____________
22. Federal gross estate ____________
    Less: Marital Deduction ____________
    Charitable Deduction ____________
    Non Recourse Mortgages ____________
    Total property subject to Federal tax ____________
23. Total taxes paid by estate:
    a. Federal estate tax ____________
    b. State death taxes ____________ ____________
24. Overall tax rate (line 23 divided by line 22) ________(%)
25. Adjustment for taxes paid by estate (line 21 times line 24) ____________
26. Basis after adjustment for taxes paid by estate (line 10 plus line 25) ____________

IV. Minimum basis adjustment

27. Basis for purposes of minimum basis adjustment (for non-excluded personal and household goods, the lesser of line 1 or line 26. For all other items, line 26). ________

28. Total aggregate adjusted basis of all assets subject to carryover basis rules (total all lines 27). ________

29. Minimum basis adjustment 60,000

30. Maximum allocable minimum basis adjustment (line 29 minus line 28). ________

31. Aggregate estate tax value of all assets subject to carryover basis rules (total all lines 1). ________

32. Remaining net appreciation of all carryover basis property (line 31 minus line 28). ________

33. Portion of minimum basis adjustment allocable to each asset (line 30 divided by line 32). ________ (%)

34. Remaining allocable appreciation (lesser of line 11 or line 14, minus line 25). ________

35. Minimum basis adjustment for asset (line 33 times line 34). ________

36. Basis after minimum basis adjustment (line 26 plus line 35). ________

37. Remaining appreciation subject to tax. (line 34 minus line 35). ________

V. Adjustment for State Taxes Paid by Beneficiary

38. Amount of asset subject to state death taxes, minus line 36. ________

39. Total state death taxes paid by beneficiary. ________

40. Value of all property subject to state death tax passing to beneficiary. (Separately computed). ________

41. Overall tax rate (line 39 divided by line 40). ________ (%)

42. Adjustment for state death taxes (line 41 times line 38). ________

43. Final adjusted basis for purposes of determining capital gain or sale of asset (line 36 plus line 42).	

VI. Basis for Loss Purposes

44. Net appreciation of asset for loss purposes (line 1 minus line 5).	
45. Remaining appreciation subject to tax considering mortgage (line 13 minus line 5).	
46. Amount of appreciation of transfer subject to tax for loss purposes (line 18 times line 44).	
47. Maximum adjustment for taxes (lesser of lines 44, 45 and 46).	
48. Adjustment for taxes paid by estate (line 47 times line 24).	
49. Basis after adjustment for taxes paid by estate (line 5 plus line 48).	
50. Remaining allocable appreciation (lesser of lines 44 or 45 minus line 48).	
51. Basis for purposes of minimum basis adjustment. (For non-excluded personal and household goods lesser of line 1 or line 49. For property subject to non-recourse mortgage, line 45 minus line 48. For all other items, line 49.	
52. Total basis all assets subject to tax. (Total all lines 51).	
53. Minimum basis adjustment	60,000
54. Maximum allocable minimum basis adjustment (line 53 minus line 52).	
55. Remaining net appreciation of all carryover basis property (line 31 minus line 52).	
56. Portion of minimum basis adjustment allocable to each asset (line 54 divided by line 55).	(%)
57. Minimum basis adjustment for asset (line 50 times line 56).	

58. Basis after minimum basis adjustment (Line 49 plus line 57). __________

59. Remaining appreciation in asset (line 50 minus line 57). __________

60. Adjustment for state death taxes (line 41 times line 59). __________

61. Final adjusted basis for purposes of determining capital loss on sale of asset (line 58 plus line 60). __________

(1) H.R 6715 proposes several changes to the carryover basis rules, including:

(1) Treating estate taxes on income items in the estate as an addition to basis.

(2) Ignoring non-recourse debts against the property

(3) Making the basis for loss purposes same as for gain, ignoring the fresh start adjustment.

(2) It is not necessary for the decedent to have actually held the property on December 31, 1976. If the property held by the decedent at his death was acquired in a non-taxable exchange for property that he did own on December 31, 1976, the fresh start adjustment will be available. Also the property on December 31, 1976.

(3) The adjustment for taxes paid does not include any additional tax imposed because of a disposition of property which qualified for the special form or closely held business valuation.

The taxes used in the computation of the second adjustment are the regular federal estate taxes and any estate, inheritance, legacy or sucession taxes, for which the estate is liable, actually paid by the estate to any state or the District of Columbia.

Mr. McMILLAN. It shows that there are 61 separate steps which can apply in computing the income tax basis and property transfer at the decedent's death because of the carryover basis rule.

Mr. McDonald has indicated that before this computation form may be used, there are approximately seven additional computations which may be necessary in order to determine the figures to insert and some of the steps indicated in the computation.

Somewhat facetiously and yet true, because of this complexity and because many farm families ranch and farm units do not have access to, and do not have the resources for the professional help that can be granted; the real beneficiaries of the carryover basis probably are going to be lawyers and accountants and corporate fiduciaries who will reap larger fees in performing the additional work required by this carryover basis.

We feel very strongly that the repeal of the carryover basis is the only equitable means by which this very complex and inequitable provision of the Tax Reform Act of 1976 can be resolved.

Thank you.

Senator PACKWOOD. Even the lawyers and accountants do not ask for this. They are not very happy with it. It may reap them some extra fees, but I think they would rather reap those extra fees in some other fashion than have to go through this.

Mr. McMILLAN. It is unfortunate that more did not recognize that in 1976.

Senator PACKWOOD. There was not a chance.

Mr. McMILLAN. They did have a crack at it.

Senator PACKWOOD. They went through very quickly and I am convinced—I will not say we did not know what we were doing, we knew what we were doing. We did not know the consequences.

Mr. McMILLAN. This is probably true. That is why that statue, "What is past is prologue," is so applicable today.

Senator PACKWOOD. Your computations will be put into the record with your statement.

Mr. McMILLAN. Thank you, sir.

STATEMENT OF KEVILLE LARSON, LARSEN AND McGOWAN, CONSULTING FORESTERS, ON BEHALF OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION, ACCOMPANIED BY WILLIAM CONDRELL

Mr. LARSON. My name is Keville Larson. I am a consulting forester giving advice and assistance to timberland owners. I am here today representing the forest industry's committee on timber valuation and taxation. I have with me the general counsel, Mr. William Condrell.

We have submitted two statements, one concerning the carryover basis provision and another concerning the Technical Corrections Act.

Most of the statements of the two previous gentlemen apply to timberland owners. In some cases, there is greater effect. There are many laws to encourage conservation and development, but the effect of the estate taxes works very strongly to the detriment of forest resources.

We have worked with many instances where poorly stocked timberlands were raised to a high level of productivity during the period of a lifetime only to be destroyed by overcutting of the timber or sale or fractionalization of the land to pay estate taxes.

Senator PACKWOOD. Are you representing individual timberland owners rather than corporate?

Mr. LARSON. That is correct.

The present law magnifies the effect. The timber growing period involves more than one lifetime and rotation cannot be completed without being subject to one estate tax valuation which, under today's laws, removes all profits as well as causes mismanagement of the forest resource, drives the land into the hands of corporations and phases out the individual.

The present law creates several specific problems. One, ownerships may be locked in and worse, may be locked into ownership of inefficient owners. Inequities may occur including taxing a gain when there is actually a loss. Administrative burdens will be great. Forestry is a long-term investment and the records are often difficult to reconstruct. Properties may be acquired over a period of time in separate purchases, swaps, exchanges, and various methods.

We believe that the carryover basis provision should be repealed or other incentives provided. At present, the only relief is the inclusion of real property with tangible personal property in the Technical Corrections Act, H.R. 6715.

In regard to additional property, we ask for an option which would be a 1976 value by appraisal. There would be some relief of administrative burdens and evaluation for those cases which would provide a tax on gain when actually there is a loss.

We would like our two statements entered into the record.

Senator PACKWOOD. Thank you very much.

Mr. Condrell, do you have anything to say?

Mr. CONDRELL. No, thank you.

[The prepared statements of the preceding panel follow:]

STATEMENT BY ROBERT L. HITZHUSEN, ASSISTANT DIRECTOR, NATIONAL AFFAIRS OF THE AMERICAN FARM BUREAU FEDERATION

We appreciate this opportunity to present our views on the carryover basis provision of the Tax Reform Act of 1976.

Farm Bureau members have been actively involved in the past several years in seeking reform of the federal gift and estate tax law. Some measure of gift and estate tax relief was achieved in the Tax Reform Act of 1976; however, much of this relief will be offset in the years to come by the greatly increased capital gains tax liabilities created by the carryover basis provision. This provision is the most objectionable feature of the Tax Reform Act of 1976 to farm and ranch families. Our members voiced their strong opposition to this provision by adopting the following AFBF policy for 1977:

We urge repeal of the capital gains carryover basis provision of the Tax Reform Act of 1976. Opposition to this provision reflects first, the complexity involved in applying the carryover basis and second, the adverse effects which the provision produces.

The complexity of applying the carryover basis provision has been described to us at length by several tax practitioners. The provision provides that gains occurring prior to December 31, 1976, will not be subject to the new carryover basis rule. In the case of property other than marketable stocks and bonds, however, gains occurring prior to December 31, 1976, are to be determined by prorating total realized gains on the basis of the number of days in the holding period that occurred before December 31, 1976 and the number that occurred after that date. This means that records, methods, and formulas are required to determine the decedent's basis for each piece of property—other than marketable securities—in the estate.

It is not uncommon for farms to be built up over several years through the acquisition of several small pieces of property at different times and different prices. In addition, many material improvements may have been added to each purchased property, which further complicates the determination of the decedent's basis. It is also not uncommon for a farmer or rancher to have many separate pieces of machinery, each requiring a separate basis calculation. Livestock—particularly livestock raised on the farm or obtained in exchange for raised livestock—further complicate the process.

Few farmers, other than the very few with complete, computerized records, will have the information needed to support an accurate determination of carryover basis—particularly for property that was acquired many years ago.

Aside from the administrative complexities, we believe the carryover basis will have a particularly adverse effect on farm and ranch families. Many farm families receive extremely low returns on invested capital (historically, about 3 percent), with the hope that these low returns can be at least partially offset by increases in the value of their assets. The appreciation of assets has been farm families best protection from inflation and has provided them with some assurance of adequate resources for retirement. This has been an important factor—for example, the Consumer Price Index increased more than 300 percent from 1940 to 1976.

Since the carryover basis affects capital appreciation, it affects income tax liability rather than estate and gift taxes. Federal tax laws do not distinguish between appreciation due to inflation and appreciation which represents an increase in the real value of an asset. Consequently, in the case of assets held over a long period of time the tax on capital gains becomes a tax on capital to the extent that capital values are increased by inflation.

The tax on capital gains hits farmers and ranchers particularly hard because of the long holding period typical of family farm assets. Prior to the carryover basis provision of the Tax Reform Act of 1976 the step-up basis was a useful method of reducing the erosive effects of applying capital gains taxes to inflated values in the case of inherited property, since successors receiving appreciated property were allowed to "step-up" the basis of assets to the fair market value at the time of the decedent's death. This also eliminated the problem of determining the decedent's basis.

The ultimate effect of the new carryover basis provision on land ownership patterns remains unclear. However, the further we move from the fresh start date of December 31, 1976, contained in the carryover basis provision, the greater will be the capital gains tax liability and, therefore, the greater will be the incentive for land to be held within families. This "lock in" effect probably will result in an increase in farm tenancy.

Because of the complexity of the carryover basis and its adverse impact on farms and ranches and other closely held businesses, we urge this Committee to favorably report legislation to repeal this provision of the Tax Reform Act of 1976.

Joint Statement of the National Livestock Tax Committee, the National Cattlemen's Association, and the National Wool Grower's Association

Summary

1. The provision of the Technical Corrections Act permitting farm corporations and partnerships which are required to change to the accrual accounting system and to capitalize preproductive period expenses to spread adjustments caused by such change over a period of up to ten years should be adopted.

2. The provisions in the Technical Corrections Act permitting farming syndicates to elect out from under the farming syndicate provision of the 1976 Tax Reform Act by changing to the accrual accounting system and capitalizing preproductive period expenses, and to spread adjustments caused by such change over a period of up to ten years should be adopted, with the suggested revision that this provision apply to farming syndicates in existence on October 4, 1976.

3. The provision of the Technical Corrections Act expanding the definition of an individual's family to include spouses for purposes of the farming syndicate rule should be adopted.

4. The provisions of the Technical Corrections Act concerning farm land valuation should be adopted.

STATEMENT

Formed in 1942, the National Livestock Tax Committee (NLTC) is sponsored by a number of national, breed and state livestock associations throughout the country and has as its purpose maintaining and assuring equity and equality in the fields of federal income, gift and estate taxation for the entire livestock industry.

The National Cattlemen's Association (NCA) was formed on September 1, 1977 through a consolidation of the American National Cattlemen's Association (ANCA) and the National Livestock Feeders Association (NLFA). NCA is a voluntary, nonprofit, nonpolitical trade association representing approximately 280,000 professional cattlemen throughout the country and is the national spokesman for all segments of the nation's beef cattle industry. Membership in NCA includes individuals as well as fifty-two affiliated state cattle organizations and thirteen affiliated national breed associations.

The National Wool Growers Association (NWGA), a voluntary, nonprofit, nonpolitical organization, represents twenty-two state and regional organizations encompassing a 25-state area, where 90 percent of the nation's lambs and wool are produced.

NLTC, NCA, and NWGA speak for the entire red meat animal industry in the nation. In addition, NLTC represents dairy and horse organizations.

Representatives of NLTC, ANCA, NLFA, and NWGA have frequently appeared before the Senate Finance Committee to testify on the subject of federal taxation of farm and ranch operations. Statements have been recently filed with this Subcommittee concerning the need for repealing carryover basis and for making other amendments to the gift and estate tax provisions of the 1976 TRA.

ACCRUAL ACCOUNTING FOR CERTAIN CORPORATIONS AND PARTNERSHIPS ENGAGED IN FARMING

The 1976 Tax Reform Act (TRA) added to provision to the federal income tax laws requiring certain corporations and partnerships engaged in farming to change to the accrual system of accounting and to capitalize preproductive period expenses of raising crops and livestock beginning in 1977. In order to prevent adverse tax consequences from such required change in accounting methods, taxpayers affected by this provision were permitted, under regulations to be prescribed by the Treasury Department, to take adjustments resulting from such change into account in each of the ten taxable years beginning with the year of change, "except as otherwise provided in such regulations." This ten-year spread rule is explained as follows in the Committee's Report:

"A taxpayer who is required to change to the accrual method pursuant to this provision will be allowed to spread the accounting adjustments required by this method over a period of 10 years. The corporation will also be treated as having made the change with the consent of the Secretary of the Treasury. Such a change will be treated as not having been initiated by the taxpayer (for purposes of the rule which prohibits adjustments resulting from changes in a taxpayer's method of accounting if the taxpayer initiates the change (sec. 481(a))." H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 96, 97 (1975).

From the wording of this provision and the cited explanation for the ten-year spread rule in the Report of this Committee, it seems clear that Congress intended for all corporations and partnerships affected by this provision to take any adjustments resulting from such change in accounting methods into account over ten taxable years beginning with the year of change, regardless of the number of years prior to 1977 the affected corporation or partnership had used a previous and different accounting method or regardless of the number of years the corporation or partnership had been in the business of farming prior to 1977.

Since the change in accounting method required by this provision is forced upon the taxpayer, rather than being elective, it seems only fair and equitable that this ten-year spread rule should be applicable and available irrespective of the number of years the taxpayer has been in the farming business or used a previous accounting method prior to 1977. However, it had been indicated that the regulations, to be issued in the future, may limit the spread period based upon the number of years a corporation or partnership had been engaged in farming prior to 1977 presumably under authority of the "except as otherwise provided in such regulations" language of this provision.

NLTC, NCA, and NWGA strongly feel that a ten-year spread period was intended by Congress to give relief to those corporations and partnerships required to change to the accrual method.

Section 2(k)(1) of the Technical Corrections Act of 1977 (H.R. 6715) (the "Act") clarifies the ten-year spread rule of section 447 of the Code by providing that corporations and partnerships required to change to the accrual system of accounting and capitalize preproductive period expenses can spread net adjustments caused by such change over the shorter of ten taxable years or the remaining stated future life of the entity. This amendment will provide appropriate and needed relief for taxpayers required by section 447 to change to the accrual system of accounting and is supported by NLTC, NCA, and NWGA.

NLTC, NCA, and NWGA also support section 4(d) of the Act which corrects references to "preproductive period expenses" in the accrual accounting provision of section 447.

LIMITATION OF DEDUCTIONS OF FARMING SYNDICATES

Pursuant to the 1976 TRA, farming syndicates are required to deduct expenses for feed, seed, fertilizer and other similar farm supplies only when used or consumed, to capitalize the costs of poultry and to capitalize the costs of planting, cultivating, maintaining and developing a grove, orchard or vineyard prior to the time it becomes productive. This farming syndicate provision does not impose the same limitations on the timing of farming expense deductions as does the generally more restrictive accrual accounting provision of section 447 previously discussed.

Section 2(k)(2) of the Act amends the 1976 TRA to permit a farming syndicate, which was in existence on December 31, 1975, to elect an accrual method of accounting and spread the net adjustments required by such change in accounting methods over ten years, or its remaining stated life, whichever is shorter. This amendment would in essence permit such farming syndicates to elect to be subject to the same accounting rules as certain corporations and partnerships under the accrual accounting provision of section 447. NLTC, NCA, and NWGA support this amendment but submit that this amendment should apply to farming syndicates in existence on October 4, 1976.

NLTC, NCA, and NWGA also support section 2(k)(3) of the Act which expands the definition of an individual's family, for purposes of determining the existence of a farm syndicate, to include the spouse of the individual and the spouses of other family members. This amendment comports with the intention of Congress to include spouses in the definition of family members and reflects the manner in which spouses are generally regarded by families engaged in the business of farming.

AMENDMENTS TO FARM LAND VALUATION PROVISION

The farm land valuation provision of the 1976 TRA should be beneficial and should help reduce the tremendous federal estate tax burden previously faced by estates of deceased farmers and ranchers. The Act contains a number of technical amendments to this farm land valuation provision. NLTC, NCA, and NWGA support these amendments and urge their adoption.

(1) *Farm land valuation provision applies only to property passing to qualified heir*

To clarify any possible misunderstanding, section 3(d)(1) of the Act specifies that the farm land valuation provision will apply only to the extent that farm land passes to qualified heirs.

(2) *Use of special use valuation property to satisfy pecuniary bequest*

Clarification is made in section 3(d)(3) of the Act that land valued under the farm use valuation provision can, like other property, be used to satisfy a pecuniary bequest without causing the recognition of capital gain to the estate, except for any appreciation occurring after the decedent's date of death. Section 3(d)(2) of the Act states that, under the farm land valuation provision, property will be considered to have been acquired from or to have passed from a decedent if it is acquired by any person from the estate in satisfaction of a pecuniary bequest.

(3) Treatment of community property under farm land valuation provision

It is made clear by section 3(d)(4) of the Act that the farm land valuation provision applies to community property in the same manner as property owned by a decedent in an individual capacity.

(4) Filing of bond by qualified heir to obtain release from personal liability on recapture tax

Under section 3(d)(5) of the Act, a qualified heir is discharged from personal liability for the recapture tax if the heir furnishes a bond for the amount of the recapture tax.

OTHER AMENDMENTS

While comments are limited in this Joint Statement to technical amendments to the 1976 TRA, NLTC, NCA, and NWGA wish to indicate their feeling that some substantive amendments are needed to the farm land valuation provision in order to confer the intended benefits to estates of deceased farmers and ranchers. Further, it is felt that at the appropriate time, amendments of a substantive nature should also be considered to other provisions of the 1976 TRA.

CONCLUSION

It is respectfully requested that the proposed technical amendments of the Act relating to the farm corporation accrual accounting provision, the farming syndicate provision and the farm land valuation provision be adopted.

Statement of the Ad Hoc Agricultural Tax Committee

SUMMARY OF POSITION

Carryover basis should be repealed.—Carryover basis creates problems of compliance and administration which are onerous and will result in additional expense. It also can have an adverse effect on the cost of transferring property at death. Further, carryover basis will result in the imposition of higher taxes; and where an estate had to sell property to pay death taxes or administration expenses, a double tax burden will result. Many family farm and ranch operations may not be able to pay this added tax without liquidating the business.

STATEMENT

Mr. Chairman, my name is Latimer Turner. I am Chairman of the National Cattlemens Association Taxation Committee.

However, today I am appearing on behalf of the Ad Hoc Agricultural Tax Committee which includes: American Horse Council, Inc.; National Association of Wheat Growers; National Cattlemen's Association; National Cotton Council of America; National Livestock Tax Committee; National Milk Producers Federation; National Wool Growers Association.

My remarks today will be directed toward repeal of the carryover basis provision.

Because the group of agricultural organizations has submitted a combined statement does not mean that each group is not equally concerned about the carryover basis provision. We have combined our testimony in order to conserve the time of this Subcommittee. Several of the organizations have written to the Chairman of this Subcommittee urging repeal of the carryover basis and, with your permission Mr. Chairman, I would like to make these letters a part of the record. I have copies of those letter with me.

CARRYOVER BASIS SHOULD BE REPEALED

Since passage of the 1976 TRA, there has been a ground swell of opposition to the carryover basis provision. Why? Because of its complexity, carryover basis will be extremely difficult to comply with as well as to administer. Moreover, carryover basis will increase the tax burden and compound the illiquidity of estates of farmers, ranchers and other family business operators which will have to sell property in order to raise sufficient cash to pay death taxes and administration expenses. In addition, it will add a new tax liability on property held by estates even where there is no estate tax liability. For example, if a modest estate which has no estate tax liability has to sell property in order to divide the estate among the heirs, it may incur a large capital gains tax.

A. Carryover Basis Creates Additional Tax Burdens

Estates which are not subject to the payment of federal estate taxes because of various deductions and credits may nevertheless have to pay higher income taxes as a result of carryover basis if property is sold by the estate or the heirs. The amount of such tax is increased in many cases where capital gains are involved because of the tightening of the minimum tax provisions under the 1976 TRA. In other cases, there will be a pyramiding of federal taxes because of the interplay of the federal estate and income taxes under the carryover basis provision.

An example of how carryover basis can virtually destroy a tenant farmer's estate is illustrative of this problem. A widowed tenant farmer dies in 1977 leaving an estate valued at $545,000 to a son. Most of the estate consists of corn and beans which were raised in 1977. The corn and beans are sold in the normal course of the farming business. After payment of federal estate taxes and state inheritance taxes and after payment of federal and state income taxes on the proceeds received on the sale of the farm crops, the son has only $154,000 left from the total estate of $545,000. The estate shrinkage in this example is about 74 percent as a result of a combination of federal and state death and income taxes.

In most farm and ranch estates, however, there is not as much liquidity available to pay death taxes and administration expenses on the death of a farmer or rancher largely because of the amount of farm or ranch land owned by the decedent. Where this occurs, the farmer's estate may be required to sell some of the land to pay death taxes, even when the impact of such taxes may be ameliorated by the special farm use valuation and extended tax payment provisions. Such sale of farm land will increase the total tax liability of the estate since the estate will have a "capital gains" tax to pay on the appreciation built into the land plus a federal estate tax on the lands value. Because the income tax basis of farm land is traditionally low, reflecting the number of years it has been held, the amount of the capital gains can be quite high. The result is a capital gains tax at death (made worse by the more stringent minimum tax rule) in addition to the federal estate tax. The estates of many farmers and ranchers may not be able to bear this double tax burden which could mean the liquidation of the family farm or ranch. With the need to maintain a sound and productive agricultural system to provide the country with adequate supplies of food and fiber, carryover basis can strike a lethal blow to this desired goal.

While not affecting farmers and ranchers as much as other persons there is a lock-in problem caused by carryover basis. Carryover basis will tend to freeze assets within estate because the heirs may not be able to afford to sell them and pay the tax which would result. Some comment has been made that this will cause an impediment to the free flow of capital and have an adverse effect on the economic structure of our country.

Whether forced to sell farm property to pay death taxes and administration expenses or whether sales occur in the regular and normal marketing of farm crops and livestock following the death of a farmer or rancher, there will now be more tax to pay because of carryover basis. The strain this added tax burden will place on many family farms and ranches could result in liquidation of the operation. For this reason, it is respectfully submitted that carryoved basis is unwise both as a tax and as an economic policy.

B. Complexity of Carryover Basis Creates Problems of Compliance and Administration Which are Onerous and Expensive

On the death of a farmer, rancher or other decedent, the executor of such persons estate is required by the carryover basis provision to compile extensive and detailed information about the income tax basis of each asset (other than certain exempted property) owned by the decedent. When the decedents income tax basis in each asset is determined, the executor must then make as many as four different adjustments to each income tax basis involving a number of separate computations.

Attached as Exhibit A is an outline entitled "Computation of Carryover Basis" drafted by William R. McDonald, an attorney and trust officer with the First National Bank of Denver. This computation form, which represents over 100 hours of research, shows that there are sixty-one separate steps which can apply in computing the income tax basis in property transferred at a decedent's death because of the carryover basis rules. Mr. McDonald has indicated that before this computation form may be used there are approximately seven additional computations which may be necessary in order to determine the figures to insert in some of the steps indicated on the computation form.

That sophisticated and expensive computers will be required to compute the correct basis figures under the carryover basis provisions is clearly apparent. Even then, computation of carryover basis cannot be accomplished unless the correct information is first obtained by the executor.

Determination of the decedent's income tax basis in property acquired in the 1930's and 1940's is going to be difficult at best and in some cases a virtual impossibility, especially for family farm and ranch estates where the farm and ranch have usually been held for a great number of years. This problem will be particularly acute if property must be traced through several transactions, or even generations, to determine the decedent's income tax basis.

The provision that where the decedent's basis in property is unknown such basis will be the fair market value of the property on the date the decedent acquired such property may be more illusionary than helpful. In the case of farm and ranch properties acquired in different segments and at various times over many years, such calculations will be burdensome. Moreover, any fair market value so determined can be expected to be examined and questioned by the Internal Revenue Service, resulting in additional and further controversy and expense.

In addition to the hardship of collecting information and making determinations of the basis in each item of property owned by a decedent, the executor must supply such information with the Internal Revenue Service as may be required by regulations. Failure to supply or file such information will result in a monetary penalty being imposed on the executor, with a ceiling of $2,500 on total penalties which may be assessed.

Executors will face additional burdens under carryover basis in distributing property to a decedent's heirs. If the heirs of a decedent do not all receive property of equal value having the same income tax basis, which is a virtual impossibility especially where farms and ranches are involved, then the executor encounters an insoluble problem in determining which heir or heirs receive property with the highest income tax basis. Similar problems will be encountered by executors in determining whether to allocate high basis assets to the marital deduction fund, thereby maximizing the basis step-up on the other assets in the estate, or allocate low basis assets to the marital deduction fund and use the high basis assets to meet the estate tax obligation, thereby minimizing the estate's income tax obligation. Distrust, family inharmony, and litigation will be the natural consequences of these problems caused by carryover basis.

The fact that assets passing from a decedent will receive a basis increase for the estate tax attributable to the appreciation on these assets will also result in uncertainty and administrative problems where the assets are sold before the estate tax obligation is finally resolved. Until the estate tax obligation is finally determined, which could take considerable time, the basis of the property for purchases of determning gain or loss cannot be determined and accordingly, the income tax liability in selling such property would be unknown. The result would be confusion and uncertainty.

The burdens imposed on executors by the carryover basis provisions will substantially increase the cost of administration of a decedent's estate. A concomitant cost will also likely be incurred by the Internal Revenue Service in administering this provision. The result will be to increase the cost of transferring property at death and requiring more federal revenue to be spent in administering this complex and unnecessary provision.

The real beneficiaries of carryover basis are lawyers, accountants and corporate fiduciaries who will reap larger fees in performing the additional work required by the carryover basis provision. It is also possible that carryover basis will force most estates to have large corporate institutions as executors or as consultants to executors because of the problems inherent in complying with carryover basis. Such an impetus away from the traditional concept of having trusted family relatives serve as executors, especially where estates are composed primarily of farms and ranches, is deplorable and unjustified.

The added complexity, burden of compliance and administration, the adverse effect on the traditional method of administering estates and the attendant costs resulting from carryover basis clearly support repeal of this undesirable and harmful provision.

For the reasons we have expressed, and other reasons which we have not been able to go into in this short space of time, we respectfully urge the Senate to repeal the carryover basis provision.

This concludes my remarks. Thank you for allowing me to appear before you and thank you for your time.

Prepared Statement of L. Keville Larson, of the Forest Industries Committee on Timber Valuation and Taxation on Carryover Basis

We respectfully submit for the consideration of the Committee on Ways and Means the views of the Forest Industries Committee on Timber Valuation and Taxation concerning the recent amendment of the estate tax laws by the addition of section 1023 of the Internal Revenue Code (Carryover Basis for Certain Property Acquired From A Decedent Dying After December 31, 1976).

Prior to the Tax Reform Act of 1976, a beneficiary's basis in property acquired from a decedent was the fair market value of the property at the date of the decedent's death (or the alternative valuation date if that date was elected for estate tax purposes). In essence, because of the stepped-up basis, any appreciation in the property between the date of acquisition by the decedent and the date of his death was not subject to income tax.

Under section 1023 of the Code, added by the Tax Reform Act of 1976, beneficiaries no longer receive this "stepped-up" basis for inherited property (with the exception of appreciation in property accruing before January 1, 1977, which is excluded under a "fresh-start" rule). The basis of property acquired from a decedent dying after December 31, 1976 is derived from the decedent's basis immediately before his death ("carryover" basis). Certain complex adjustments, however, must be made to decedent's basis in order to determine the beneficiary's basis.

As discussed below, we believe section 1023 is an ill-conceived and inadvisable provision which creates enormous administrative burdens, yet does not achieve or even promote the objectives which motivated its enactment. In fact, it is more likely that the problems which section 1023 was designed to correct have been exacerbated rather than improved.

OBJECTIVES OF SECTION 1023

Major objectives of section 1023 are to promote tax equity and eliminate the temporary "lock-in" caused by a step-up in basis at death. With respect to tax equity, section 1023 is designed to correct an imbalance in prior law by imposing equal tax on the sale of an appreciated asset during a taxpayer's lifetime and the sale of the same asset after taxpayer's death. However, the imbalance of prior law has been reversed rather than corrected by section 1023, so that now post-death sales result in greater tax than lifetime sales. This occurs because money used to pay income tax on sales made after death is subject also to the federal estate tax, while income tax paid on sales made prior to death is not.

To take a simplified example, assume a taxpayer in 1978 sells for $110 an asset which is purchased in 1977 for $10. Regardless of whether the sale is made during the taxpayer's lifetime or by his beneficiary after his death, the income tax consequences will now be approximately the same. Assuming, say, a 40 percent tax on the $100 gain, the income tax due will be $40. The estate tax consequences differ, however. With a lifetime sale, only $70 will go into the taxpayer's estate, since $40 has gone to the federal government in the form of income tax. Assuming, say, a 20 percent estate tax rate, the estate tax due would be $14. With a post-death sale, however, the full $110 goes into the taxpayer's estate, so the estate tax due is $22 (20 percent of $110). The total federal tax due is thus $54 for the lifetime sale but $62 for the post-death sale.[1] Hence tax equity, even in the specific area to which the section 1023 change is addressed, is not achieved.

As the example above illustrates, the carryover basis provision causes a greater tax burden to fall on those taxpayers who keep property until death, than on those who sell prior to death. Yet if any imbalance is to exist, it is appropriate that the lighter tax burden should be on the post-death sale. Death is an involuntary event, in contrast to the usual lifetime sale of an asset.

Assets must be sold to satisfy the estate tax liabilities. With the new carryover basis provision, such a sale now generates an income tax as well. Furthermore, sales are likely to be bunched into a period shortly after the taxpayer's death thereby increasing the overall tax burden. Frequently, survivors are at the same time coping with the financial problems inherent in the loss of the family's primary wage earner, as well as the inevitable stress caused by the loss of any family member. The additional tax burdens placed on them are certain to generate hostility towards the tax system. Hence, not only is equity not achieved between pre-death and post-death sales, but it is also likely that a step backward rather than forward has been made.

Broadening the focus from "equal" treatment of pre-death and post-death sales to more general fairness questions, it becomes apparent that new inequities are created by section 1023. First, double taxation (both income and estate tax) of the same gain results, as the preceding example illustrates. Second, the administrative costs created by section 1023 will be more crippling to estates with few liquid assets, such as the estates of farmers and small businessmen, since such estates lack the cash to cover the administrative costs without liquidating assets. Third, tax planning to minimize the burden of the new tax is affordable only by those with substantial assets.

Ironically, it is the persons that revisions in estate tax laws were designed to assist—surviving spouses, farmers and small businessmen and persons with small estates—who suffer most from the "incidental" adverse effects of the carryover basis provision. In fact, there are indications that the progress achieved by the 1976 estate tax law changes—increase in the marital deduction, the increased exemption as a credit, "use" valuation of farm properties, and deferred payment of estate taxes on farms and small businesses—has been completely nullified by the carryover basis provision.

In addition to promoting tax equity, a second major goal of section 1023 is to eliminate the temporary "lock-in" effect caused by a step-up in basis at death. The sale of appreciated property generally results in a capital gain tax measured by the amount of the appreciation. Under prior law, however, if the property were held until death a step-up in basis would result and the gain would "escape" taxation. This was thought to create an artificial incentive to hold appreciated property until death, the so-called "temporary lock-in effect."

The tax burden faced by a prospective seller, however, not the step-up basis, is what creates a disincentive to sell. The step-up in basis provision made the "lock-in" only temporary, by providing a release valve of sorts. Once the owner of the property had died, basis was adjusted to equal fair market value. A decision to sell or not to sell could then be made without the distortion created by a substantial tax burden upon sale.

Substitution of a carryover basis in place of a stepped-up basis eliminates this release valve and converts the temporary lock-in effect to a permanent one. Death no longer eliminates the prospective tax burden upon sale, so it is passed from generation to generation. As the appreciation in the property and hence the tax burden grows, so too does the disincentive to sell. Farmland and timberland, which frequently pass within the family from generation to generation, are particularly susceptible to this increasing pressure against sale.

To illustrate, suppose Junior inherits the family farm, but is not interested in, or not particularly expert at farming. Under prior law, he probably would sell the property to someone more inclined towards farming. With more skillful management, the land would be made more productive. Under section 1023, however, Junior would incur a large tax bill upon sale (particularly if the

[1] In assuming that the basis for both the lifetime sale and the post-death sale is $10, the example does not include any of the adjustments to basis required by section 1023. Usually the post-death basis would be higher than the lifetime basis once the adjustments called for by section 1023 are made, but not sufficiently high to counterbalance the greater estate tax burden on these sales.

land were passed down through many generations, so that the basis was very low). The mechanism for passing the land into the hands of a more efficient producer is therefore impeded.

At the same time section 1023 converts this lock-in effect from temporary to permanent, it creates an entirely new distortion in allocation of property. Any asset whose basis is lower than its value has a built-in income tax burden. Under section 1023, this burden is now transferred to the decedent's beneficiaries. A testator can minimize the tax burden on his beneficiaries by passing assets with large built-in tax burdens to beneficiaries in low tax brackets, and vice versa. Since the tax savings can be substantial, this factor is likely to affect a testator's decision about which beneficiary will inherit particular assets. Yet, in the case of productive assets, such as farms and timberlands, maximum efficiency would only be achieved if the decision could be made solely upon the basis of which beneficiary could best use the farm or other productive asset. A stepped-up basis at death facilitates this efficient allocation process; a carryover basis distorts it. Once a misallocation occurs, moreover, the carryover basis makes it less likely to be corrected, given the lock-in effect (or incentive against sale) discussed above.

These distortions—permanent lock-in and misallocation of property—cannot be overemphasized. Their adverse impact is particularly noticeable in the case of the productive units in our economy—farmlands, timberlands, and small businesses. Maximum efficiency in production can be achieved only if productive property is in the hands of the most efficient producer. Section 1023 encumbers the transfer process.

ADMINISTRATIVE BURDENS

Even if the substantive goals of section 1023 had been achieved, it is important to ask, at what cost? The new provision creates an administrative jungle.

The process of determining carryover basis is incredibly complex. The first step is to establish decedent's basis in each asset in his estate. Yet rarely does a decedent leave adequate records of date of purchase, cost, and capital improvements for each asset which he owns. Even if there are records, establishing the basis of a farm or closely held business, with property frequently purchased in small lots over the years, improvements constantly being made and depreciated, and large numbers of other business assets, can involve enormously complex calculations.

Admittedly, a taxpayer who sells property during his lifetime is required to determine his basis in the property he sells. Several important factors, though, distinguish the lifetime sale situation from transfers at death. After the taxpayer's death, he is obviously no longer available to reconstruct the facts surrounding his ownership of the property. Incomplete records that the taxpayer could have supplemented by memory, or missing records he could have found, are no longer of any use. Moreover, upon death, basis must be fixed in all assets at once, requiring an enormously time-consuming and costly process. In contrast, the occasional lifetime sale creates little difficulty.

The necessity of determining decedent's basis not only causes expense and annoyance for the survivors at the taxpayer's death, but also requires detailed record-keeping by the taxpayer during his life of every transaction affecting every asset he acquires. Moreover, death no longer provides a time for "cleaning house", or throwing out records kept by the decedent. Until a sale takes place old records must be preserved, for section 1023 requires not only knowledge of basis, but proof. In many situations, this means records must be kept for many years, and even many generations, as property is passed down through the family.

The second step in the process, "adjusting" basis, is even more difficult. Four possible adjustments can be made: (1) a fresh start adjustment; (2) an estate tax adjustment; (3) a minimum basis adjustment; and (4) a succession tax adjustment. Calculation of adjustments must be made separately for each asset in the estate. Each adjustment depends upon calculations made in the preceding adjustment, so that an error in one can throw off calculations all down the line. Moreover, adjustments in the basis of one asset are dependent upon the "adjusted" basis of all other carryover basis assets, so an error in the calculation of adjustments for one asset can throw off calculations made for all other assets as well. Adjustments are also dependent upon the average federal estate tax rate, yet that rate can only be finally determined at the time of the final audit. Again, any change sets off a chain reaction of necessary recalculations. Given all these interrelated factors in calculating basis, the likelihood of numerous recalculations is enormous.

Furthermore, there may be several bases for a single asset. The fresh start adjustment is made only for the purposes of determining gain, ont loss. Additionally, assets allocated to a marital deduction share for the spouse will have a different basis than if allocated to the residue, since only assets subject to tax qualify for some of the adjustments.

These enumerated complications are merely illustrative, not exhaustive, of the administrative difficulties created by section 1023. In short, the carryover basis provision creates an administrative nightmare which will unfairly burden all taxpayers.

In conclusion, it is our view that the objectives of equity, economic efficiency, and administrative simplicity are not served by section 1023. We believe section 1023 should be repealed or substantially revised. We wholeheartedly support the bills already sponsored by numerous Congressmen to repeal section 1023 and restore prior law.

PREPARED STATEMENT OF L. KEVILLE LARSON OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION—THE TECHNICAL CORRECTIONS ACT OF 1977

We respectfully submit comments of the above-named organization on H.R. 6715, "The Technical Corrections Act of 1977" (the"Act"). Our comments are limited to proposed Section 3(c)(1) of the Act, as passed by the House of Representatives.

Section 3(c)(1) of the Act would amend Section 1023(h) of the Internal Revenue Code to provide a minimum carryover basis for tangible personal property held by a decedent on December 31, 1976. Under present Section 1023(h), the executor or heirs of a decedent are permitted a "fresh start" adjustment to the basis of inherited assets to reflect fair market value on December 31, 1976. In order to compute the fresh start adjustment, however, it is necessary to know the date of acquisition of the inherited asset and its basis immediately prior to death.

As explained in the Report of the Committee on Ways and Means on H.R. 6715 (October 12, 1977), it is particularly difficult to ascertain the fresh start adjustment with respect to tangible personal property because executors and heirs may not be able to determine the basis of the property or even the approximate date on which the decedent purchased the property. Section 3(c)(1) of the Act would alleviate the problem by providing a minimum carryover basis for the tangible personal property. This minimum basis would be determined by discounting their fair market value of the property at the date of death in order to determine the value on December 31, 1976. Under this formula, it would only be necessary to determine the value of this property at the decedent's death.

We believe that the minimum basis rule should be extended to real property as well as tangible personal property, at least with respect to certain farms and timberlands. In many cases, individual farmers and timber farmers have acquired their interests in farmland and timberland by numerous small purchases at different times over a period of years. As with tangible personal property, the purchase prices and acquisition dates are difficult, and under certain circumstances impossible, to reconstruct. This lack of available data would create an enormous burden on the executors and heirs of farmers and timber farmers in trying to apply Section 1023(h) of the Code. The executors and heirs of decedents holding tangible personal property and those holding farm or timber properties thus share a similar difficulty.

We recognize that in many cases, indeed in most cases, land records are much more easily obtainable than records concerning tangible personal property but they are often frustratingly incomplete and inexact. This leads us to urge that Section 3(c)(1) of the Technical Corrections Act of 1977 be amended to include real property in the minimum carryover basis allowance. If it is found appropriate that not all real property be included, we suggest that the provision be revised to include farms and timberlands used in a business or held for investment where it can be demonstrated that such property was acquired in more than one transaction.

In addition to the inclusion of real property as well as tangible personal property in the minimum carryover basis provision, we believe that the provision should permit taxpayers owning real property to determine by appraisal the valuation on December 31, 1976, if the taxpayer can demonstrate that the value shown in the appraisal is more accurate than the value as otherwise determined under the minimum carryover basis provision. This change would allow a more equitable determination of value in cases where a discounted value is not accurate under the particular circumstances.

Our suggested revisions would clearly not provide an undue benefit to farmers and timber farmers. Rather, the revision would recognize the severe administrative burden placed on the executors and heirs of farmers and timber farmers and would alleviate this burden by simple administrative changes.

We thank you in advance for your consideration of our comments.

Senator PACKWOOD. Let me thank you, gentlemen. Let me say to the other witnesses that I will be gone for about 10 to 15 minutes and then we will take, in order, Mr. McGrath, Mr. Boasberg, Mr. Klineman and Mr. Shulman, in that order.

I will be back at about 20 after 11.

[A brief recess was taken.]

Senator PACKWOOD. The committee will come to order. Mr. Thomas McGrath.

STATEMENT OF THOMAS McGRATH AND JONATHAN BLATTMACHR

Mr. McGRATH. Thank you, Mr. Chairman.

My name is Thomas McGrath. My colleague, Jonathan Blattmachr and I are practicing attorneys in New York City. We specialize in the areas of trust and probate law. We have spent about 2,000 hours in the last 9 to 12 months studying and analyzing the new carryover provisions of the code, as well as other sections of the code that are affected by the carryover basis provisions.

The end result of our study is a treatise on carryover basis, and that treatise contains not only analysis of the new law, but forms, charts, guides, and tables for use by the general practitioner.

Over this period of time, we have also conferred with members of the staff of the joint committee and, in fact, have sent copies of our manuscript in progress to the staff.

There is no doubt that carryover basis is very burdensome and imposes a heavy tax cost on our taxpayers.

Also, as often occurs with new, complex legislation, serious oversights and administrative problems, unforeseen in the drafting stage, surface; and those problems should be addressed and they should be addressed immediately.

All of this, coupled with the slow awakening of the general public to the true impact of carryover basis on the average taxpayer has created much hue and cry for repeal.

However, any rational response must not lose sight of the fact that carryover was enacted for two primary reasons. First of all, the revenue generated by carryover basis is to offset the revenue losses occasioned by the general reduction in the amount of estate taxation arising out of the changes to chapter 11 of the code by the Tax Reform Act of 1976.

Perhaps more importantly, for decades it has been stated that the so-called step in basis at death was a give-away in our Federal tax system, that was a serious tax loophole.

Reasonable men may differ on this point. Certainly I do. I do not believe that death is a tax loophole and if it is, it is one loophole that I do not care to avail myself of for the longest period of time. But I think we are beyond the point of that debate.

The purpose of carryover basis was to close this so-called tax loophole and create greater horizontal and vertical equity among our taxpayers so that those who could afford to hold on to appreciated property until death were not to be favored over those who could not hold on to appreciated property until their death.

If Congress at this stage concludes that that socioeconomic posture was not or is no longer valid, and that we should return to prior law, then I would personally agree. However, that does not appear to be a probability at this stage.

In my view, the real issue today is not repeal of carryover basis and a reversion to prior law, but rather substituting carryover basis with either an appreciation estate tax at death—so-called AET—or the administration's proposal several weeks ago of a capital gains tax at death, with the possibility of a moratorium now; moratorium of the carryover basis provisions until that is accomplished.

Therefore, the issues that I would like to address myself to are: one, as among the three options, AET, capital gains at death, or carryover basis, is carryover basis more desirable; two, can carryover basis be made to work?

Our extensive study and analysis indicates without question that through appropriate amendment and regulation, carryover basis can be made internally consistent and can be made consistent with other provisions of the code and it can be administered without undue complications and problems—particularly when you compare carryover basis to other provisions of the code such as ERISA, subchapter J, private foundations and so forth.

There is not a doubt in our minds that virtually all of the legal and administrative problems that we have been talking about with regard to carryover basis apply also to the AET and the capital gains tax at death.

The greatest administrative burden of all—trying to ascertain the decedent's basis of that asset—still exists. The burden is the same under AET or capital gains at death.

In fact, either of those taxes further aggravate the burden. Because, all of the tax has to be paid up front—whereas with carryover basis it can be delayed until the asset can be disposed of by the heirs—basis information must be ascertained immediately after death.

Of course, both appreciation estate tax and capital gains tax at death impose a brandnew burden, that is paying a tax at death. Assessing the tax at death, in our view, also creates inequities by taxing the appreciation at one point in time, death. We have a bunching effect. If the rate of tax is graduated, then the bunching is unfair. What happens if the economy falters the next day and paper appreciation is not what it was the day before? Even the estate tax provides for alternate evaluation.

What could be more arbitrary than looking at an unexpected, unforeseen, unfortuitous death as the moment to tax paper profits?

The notion is contrary to the firmly established principle in our tax system that death is not a taxable event.

There has been a bill introduced which would impose a moratorium on the implementation of the carryover basis rules.

Senator PACKWOOD. Let me interrupt you and ask you a question.

Early on in your statement you say that at least the carryover basis attempts to address the problem that used to exist in the discrimination between those who could afford to own the property and those who could not. Then on page 3, you indicated that if Congress wanted to return to the prior law you would wholeheartedly agree, not from a legal standpoint but from an equity standpoint.

Would you care to return to prior law, or do you think the philosophy of carryover is fair?

Mr. McGRATH. My personal view is that the carryover basis tax, as with the gift tax and estate tax, is not a tax to raise the revenues to run our Government, but it is social engineering. I have a personal view about that kind of taxation.

I think that the argument that has been made over the years that step up at death is a tax loophole is a very viable argument. Nonetheless, it is a philosophical argument with which I personally disagree.

However, once we have covered that hurdle and we must address ourselves as to how to achieve this horizontal and vertical equity among taxpayers, I think the carryover basis is the only way that it can be done fairly.

Senator PACKWOOD. Philosophically, you do not think there should be a tax on the step up basis regardless of what form the tax takes?

Mr. McGRATH. That is correct.

Senator PACKWOOD. Go ahead.

Mr. McGRATH. We were talking about the moratorium. The reason I spent so much time talking about AET and capital gains at death is that the reason given in support of moratorium is that we will have more time to consider the appropriate form of taxation and appreciation. As I have stated, there is no question in my mind but that carryover basis is far superior to any one of the AET or capital gains at death.

Senator PACKWOOD. Let me say this. Your 5-minute bell has rung. Since you are the only witness so far that has testified on the possibility of making it work, I am going to let you go on, just to try to balance off the weight of testimony that we have had today.

Mr. McGRATH. Thank you.

If moratorium is a tactic to be used to substitute carryover basis for some other form of taxation, then it should be rejected.

Furthermore, what we need now is certainly in our law, not delay. What we need is the staff and Treasury to spend their time working on regulations rather than working on new taxing systems.

Mr. Blattmachr and I have submitted to this committee 10 specific proposals, technical and clerical in nature. They can be dealt with by regulation.

We have also submitted five proposals which are substantive in nature. If these proposals are adopted, carryover basis can be made not only workable, but also acceptable to our taxpayers. There is one major proposal in Senator Byrd's and Senator Dole's bill which has to do with replacing the fresh start adjustment with "grandfathering."

First, we certainly believe that the fresh start adjustment should be retained, but should be permitted whether the asset is ultimately disposed of at a gain or a loss. That change would go a long way toward simplifying carryover basis.

We also believe that the proposed h-3 [IRC § 1023] adjustment, that is the minimum basis adjustment for personal tangible property, should be expanded to include all personal tangible property, not only that property owned on December 31, 1976.

And finally, there is the Byrd-Dole concept of grandfathering. We believe that grandfathering should be rejected.

First of all, philosophically it gets us back into a perpetuation of the "lock-in" concept. Second, while it is very beneficial to certain taxpayers in our system, it nonetheless still does not remove the substantial burden, the administrative burdens, such as keeping basis records.

Last, and I think most important, grandfathering, I believe, cuts across one of the most important changes that I think should be made in our law, and that is the carryover of unused carryforward losses of a decedent to his estate, and those losses, it seems to me, being carried over to his estate, should be losses attributable to his property sold prior to 1976 or losses realized on the disposition of assets after January 1, 1977 where the asset was acquired prior to 1977.

In other words, all unused carryforward losses should be carried over to the decedent's estate regardless of when recognized.

Thank you.

Senator PACKWOOD. I have just finished reading your statement. It is an excellent statement and it is very helpful to the committee to have somebody come forward and say I do not like the law and wish it repealed but if it is going to say, here are the ways it could be made possibly bearable and at least workable.

It is an excellent piece of work and I congratulate you.

Mr. MCGRATH. Thank you, sir.

[The prepared statement of Mr. McGrath and Mr. Blattmachr follows:]

STATEMENT OF THOMAS J. MCGRATH AND JONATHAN G. BLATTMACHR

SUMMARY

I. The significant issue is whether carryover basis should be retained or substituted by another form of taxation which would impose a tax on inherent appreciation. Carryover basis can be made to work satisfactorily through modest statutory amendments. It is preferable to either an appreciation estate tax or a capital gains tax at death, both of which may be legally and administratively more complex than carryover and neither of which provides the same equivalent tax treatment for transfers before death and for those after death which carryover provides.

II. A moratorium on carryover is a form of repeal, and unfairly places the taxpayer and advisor in a state of limbo. What is needed now is certainty not delay.

III. Allowing all assets owned at death whose holding period includes December 31, 1976 to receive their estate tax values as their bases will not substantially reduce legal and administrative complexity; also, because all appreciation to death (and not just to December 31, 1976) on such assets would also be "grandfathered", taxpayers will be more prone to hold assets until death. Further, allowing unused capital losses recognized on disposition of assets acquired prior to January 1, 1977 is more significant than grandfathering.

IV. Ten specific clerical changes and five specific substantial changes would make carryover basis simpler to apply and understand.

STATEMENT

This statement has been prepared by Thomas J. McGrath and Jonathan G. Blattmachr, the authors of a major tax treatise entitled, "Carryover Basis Under the 1976 Tax Reform Act: A Working Guide, with Forms to Estate Planning and Administration" published by The Journal of Taxation. Messrs. McGrath and Blattmachr are practicing attorneys in New York City specializing in probate and trust law. Mr. McGrath is a member of the firm of Simpson Thacher & Bartlett with offices at One Battery Park Plaza, New York, N.Y. 10004. Mr. Blattmachr is associated with the firm of Milbank, Tweed, Hadley & McCloy with offices at One Chase Manhattan Plaza, New York, N.Y. 10005. This statement reflects the views of only Messrs. McGrath and Blattmachr with respect to certain matters relating to the provisions of the Internal Revenue Code of 1954 as amended (herein "IRC") and H. R. 6715 (herein "Technical Corrections Bill of 1977") relating to the carryover basis of property acquired from or passed from a decedent.

INTRODUCTION

We have spent approximately 2,000 combined hours over the last twelve months analyzing and studying not only the new carryover basis sections added by the Tax Reform Act of 1976, e.g. IRC §§ 1023 and 1040, but also the other sections of the IRC affected by this momentous change in our tax laws, such as IRC §§ 303, 306, 1245, 1250 and subchapter K. Over this period of time we have also conferred with members of the Staff of the Joint Committee on Taxation and have provided the Staff with our manuscript in progress.

There is no doubt that carryover basis is very burdensome and imposes a heavy tax cost upon our taxpayers. Also, as often occurs with new complex legislation, many serious oversights and administrative problems, unforeseen in the drafting stage, have surfaced since enactment which require immediate correction. All of this, coupled with the slow awakening of the general public to the true impact of carryover basis on the average taxpayer, has created much hue and cry for repeal.

However any rational response must not lose sight of the fact that carryover basis was enacted for two primary reasons: First, the revenue generated by the carryover basis tax offsets the revenue loss occasioned by the general reduction in the amount of estate taxation due to changes to Chapter 11 of the IRC by the Tax Reform Act of 1976. But perhaps more importantly, for decades it has been stated that the so-called "step-up in basis" at death was a serious tax loophole and a major "give-a-way" in our federal income tax system. The purpose of carryover basis was to close that loophole and create greater horizontal and vertical equity among taxpayers so that those who could afford to hold on to appreciated property until death would no longer be favored over those who could not hold on to appreciated property until death.

If the Congress at this stage should conclude that that socio-economic posture was not or is no longer valid and that we should return to prior law, we would whole-heartedly agree. However, it does not appear that reversion to prior law at this stage is a probability. Thus, the real issue today is not repeal of carryover basis and reverting to prior law but rather substituting carryover basis with either an appreciation estate tax, the so-called "AET", or the Administration's proposal of a capital gains tax at death with a possibility of moratorium of carryover basis until that is accomplished.

APPRECIATION ESTATE TAX AND CAPITAL GAINS AT DEATH ARE NOT BETTER ALTERNATIVES TO CARRYOVER BASIS

Therefore, the issues to which we wish to address ourselves are: One, as among the three options (carryover basis, appreciation estate tax and capital gains tax at death) is carryover basis more desirable; and two, can carryover basis be made to work? Our extensive study and analysis indicates without question that through appropriate amendments and regulations, the carryover basis law can be made internally consistent, consistent with other provisions of the IRC and can be administered without undue complications and problems—particularly when compared to other provision of the IRC such as Subchapter J, ERISA, etc.

Furthermore, there is not a doubt in our minds that virtually all of the legal and administrative complications that now exist in carryover basis are inherent in both the appreciation estate tax and the capital gains tax at death. Both proposals would, for example, impose a tax on appreciation between the decedent's basis in an estate asset and the asset's estate tax value. Thus, the greatest administrative of all—acquiring basis and related information—will be exactly the same as that under carryover basis. However, under appreciation estate tax or capital gains tax at death, the burden is further exacerbated. Because those taxes would be imposed at death, there will be less time within which to gather the necessary information.

And, of course, both the appreciation estate tax and the capital gains tax at death impose the brand new burden of having to pay the full tax at death, whereas at least with carryover basis, the tax is deferred until the estate asset is disposed of. Assessing the tax at death also creates serious inequities, by imposing the tax at one point in time—death—all of the appreciation (the income subject to tax) is bunched at that moment. What happens if the economy falters the next day and the paper appreciation is not what it was the day before. (Even the estate tax provides the executor with optional valuation dates.) What could be more arbitrary than looking at an unexpected, unforeseen and unfortuitous death as the moment to tax paper profits. Such a notion is contrary to the firmly established principle of our tax system that death is not a taxable event.

Furthermore, additional exceptions to the general application of either an appreciation estate tax or capital gains tax at death are contemplated which will invariably make either of those approaches more complicated than carryover basis. It seems that the proponents of the appreciation estate tax and the capital gains tax at death will urge that farms, closely held business interests and property qualifying for the marital deduction will, in some fashion, be excluded from the application of either of those taxes. A perusal of IRC § 2032A should indicate the types of complexities which will arise in those circumstances. It has even been urged that the carryover basis provisions be applied in those cases where the appreciation estate tax and the capital gains tax at death would not apply. In other words, we would have two different taxing provisions with which to contend.

MORATORIUM SHOULD BE REJECTED

It has been suggested in some quarters that there should be a moratorium on the implementation of the carryover basis provision. The reason given in support of moratorium is that we will have more time to consider the appropriate form of taxation on appreciation. There is no question in our minds but that carryover basis is far superior to either appreciation estate tax or capital gains tax at death. If moratorium is a tactic to be used to substitute carryover basis with some other form of similar taxation it should be rejected. Furthermore, a moratorium is another form of repeal. If the Congress is of a mind to repeal carryover basis and revert to prior law then let us repeal it and not place the taxpayer and the tax adviser in a state of limbo. What is needed now is certainty not delay.

CARRYOVER BASIS CAN BE MADE TO WORK

The basic concept of carryover basis is extremely simple: The estate or beneficiary takes over the decedent's tax basis at death. In that respect it is no more complicated than the general carryover basis concept used for property which is transferred by gift. However, in application of the carryover basis rules, as enacted, both legal and administrative complications arise.

Legal complications arise because of the exceptions from the definition of carryover basis property, exceptions from the operation of the general rule of carryover basis, the special rules provided for in the statute, and the limitations placed on the exceptions and the special rules. Legal complications also arise because of the interrelationship with the carryover basis provisions and other provisions of the IRC and state laws.

The exceptions, special rules and limitations provided for with respect to carryover basis do not seem especially complex compared to many other provisions of the IRC. Nevertheless, certain open questions in the statute do cause substantial complications which must be resolved in order to have carryover basis work.

The nonlegal complications are administrative in nature and revolve primarily around the question of how to acquire basis information: Date of acquisition data, capital changes and improvement information and the like.

In most cases, for investment-type assets, such as marketable stocks and bonds and for real estate the information is not difficult to obtain because taxpayers generally keep accurate records for those types of assets.

It seems that the administrative burden most often will be greatest with respect to tangible personal property, especially personal and household effects. We have all heard the stamp collection argument ad nauseam. But the fact is that the carryover basis law provides relief by allowing the executor to select up to $10,000 worth (based on estate tax values) of personal and household effects to have their estate tax values be their bases. While that exception will cover the majority of estates, certain administrative problems still arise. State law may require the executor to make an inquiry if it has anticipated that the decedent's basis is greater than estate tax value even where the aggregate estate tax values of all personal and household effects of $10,000 or less. Moreover, the executor may be faced with competing demands of beneficiaries when more than $10,000 worth of personal or household effects are contained in the estate. The answer perhaps is to expand the exclusion as suggested later.

Carryover basis provisions also appear to cause special problems when closely held business interests and farms are involved and special exceptions or treatment for such circumstances could be provided.

But in all events, it cannot be emphasized strongly enough that both the legal and administrative problems inherent in carryover basis will exist with the alternative forms of tax on appreciation. Reducing the number of exceptions, exclusions, and special rules would decrease the complications for all systems.

There are ten clerical and technical amendments and five substantive changes in the law which we believe, if enacted promptly, would make the carryover basis law adequately consistent, would provide for a feasible, viable method of administering the law both for the taxpayer and the government, and would create a greater degree of fairness.

TEN SPECIFIC PROPOSALS CLERICAL AND TECHNICAL IN NATURE

1. *Satisfying pecuniary legacies with appreciated IRC §§ 1245 or 1250 property.*—Specifying which of IRC §§ 1245 and 1250 (each of which prescribes, in part, that "gain shall be recognized notwithstanding and other provision of this subtitle"), on the one hand, and IRC § 1040, contained in the same subtitle, (which prescribes, in part, that the executor who satisfies a pecuniary legacy with appreciated carryover basis property shall recognize gain only to the extent that the fair market value of the property exceeds its estate tax value), on the other hand, controls when appreciated carryover basis IRC § 1245 or IRC § 1250 property is used to satisfy a pecuniary legacy.

2. *Satisfying pecuniary legacies with appreciated IRC § 306 stock.*—Specifying which of IRC § 306 (which provides, in part, that the "amount realized" upon disposition shall be treated as gain from the sale of property which is not a capital asset rather than providing for the "recognition" of gain upon disposition) and IRC § 1040 controls when appreciated carryover basis IRC § 306 stock is used to satisfy a pecuniary legacy.

3. *Reducing "amount realized" under IRC § 306 for December 31, 1976 basis.*—Modifying Section 3(a) of H.R. 6715 to provide that the "amount realized" upon the disposition of IRC § 306 stock is to be reduced by the adjusted basis of the stock on December 31, 1976 (provided that the basis of such stock in the hands of the person disposing of it reflects the basis of such stock on December 31, 1976) whether or not an adjustment to basis under IRC § 1023(h) is to be made. The Technical Corrections Bill of 1977 as passed by the House on October 17 provides for this modification.

4. *Changing the rules for charitable income tax deductions for estates and trusts.*—Amending IRC § 642(c)(1) to provide for the allowance of a charitable income tax deduction in certain instances in which IRC § 642(c)(1) apparently would not allow a deduction (as in the case where appreciated carryover basis

property in the estate must be sold in order to satisfy a preresiduary charitable bequest and where the carryover basis tax on the gain must be borne by the residuary estate) and to provide for the denial of a deduction, in certain other cases, in which IRC § 642(c)(1) apparently would allow a deduction, for amounts of income, attributable to gains carried over from a decedent, paid or permanently set aside for charitable purposes (as in the case where appreciated carryover basis property in the estate must be sold in order to satisfy a non-charitable preresiduary bequest and where the carryover basis tax on the gain must be borne by a charitable residuary legatee).

Consideration should also be given to the question of whether the estate tax charitable deduction would be affected under those circumstances.

5. *Satisfying pecuniary legacies in kind with appreciated encumbered property returned in 706 encumbered.*—Amending IRC § 1040 to provide for the purposes of that section that the fair market value of appreciated carryover basis property used to satisfy a pecuniary legacy is to be diminished by any mortgage on or indebtedness with respect to such property whenever the property has been included in the gross estate diminished by such mortgage or indebtedness in order to ensure that property which has not, in fact, appreciated from the time of death (although included in the gross estate net of any mortgage) will not trigger gain.

6. *Determining net appreciation for encumbered property.*—Amending IRC § 1023 to provide that the adjustments to basis under IRC § 1023 (c), (d), (e) and (h) are to be computed by reducing the adjusted basis by any mortgage on or indebtedness in respect of property if the property has been included in the gross estate diminished by such mortgage or indebtedness so that the accurate amount of net appreciation is used in making the adjustments to basis.

7. *Specifying which property is not subject to a tax.*—Clarifying how the determination of what property is deemed not subject to a tax within the meaning of the IRC § 1023(f)(4)(A) is to be made. This is one of the most perplexing and important open questions. An alternative solution would be to allow the adjustment for estate taxes to be made even for marital or charitable deduction property (either with or without a corresponding reduction in the estate taxes adjustment for other property).

8. *Specifying whether death on the distribution by the executor constitutes a taxable disposition if liabilities exceed basis.*—Specifying whether the change of ownership from the decedent at death to his estate or beneficiaries or the distribution from the executor to a benficiary of carryover basis property constitutes a disposition for income tax purposes if liabilities with respect to such property exceed its basis at the time of death or of such distribution.

9. *Clarifying purpose of fresh start minimum basis.*—Modifying Section 3(c)(1)(A) of H.R. 6715 to specify that the minimum basis adjustment is an alternative "fresh start" adjustment and is not to be made before application of the adjustment under IRC § 1023(h)(1) or IRC § 1023(h)(2) as the words "the adjusted basis of such property immediately before the death of the decedent shall be treated as being not less than" in the bill might indicate.

10. *Reducing IRC § 305 stock ordinary income for IRC § 1023 adjustments made.*—Amending IRC § 306 to provide that the "amount realized" upon disposition shall be reduced by the adjusted basis of IRC § 306 stock after all adjustments to basis under IRC § 1023 and provide further that the amount of ordinary income otherwise recognized under that section be reduced by such adjusted basis before reducing the amount of capital gain income otherwise recognized under that section.

FIVE SPECIFIC PROPOSALS SUBSTANTIVE IN NATURE

(1) *Allowing fresh start for purposes of loss and allowing the fresh start minimum basis for all tangibles.*—One provision which causes considerable legal complications, administrative burdens and inequitable results is that the adjustment provided to basis under IRC § 1023(h) the "fresh start adjustment") is available only for purposes of determining gain. The consequence of this limitation is that the estate and subsequent beneficiaries must keep track of two sets of bases for each asset entitled to a tentative fresh start adjustment. Further, by adjusting an asset for fresh start, each subsequent adjustment to the basis of that asset is thereby reduced. If the asset is then sold at a loss, the fresh start adjustment is eliminated by the other adjustments are not increased. Additional complexity is introduced if the asset is sold at neither gain nor loss.

The lack of equity inherent in limiting the fresh start adjustment only to cases of gain, and the legal and administrative complications which arise by virtue of that limitation, simply cannot be justified by any extra tax revenue that may be generated because of it. The fresh start adjustment should be available whether the asset entitled to it is disposed of at a gain or a loss.

Moreover, in order to avoid the costly burden of ascertaining basis information which is, in many cases, difficult to determine with respect to tangible personal property, we would recommend that the concept of the fresh start minimum basis adjustment as proposed in Sec. 3(c)(1) of the Technical Corrections Bill) be expanded to cover all tangible personal property including that property whose holding period does not include December 31, 1976. Because the adjustment would relate back to that date there would be virtually no revenue loss, in most cases, by allowing such an adjustment of convenience for all tangible personal property.

It has been seriously urged by certain groups that the fresh start adjustments to basis be eliminated entirely and replaced with the "grandfathering" of all assets where the adjusted basis in such assets immediately before the death of the decedent reflects the adjusted basis of those assets on December 31, 1976. Such assets would be excluded from the definition of carryover basis property and would receive a step-up in basis at death under IRC § 1014. We believe that such a change would perpetuate the so-called "lock-in" which is contrary to the Congress' stated purpose for enacting carryover basis. Furthermore, while the grandfathering of assets held on December 31, 1976 would provide substantial tax relief for certain taxpayers, it would not reduce in any meaningful way the administrative burdens under carryover basis because all taxpayers would be required to inventory all assets owned by them on December 31, 1976. But, more importantly, such a proposal would, in our view, cut across one of the most important changes we believe should be made in the present law: allowing an unused capital loss to be carried forward after death. (See Item (5), supra.) In our view allowing unused capital losses to be carried over after death whether those losses were incurred prior to January 1, 1977, and whether those losses were incurred as a result of the disposition of assets after January 1 which were acquired prior to January 1, 1977 is significantly more important than grandfathering.

(2) *Providing for an adjustment to basis for the marginal increase in federal and estate tax attributable to net appreciation.*—As presently drafted, the adjustment to basis for federal and state estate taxes under IRC § 1023(c) is made for the average amount of such taxes attributable to the net appreciation. Providing for the adjustment at the marginal increase in estate taxes attributable to net appreciation seems to supply a more equitable result when one compares this approach to disposition prior to death and the income tax paid during lifetime is, in fact, subtracted from the "top" of the estate tax bracket not the average.

Moreover, by converting to a marginal adjustment, at least in some circumstances (though clearly a minority of cases) the problem of the changing adjustment because of a change (for example, on audit) in the taxable estate will be avoided.

(3) *Modifying the $60,000 minimum basis adjustment.*—The $60,000 minimum basis adjustment should be eliminated entirely and replaced with a simple exclusion of $60,000 worth of assets (based on estate tax value) from the definition of carryover basis—similar to the $10,000 personal and household effects exclusion now provided for under IRC § 1023. A corollary to this change would be the elimination of the $10,000 personal and household effects exclusion. This would provide greater relief for modest estates from the administrative burdens of carryover basis.

(4) *Modifying the relationship between IRC § 306 stock and IRC § 303 redemptions.*—The Congress has determined to provide relief from ordinary income dividend treatment when a redemption occurs within the provisions of IRC § 303. There is no corresponding redemption provision for stock ownership during lifetime. Thus, allowing a redemption of IRC § 306 stock to qualify under IRC § 303 would not create an inconsistency with property disposed of before death, especially when one considers the policy decision made by the Congress to provide relief when stock is redeemed to pay for taxes and expenses. We, therefore, recommend that a redemption of IRC § 306 stock be afforded capital gain treatment by allowing a qualifying redemption of such stock under IRC § 303.

We also strongly urge that because of the impact of carryover basis, IRC § 303 be amended by increasing the amount of a qualifying distribution to include income taxes generated as the result of a qualified redemption under IRC § 303.

(5) *Allowing a capital loss carry forward after death.*—The oft heard argument in support of carryover basis was that under prior law a taxpayer was "locked-in" to holding assets until death because of the automatic step-up in basis under IRC § 1014. Thus, with the introduction of carryover basis, taxpayers would be more willing to dispose of appreciated assets and realize the gain which would have to be realized by his estate or beneficiary ultimately in any event. However, now the "lock-in" argument applies with equal force with respect to assets which have depreciated in value. In other words, under present law, if a taxpayer realizes a loss upon disposition of an asset which might otherwise be carried forward, but the taxpayer dies, that loss cannot be carried forward to his estate or beneficiaries. Therefore, a taxpayer may be less willing to dispose of a depreciated asset before death. Instead he might hold on to the asset until death, have his estate dispose of it and then have the loss carried forward to his beneficiaries under IRC § 642(h).

In order to avoid this newly created "lock-in of losses", a reasonable corollary to carryover basis would be to permit a taxpayer's unused capital losses to be carried over to his estate and his beneficiaries. Such a rule would also create a closer degree of fairness and equity in the application of carryover basis.

CONCLUSION

We believe that if the technical and substantive changes recommended are made, and regulations are promptly issued, carryover basis can work and does not have to be an undue administrative burden to the fiduciary, the lawyer or the taxpayer.

In all events, we would urge retention of a modified carryover basis approach rather than the adoption of an appreciation estate tax, or a capital gains tax at death.

Respectfully submitted on behalf of Thomas J. McGrath and Jonathan G. Blattmachr.

THOMAS J. MCGRATH.

Senator PACKWOOD. Mr. Boasberg.

STATEMENT OF TERSH BOASBERG, ESQ., GENERAL COUNSEL, PRESERVATION ACTION

Mr. BOASBERG. This is probably not the most burning issue that you are going to face today, but we do appreciate being able to come up here.

I am testifying on S. 2241 which briefly is a technical amendment allowing long-term leasees, people who lease buildings, to take 60-month writeoff of certified rehabilitation on certified historic structures.

The law now provides that only owners can take a quick writeoff when they rehabilitate certified historic structures.

This amendment will enable long-term lessees to do the same thing.

As you know now, leases on certain other property do have the advantages of owners. They can depreciate their leasehold interest and so forth.

Ordinarily, when the Congress passed the new act last year to encourage certified rehabilitation on historic buildings it was a great encouragement because it would allow owners to write off their rehabilitation over a quick 5-year period.

We are now trying to extend this to long-term lessees.

The reason is that profits groups, States, and cities just do not have the money to fix up these buildings themselves. The only way to make them viable is to allow the long-term lessee to get the advantages of this quick writeoff rather than be restricted to the straight line method.

I am sure you are familiar with the historic preservation work done in your part of the world in San Francisco, Portland, and Seattle. It has really been marvelous. Old buildings have really come to new life. It means jobs, new tax revenue, economic development. It is very helpful in urban rehabilitation.

This amendment would extend that. For example, in Nashville, Tenn., we have the customs house. It was given by the United States to the city of Nashville. They do not have the funds to redo it, but if they can get a long-term lease in there and give him this 5-year advantage, that building can go. The same is true about a lot of the buildings under the Surplus Property Act.

Senator PACKWOOD. What would the leasee do with the old customs house?

Mr. BOASBERG. You have probably been to Ghirardelli Square in San Francisco: stores, restaurants, office space. I think it is just another shot in the arm for historic preservation for cities.

We appreciate your consideration.

[The prepared statement of Mr. Boasberg follows:]

STATEMENT OF TERSH BOASBERG, ESQ., GENERAL COUNSEL, PRESERVATION ACTION

My name is Tersh Boasberg. I am a partner of the Washington, D.C. law firm of Boasberg, Hewes, Finkelstein and Klores. I am General Counsel of Preservation Action, the national citizens' lobby for historic preservation. Preservation Action is composed of over 300 individuals and non-profit historic preservation organizations from Maine to California and from Florida to Alaska. A number of our members also are cities, counties and state offices of historic preservation.

Members of Preservation Action such as Historic Annapolis, the Galveston Historical Foundation, the City of Seattle, Historic Denver and others are converting handsome, older buildings to new adaptive uses for stores, restaurants, office space, businesses, educational institutions, and a host of other 20th century uses. Historic preservation in this enlarged sense means job development, additional municipal tax revenues, an influx of new businesses and higher local bond ratings. Preservation, indeed, means progress.

I am pleased to support S. 2241, which will give long-term lessees the same advantages which owners now have for the quick, 60-month write-off of certified rehabilitation expenses on certified historic structures. This means there will no longer be discrimination between owners and long-term lessees.

As this Committee knows only too well, many of the local communities and non-profit organizations do not themselves have the necessary funds with which to rehabilitate historic structures such as courthouses, schools, police and fire stations and municipal buildings.. In many communities such as Louisville, Seattle, New York and San Antonio, these buildings can be commercially adapted through rehabilitation but only a long-term lessee would have the requisite funds. S. 2241 would encourage such lessees to rehabilitate and adaptively use these properties by taking advantage of the Sec. 191 tax benefits.

Indeed, in many cases it is only by such encouragement that these buildings can become useful once again. For example, one of our members, Maydean Eberling of Nashville, Tennessee, tells us that the City cannot raise the funds necessary to rehabilitate the U.S. Customs House there. However, she feels that if a long-term lessee could secure the Sec. 191 benefits, the Customs House can again become an economically viable operation.

S. 2241 takes on even greater importance in situations such as that noted above with respect to Nashville. This is because under the recent amendments dealing with disposal of surplus properties, 40 U.S.C.A. § 484, the Federal Government may turn over to local communities historic buildings and properties which the United States Government no longer needs. Cities and towns receiving such properties cannot sell them to private owners and, yet, often do not have the funds necessary for their rehabilitation. S. 2241 would encourage the rehabilitation of these structures by long-term lessees by allowing them the Sec. 191 benefits.

In addition, the U.S. Treasury will not be hurt since, under other provisions of the IRC, the Sec. 191 benefits would be subject to recapture should the lessee dispose of his leasehold interest prematurely.

In conclusion, Preservation Action believes that S. 2241 would greatly facilitate historic preservation and job development, especially in decaying urban ghetto and downtown areas by encouraging long-term lessees as well as owners of certified older historic structures to rehabilitate them for current usage. We strongly support this measure and urge your favorable consideration thereof.

Senator PACKWOOD. Mr. Klineman?

STATEMENT OF KENT M. KLINEMAN, KLINEMAN ASSOCIATES, ACCOMPANIED BY EDWARD L. MERRIGAN

Mr. KLINEMAN. Good morning, Mr. Chairman. My name is Kent M. Klineman. My firm, Klineman Associates, located in New York City, is a small business concern and, like hundreds of others throughout the United States, it engages in the leasing of office furnishings, machines, and equipment to businesses and professional firms which prefer to rent rather than buy their office requirements. I am accompanied by my counsel, Mr. Edward L. Merrigan, of Washington, D.C.

We deeply appreciate the opportunity the subcommittee provided for the presentation of this testimony, and in line with the hearing notice, we shall endeavor to be as brief as possible.

The purpose of our appearance, Mr. Chairman, is to urge your committee to correct a serious inequity which we believe was unintentionally created by the at-risk equipment leasing provision of the Tax Reform Act of 1976 for unincorporated small business office equipment leasing firms that must compete day in and day out with some of the largest corporations in the United States.

The House version of the Technical Corrections Act of 1977 already changes and corrects some of the erroneous aspects of the at-risk equipment leasing provisions of the 1976 act, so plainly it is appropriate and vitally important to our industry for the Senate to correct this additional glaring inequity which threatens adversely to affect the ability of all unincorporated small office equipment lessors to continue to compete effectively with the giants of our industry. In my opinion, if it is not rectified soon by the Congress, it will actually destroy many small leasing firms which simply cannot continue to finance all their lease transactions on a total at-risk basis in order to meet the tax deduction requirements of the Tax Reform Act of 1976.

Prior to adoption of the new at-risk provisions of the 1976 act, big business office equipment lessors such as IBM, Xerox, major U.S. banks, et cetera, and local small business office equipment lessors competed on an equal footing under the Internal Revenue Code, at least. Both were entitled to claim on the same basis expenses, depreciation, and losses on office equipment they owned and leased to their customers, irrespective of how the equipment was purchased or financed.

The 1976 act, however, unintentionally and unfairly changed the tax rules for local unincorporated small business office equipment lessors only, while it left the incorporated giants of the equipment leasing industry free to continue to operate precisely as they did in the past.

More specifically, it did this by inadvertently subjecting small unincorporated office equipment leasing firms to the stringent new at-risk tax rules of section 465, while it expressly exempted their large incorporated competitors from those at-risk requirements.

Congress, of course, never intended to appy those oppressive new at-risk tax requirements to either large or small regular, normal equipment leasing businesses, but rather to large, artificially created equipment leasing tax shelters only. That explains why Congress exempted corporations from at-risk. It wanted to exempt everyday equipment leasing operations such as those of Hertz, Avis, National Car Rental and their small competitors in the automobile leasing industry; and those of Xerox, IBM and major banks and their small business competitors in the office equipment leasing industry.

In this regard, both the Senate and House reports in support of the 1976 act went to great lengths to explain that the new risk rules are aimed strictly at tax shelters which allow taxpayers to offset artificial losses from outside investment activities such as farming, motion pictures and large, unusual equipment leasing arrangements against income received in their regular, everyday businesses or professions—and that under no circumstances were the at-risk rules meant to apply to regular equipment leasing activities such as those conducted by large and small companies in the automobile and office equipment leasing industries.

Indeed, the Senate report emphasized that application of at-risk to normal, everyday business operations in these particular industries would be counterproductive and would eliminate many such operations—a serious mistake in a time of high unemployment.

But, by exempting corporations only, Congress patently erred. It apparently assumed that all regular, normal equipment leasing concerns are incorporated. The big companies and the banks are incorporated, but many of their local, small business competitors are not.

In the final analysis, therefore, the 1976 act unintentionally exempted large and small corporations in the office equipment leasing industry but it left the small unincorporated leasing concern subject to the oppressive new at-risk rules designed to crush tax shelter operations only.

In effect, Congress mistake now threatens to crush regular small unincorporated office equipment leasing firms for no valid tax reason whatsoever.

Why, I ask, would Congress exempt the regular equipment leasing activities of the corporate giants and simultaneously install crushing new at-risk tax rules for the regular equipment leasing activities of their unincorporated small business competitors?

Further evidence that Congress never intended any such ridiculous result is also found in the 1976 reports in support of the 1976 act. In the Senate report, for example, the Finance Committee specifically described the type of tax shelter equipment leasing activities to which the new at-risk rules were intended to apply. Almost without exception, the activities listed are extraordinary, multimillion dollar, artificial leasing operations involving the leasing of aircraft, ships, railroad rolling stock, oil drilling rigs, and nuclear fuel assemblies. No indication of any kind is given that this committee or the Senate intended to apply at-risk to the normal, regular leasing activities of a small, unincorporated office equipment leasing concern.

Unfortunately, however, unless this committee acts now to clarify and correct this statutory oversight, every unincorporated office equipment lessor in the United States will continue to be saddled with the crushing at-risk tax rules which were never meant to apply to them in the first place.

Under the at-risk concept, these small concerns, regularly competing with IBM, Xerox, and the banks in cities throughout the Nation, cannot deduct for tax purposes their losses on any of their leased office equipment in excess of the amount they are actually at-risk with reference to that equipment, that is, the amount for which they are personally liable on loans used to purchase the equipment. Their big business competitors, however, can deduct any losses they sustain for tax purposes even if they have no liability whatsoever in connection with the financing of their leased equipment.

In conclusion, I submit this is clearly the type of technical error and inequity the Technical Corrections Act of 1977 must eliminate.

Earlier this year, when other tax legislation was before the Senate for consideration, I understood Senator Johnston of Louisiana prepared a floor amendment which would have solved this problem in consultation with the Joint Committee on Taxation chief of staff and with staff members of the Senate Finance Committee. A copy of that amendment is annexed hereto for this committee's consideration at this time.

It is my understanding that Senator Johnston withheld his amendment because he was advised by the chairman that this was the type of matter which should be corrected by this committee when legislation designed to correct other errors and inequities in the Tax Reform Act of 1976 was before this committee for consideration.

Hopefully, because of the extremely serious nature of the problem confronting so many unincorporated firms in our industry, that time has now arrived.

Correction of this error, of course, will have no real valid revenue impact because Congress did not intend to apply the at risk rules to regular office equipment leasing operations in the first place. But, in any event, correction of this inequity will have a negligible effect on tax revenues for the Treasury.

When the 1976 act was passed, the new at risk equipment leasing provision—applicable to leasing of such large items as ships, airplanes, railroad cars, oil rigs, nuclear assemblies, et cetera—was estimated to raise only $6 million in additional revenues in fiscal 1977 and $14 million in fiscal 1981.

The new rules will continue to apply to all tax shelter operations in these multimillion dollar items and the elimination of relatively small office equipment leased by small unincorporated leasing concerns will be negligible insofar as the Treasury is concerned.

We therefore urge the committee, Mr. Chairman, to include a provision such as Senator Johnston's amendment, or some similar effective provision in the legislation now before you.

[Senator Johnston's amendment follows:]

AMENDMENT

Intended to be proposed by Mr. JOHNSTON to S. ——, a bill H.R. 3477, an Act viz: On page 119, between lines 15 and 16, insert the following:

"SEC. ——. Small business concerns that are Lessors of Office Equipment.
If a taxpayer—
"(1) has an interest in—
"(A) a small business concern (as defined in section 2 of the Small Business Act of 1958 (15 U.S.C. 632)), or
"(B) a small business corporation (as defined in section 1371(b) of the Internal Revenue Code of 1954 (26 U.S.C. 1371(b))
which is engaged in leasing activities solely to the extent of leasing office furniture, fixtures or equipment such as typewriters, file cabinets, computers, duplicating machines or other similar office requirements, and,
"(2) actively participates in the management of such small business concern or small business corporation,
then section 465 of the Internal Revenue Code of 1954 (26 U.S.C. 465) shall not apply with respect to such leasing activities."

Senator PACKWOOD. You are right about your history. I recall the debate, and we were not thinking of unincorporated small businesses.

Why would it not be an answer to you to just incorporate?

Mr. KLINEMAN. Senator, the incorporation is an enormous additional tax cost because of the double taxation problem. That is why many of us are not incorporated in the first place, and the subchapter S solution would not be a good one either, because subchapter S is also subject to the at risk provisions.

We have to remain unincorporated to avoid the double taxation.

Senator PACKWOOD. Your point is valid. I know we did not think about it.

Much in line with the comments I made earlier, there are many provisions in this act that we did not know the effect of. It was not conscious malice. We did not grasp, in many cases, what the effect would be.

I think your case is very valid. I appreciate your bringing it to our attention.

Thank you.

Mr. KLINEMAN. Thank you for the opportunity.

Senator PACKWOOD. Mr. Shulman?

STATEMENT OF ROBERT A. SCHULMAN, ESQ., WASHINGTON, D.C., ACCOMPANIED BY WILLIAM H. SULLIVAN, JR., PRESIDENT, NEW ENGLAND FOOTBALL CLUB, INC.

Mr. SCHULMAN. Senator Packwood, my name is Robert A. Schulman. I am a partner in the law firm of Wenchel, Schulman & Manning. I appear on behalf of William H. Sullivan, Jr., who is with me today. and the New England Patriots Football Club, Inc., of which he is the founder and also the president.

He founded the team in 1960 notwithstanding that two other teams could not make it in Boston—one of which was the old Boston Redskins, now the Washington Redskins—and has been able to keep the team alive. He has labored long and hard under a rather adverse series of circumstances.

As of 1973, the corporation had outstanding 100,000 shares of voting stock, and approximately 140,000 shares of nonvoting stock. At that point Mr. Sullivan owned 24 percent of the voting and also some of the nonvoting. In 1973, a series of disputes arose which were rather bitter and long in nature, as a result of which in 1975, after almost 2 or 3 years of negotiations, Mr. Sullivan undertook to purchase all of the remaining voting stock.

In order to do this, he went to a bank and committed himself to borrow upwards of $5 million.

The bank loan was made on two very, very stringent commitments, one that somehow or other all of the assets and all of the stock including all of the nonvoting, all of the stock outstanding, would be applied as security for the bank loan; and two, after very careful examination, both by Mr. Sullivan's attorneys and by the bank's attorneys, to the effect that the depreciation which would be allowable in respect to players' contracts would continue to be allowable, and the commitments were made, on the basis of the then very clear, precise law as to what depreciation would be computed in respect to the players' contracts.

The purchase was made November 7, 1975, long before any action was taken to amend the sections of the code with respect to depreciation of players' contracts and long before the enactment of section 1056 to the code by section 212 of the Tax Reform Act of 1976.

Following that and as a result of filings with the SEC and following extended litigation in the Federal courts, which went as high as the Court of Appeals for the First Circuit, on January 31, 1977, at long last, after a new corporation was formed to which Mr. Sullivan transferred all of the 100,000 shares consisting of the 24 percent he previously owned and the shares he had purchased from the others, the former New England Patriots Football Club, Inc. was merged into the new corporation.

The nonvoting shareholders were paid at $15 a share—which, incidentally, was a capital gain to most of them, three times as much as they paid when they originally subscribed—and were it not for the amendments by section 212 of the Tax Reform Act which provide that the basis to a new acquirer of player's contracts must be limited by the gain to the transferor plus the transferor's original basis, Mr. Sullivan could complete the payment of his bank loans.

As matters now stand, it is impossible for him to do so as a result of action that was taken by the Congress long after he had made an absolutely firm and binding commitment. And the matter has now reached the crucial state where, if things cannot be remedied, he will perhaps be unable to make the payment due December 31 of this year.

What we are asking for, and I have to echo the statement of a previous speaker here—this is by no means the most important or crucial piece of legislation to be considered by the Congress but, nevertheless, it is the most important and crucial piece of legislation to be considered for Mr. Sullivan, who has dedicated his whole life, his career and in truth, his entire net worth, to this thing.

I do not mean to imply that we cannot find some buyer, but he has built this team, he has bled and died with it, he has managed to get a stadium in Foxboro after many, many years of moving around to different stadiums in the Boston area and, at long last, to get the popular appeal and the support. And, being a Washingtonian, I hesitate to say this, but he has put together a pretty good ball club up there.

In any event, we are submitting before this committee a proposed bill which is identical to a bill that passed the Senate last year and failed of passage in the House by only one vote because it had to go on the unanimous consent calendar in the very last days of the session.

We are not asking for any relief other than relief which, when I was with the Internal Revenue Service, was customarily given, which is that you do not apply anything retroactively, and all we are asking is that the Congress do as much as the Internal Revenue Service would do, which is to not penalize a taxpayer in midstream of something that he is already committed to do.

Senator PACKWOOD. Let me say that Congress did not intend to. We were looking at people who were rolling over franchises and depreciating players' contracts and they had a good team and everybody gained a great benefit out of it.

Mr. SCHULMAN. I thoroughly agree with the intent of the legislation.

Senator PACKWOOD. It was never intended to apply to long-term owners trying to build a club. It was intended to stop these 3-, 4-, or 5-year rollovers.

Mr. SCHULMAN. I must say frankly this is special legislation. We know of no other case where a man made the commitment, was bound by it, prior to the consideration, much less, the enactment by the Congress of new law.

Senator PACKWOOD. You do not need to feel embarrassed or ashamed to plea for special legislation. Every now and then when the media brings up special interest legislation, the question should be, what is meritorious? Sometimes it is more effective than some of the other legislation that we have had.

Mr. SCHULMAN. You have made my argument.

Mr. SULLIVAN. I am the fellow that Mr. Schulman has been describing. He reminds me of my father-in-law. When somebody would say something nice about him, he would inevitably reply: "the fact that I am unworthy of your compliment does not prevent me from enjoying it."

I do not know if that is appropriate to say here, but I would echo what Mr. Schulman said on the special legislation. We have often talked about that. My feeling is that the Congress should never be asked to do something for one person. I do not think it should ever be asked to penalize one person in the entire Nation.

Originally I bought this franchise for $25,000 borrowed dollars and now I think it is worth somewhat more than that. But over the years I took in a few friends, not really because I needed them, because I could have borrowed the money to operate it, but they had helped me and eventually they took in friends, and eventually some of them tried to take it away from us and we went through some difficult times.

I would also, for the record, like to say that we built a stadium, not with public funds, but with money we raised ourselves as a private vehicle. We have a 62,000-seat stadium.

As Mr. Schulman said, we do have our whole life in this, and that of my family, and everything that we own is in it and we would appreciate your consideration.

Senator PACKWOOD. We will see what we can do.

Mr. SCHULMAN. We have submitted a written statement.

Senator PACKWOOD. It will appear in full in the record.

Thank you very much.

[The prepared statement of Mr. Schulman follows:]

STATEMENT OF ROBERT A. SCHULMAN, ESQ.

My name is Robert A. Schulman. I am an attorney practicing law in Washington, D.C. as senior partner of Wenchel, Schulman & Manning. I am appearing as counsel to William H. Sullivan, Jr. and the New England Patriots Football Club, Inc. Mr. Sullivan, the founder and President of the Patriots, is here with me today.

I speak in favor of the adoption of H.R. 8489. The intended beneficiaries of H.R. 8489 are William H. Sullivan, Jr. and the New England Patriots Football Club, Inc. The purpose of the bill is to correct an inequity resulting from a major change in the tax rules affecting the allowance for depreciation of players' contracts owned by sports enterprises. This change is the result of the enactment of section 212 of the Tax Reform Act of 1976, which added section 1056 to the Internal Revenue Code. H.R. 8489 does not change the operative provisions of section 1056 of the Internal Revenue Code but, instead, provides a limited exception to the application of section 1056 of the Code in a situation where, prior to the enactment of the Tax Reform Act, a taxpayer had entered into binding commitments based on then existing law.

As I stated, the specific statutory section with which we are concerned is section 1056 of the Internal Revenue Code. It provides that when player contracts are transferred in conjunction with a sale or exchange of a franchise to conduct a sports enterprise, the acquirer's basis in the player contracts is limited to the transferor's basis in such contracts plus the gain recognized by the transferor. Prior to the enactment of section 1056 of the Code, there was no statutory provision so limiting the basis of player contracts.

The pertinent facts here involved are:

As of 1973, the Patriots had outstanding 100,000 shares of voting common stock and 139,800 shares of non-voting common stock. In 1973, certain problems arose between Mr. Sullivan, who held about 24 percent of the voting shares, and two other groups of voting shareholders. After extended negotiations, these problems were resolved in 1975 by Mr. Sullivan committing himself to purchase the voting shares of the other two groups which together held the remaining voting shares and then to restructure the corporation through the formation of a legal entity as the successor to the Patriots.

Pursuant to that undertaking and on November 7, 1975, Mr. Sullivan borrowed in excess of 5.3 million dollars which he used to purchase from the other two groups all of their voting shares.

This buyout of the other voting shares by Mr. Sullivan was accomplished (a) on his representation to the bank that when the rest of the plan was carried out, in addition to all of the ownership interest of the new entity, the principal assets of the new entity as well—that is, the NFL franchise, player contracts, ticket sales and television revenues,—would be pledged as security for the loan to Mr. Sullivan personally, and (b) on the clear understanding, both by the bank and by Mr. Sullivan, each of whom was independently so advised, that the new entity would be entitled to a basis for player contracts in accordance with then current provisions of the Internal Revenue Code.

Thereafter and pursuant to a proxy statement dated November 5, 1976, in all essential respects identical to the proposed proxy statement filed September 9, 1976, the restructuring of the Patriots was accomplished through a state law merger into New Patriots Football Club, Inc., a newly formed Massachusetts corporation. This state law merger constituted a taxable event both to the holders of the voting and the non-voting stock of the Patriots.

The effect of the statutory provision here involved on those facts is that solely because of the addition of section 1056 of the Code, and in midstream of a plan the first of the two major steps of which was consummated in 1975 after almost three years of difficult negotiations, Mr. Sullivan will be unable to service and amortize the loan of 5.3 million dollars already made to him personally and the new entity will be unable to service and amortize the additional loan of approximately 1.4 million dollars, borrowed by it to assist in paying for the non-voting stock of the Patriots. Therefore, because of legislative changes made in 1976, and after Mr. Sullivan now faces the serious risk of being unable to retain the ownership interest of the football team which, since its founding in 1960, he has continuously fought to save and preserve, and which constitutes almost his entire net worth.

The relief sought is a technical amendment to a complicated statutory provision in which Congress recognized the need for exceptions by providing in it, as initially promulgated, three such exceptions. First, section 1056 of the Code does not apply to a so-called like-kind exchange. It also does not apply to a person acquiring the property from a decedent or to whom the property passed from a decedent. And, third, gain realized by the transferor but not recognized because of the application of section 337(a) of the Internal Revenue Code, is treated as gain recognized by the transferor to the extent gain is recognized by the transferor's shareholders.

Thus, in section 1056 of the Code, Congress recognized that certain circumstances should be exempt from the limitations it provided and acknowledged that a taxpayer should not be penalized if a transaction took a particular form, the substance of which was not materially different from a transaction which received more favorable treatment.

The proposed bill, which we believe affects only Mr. Sullivan and the New England Patriots Football Club, Inc., in these limited circumstances, would continue, effective October 1, 1977, the basis for player contracts which existed under the law prevailing at the time the commitment was made for the first loan of 5.3 million dollars to Mr. Sullivan personally—and at the time Mr. Sullivan purchased the other voting shares—each of which occurred in 1975, long prior to the enactment in 1976 of section 1056 of the Code.

[H.R. 8489, 95th Cong. 1st sess.]

A BILL To limit the retroactive application of section 1056 of the Internal Revenue Code of 1954 (as added by section 212 of the Tax Reform Act of 1976)

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, effective October 1, 1977, section 1056 of the Internal Revenue Code of 1954 (relating to basis limitation for player contracts transferred in connection with the sale of a franchise) shall not apply to property acquired by the transferee in a taxable merger in respect of which a proposed proxy statement was submitted to the Securities and Exchange Commission before September 21, 1976. If the transferee corporation has held any player contract continuously from the time of its transfer to October 1, 1977, and if the adjusted basis of such contract in the hands of the transferee corporation immeditely after the transfer (determined as if the preceding sentence applied at such time) would have exceeded the adjusted basis of such contract at such time (determined without regard to the preceding sentence), then, as of October 1, 1977—

(1) the adjusted basis of such contract shall be increased by the amount of such excess,

(2) the adjusted basis of property (other than player contracts) which would have been lower if the preceding sentence had applied at the time of the transfer shall be properly reduced, and

(3) the adjusted basis of property (other than player contracts) held by the transferee corporation on October 1, 1977, shall be reduced in the order provided by section 1082(a)(2) of the Internal Revenue Code of 1954, to the extent that the reduction under paragraph (2) is less than the increase under paragraph (1).

EXPLANATION OF PROPOSED BILL

The New England Patriots Football Club, Inc., was founded in 1960 by William H. Sullivan, Jr., and had outstanding 100,000 shares of voting common stock and 139,800 shares of non-voting common stock.

The team attracts a following from the six New England states and plays an important role in the New England sports scene. It plays its home games in a sports stadium in the rural town of Foxboro, Massachusetts which is located within convenient driving distance of Boston, Massachusetts; Worcester, Massachusetts; Fall River, Massachusetts; Providence, Rhode Island and Hartford, Connecticut.

Commencing in 1973 certain problems arose between Mr. Sullivan, who held about 24 percent of the voting shares, and two other groups of voting shareholders. After extended negotiations, these problems were resolved in 1975 by Mr. Sullivan deciding to purchase the voting shares of the other two groups which together held the remaining voting shares and then to restructure the corporation through the formation of a legal entity as the successor to the Patriots.

Pursuant to that undertaking and on November 7, 1975, Mr. Sullivan borrowed in excess of 5.3 million dollars from a bank and used such funds to purchase from the other two groups all of their voting shares.

This buyout of the other voting shares by Mr. Sullivan was accomplished (a) on his representation to the bank that when the rest of the plan was carried out, in addition to all of the ownership interest of the new entity, the principal assets of the new entity as well—that is, the NFL franchise, player contracts, ticket sales and television revenues—would be pledged as security for the loan to Mr. Sullivan personally, and (b) on the clear understanding, both by the bank and by Mr. Sullivan, each of whom was independently so advised, that the new entity would be entitled to a basis for player contracts in accordance with then current provisions of the Internal Revenue Code.

Thereafter and pursuant to proxy statement dated November 5, 1976 in all essential respects identical to the proposed proxy statement filed September 9, 1976, the restructuring of the Patriots was accomplished through taxable state law merger into New Patriots Football Club, Inc., a newly formed Massachusetts corporation, providing for the payment of $15.00 a share in cash in exchange for each of the non-voting shares.

Solely because of the change in basis for player contracts made by section 212 of the Tax Reform Act of 1976, and in midstream of a plan the first of the two major steps of which was consummated in 1975 after almost three years of difficult negotiations, Mr. Sullivan will be unable to service and amortize the loan of 5.3 million dollars already made to him personally, nor will the new entity be able to service and amortize the additional loan of approximately 1.4 million dollars, in the manner originally contemplated at the time the 5.3 million dollar loan was made, with the consequence that Mr. Sullivan faces the serious risk of being unable to retain the ownership interest of the football team which, since its founding in 1960 and most particularly since 1973, he has fought to save and preserve, and which constitutes almost his entire net worth.

The proposed bill would, in these limited circumstances only, continue, effective October 1, 1977, the basis for player contracts which existed under the law prevailing at the time the commitment, which contemplated as its final step a taxable restructuring, was made—at the time the bank made the first loan of 5.3 million dollars to Mr. Sullivan personally—and at the time Mr. Sullivan purchased the other voting shares—all of which occurred in 1975 and long prior to the enactment of section 212 of the Tax Reform Act of 1976.

A copy of the proxy statement dated November 5, 1976, which describes the transaction in detail, is available for inspection at the Securities and Exchange Commission.

A BILL To limit the retroactive application of Section 1056 of the Internal Revenue Code of 1954 (as added by Section 212 of the Tax Reform Act of 1976)

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled, That, effective October 1, 1977, section 1056 of the Internal Revenue Code of 1954 (relating to basis limitation for player contracts transferred in connection with the sale of a franchise) shall not apply to property acquired by the transferee in a taxable merger in respect of which a proposed proxy statement was submitted to the Securities and Exchange Commission before September 21, 1976. If the transferee corporation has held any player contract continuously from the time of its transfer to October 1, 1977, and if the adjusted basis of such contract in the hands of the transferee corporation immediately after the transfer (determined as if the preceding sentence applied at such time) would have exceeded the adjusted basis of such contract at such time (determined without regard to the preceding sentence), then, as of October 1, 1977—

(1) the adjusted basis of such contract shall be increased by the amount of such excess,

(2) the adjusted basis of property (other than player contracts) which would have been lower if the preceding sentence had applied at the time of the transfer shall be properly reduced, and

(3) the adjusted basis of property (other than player contracts) held by the transferee corporation on October 1, 1977, shall be reduced in the order provided by section 1082(a)(2) of the Internal Revenue Code of 1954, to the extent that the reduction under paragraph (2) is less than the increase under paragraph (1).

Senator PACKWOOD. That adjourns the hearing today.

[Thereupon, at 11:55 a.m. the subcommittee was recessed to reconvene at the call of the Chair.]

APPENDIX

Communications Received by the Committee Expressing an Interest in These Hearings

U.S. Senate,
Committee on Energy and Natural Resources,
Washington, D.C., October 26, 1977.

Hon. Harry F. Byrd, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally of the the Committee on Finance,
Washington, D.C.

Dear Harry: We understand you will be holding hearings later this week on H.R. 6715, the Technical Amendments Act of 1977.

We would like to call to your attention a technical matter that you might consider appropriate for inclusion in this bill. Section 207 of the Tax Reform Act of 1976 requires most farming corporations to change from the cash to the accrual basis of accounting for tax purposes. An exception was made for family corporations, but the definition of family was drawn in such a way as to exclude certain taxpayers whose situation is not materially different from any taxpayers who were permitted to continue using the cash basis. We brought this problem to the attention of the Senate last April, and an amendment was agreed to at that time by a roll-call vote of 85 to 11 to permit the excluded family companies to continue using the cash basis for all taxable years beginning on or before December 31, 1977. This was, in effect, a one-year extension of the effective date of the 1976 Act. The rationale for the extension was simply that the President's tax-reform package would probably be coming before us this fall, at which time there would be a chance to address these and similar issues of tax accounting and come to a final conclusion about them that would be fair to all similarly situated taxpayers.

By way of further explanation, I enclose a copy of the debate on the Senate floor on the amendment that was agreed to last spring. This amendment is now Section 404 of the Tax Reduction and Simplification Act of 1977, Public Law 95-30.

As it turns out, of course, the President's tax-reform proposal has not yet been transmitted to us. The one-year extension is about to expire, and it seems appropriate to seek a further extension so that the status quo can be preserved until the matter can be thoroughly reviewed in the context of general tax reform. We have therefore prepared an amendment to H.R. 6715 and are enclosing a copy of it. If you could look it over and consider including it in the bill at this time, we would be most grateful. We also ask that this letter be made a part of your hearing record.

There is a possibility that we may offer the same amendment to some other appropriate vehicle, if one becomes available before this session adjourns. It is important to resolve the matter one way or the other before the end of the year.

Many thanks for your courtesy and consideration.

Sincerely yours,

John L. McClellan,
John Sparkman,
Edmund S. Muskie,
James B. Allen,
William D. Hathaway,
Dale Bumpers.

Mr. BAKER. At the end of 30 minutes then, we would proceed to the Chafee amendment.

Mr. President, if I understand the request of the Senator from Pennsylvania, he simply wants to make sure his amendment comes next after the Kennedy amendment, is that correct?

Mr. HEINZ. Correct.

Mr. BAKER. Without any provision for when the vote occurs.

Mr. ROBERT C. BYRD. That is all right with me, if it is agreeable with the managers of the bill. I simply wanted to correct the situation.

Now we have Mr. Kennedy in the Chamber. Yesterday we ordered his amendment to follow Mr. Chaffee's. Now we have switched that around to where the vote on Mr. Chaffee's amendment will precede Mr. Bumpers' amendment. Mr. Bumpers has taken the place of Mr. Kennedy in following Mr. Chaffee and I simply want to put Mr. Kennedy behind the two.

Mr. BAKER. All right. And I would like to put Mr Heinz after the Kennedy amendment.

Mr. HEINZ. Assuming the Kennedy amendment is, in fact, offered.

Mr. ROBERT C. BYRD. Yes.

Well, it is fine with me, I do not know about the manager of the bill.

Mr. MOYNIHAN. That is agreeable with us, if that is agreeable with the majority leader.

Mr. BAKER. Mr. President, is that agreeable to the distinguished manager of the bill on our side?

Mr. CURTIS. Yes.

Mr. ROBERT C. BYRD. Mr. President, following the disposition of the amendment by Mr. Bumpers at 12 noon today, I ask unanimous consent that Mr. Kennedy be recognized to call up his amendment, and that upon the disposition of the Kennedy amendment, Mr. Heinz be recognized to call up his.

Mr. BAKER. Mr. President, before the Chair rules, reserving the right to object, I think we have one more problem. If the Bumpers amendment has no time limitation, then there is a possibility that the distinguished Senator from Rhode Island might find himself without his full hour to debate before 11:45 arrived.

Mr. MOYNIHAN. Our argumments are so compelling we really do not need much time.

Mr. BAKER. The observation of the distinguished Senator from New York is reassuring, but it is not protection.

Mr. President, I think we could address that two ways. We could either establish a time limitation on the Bumpers amendment or slip the time to vote on the Chafee amendment in the event there is not a full hour for debate.

Mr. ROBERT C. BYRD. Mr. President, how much time has run on the Chafee amendment?

The PRESIDING OFFICER. No time has yet run on the Chafee amendment.

Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that——

Mr. CURTIS. Mr. President, I ask unanimous order. Let us go ahead with this tax bill.

The PRESIDING OFFICER. Is there objection?

Mr. BAKER. Mr. President, reserving the right to object——

Mr. ROBERT C. BYRD. Mr. President, I withdraw my request.

The PRESIDING OFFICER. Very well, the request is withdrawn.

The Senator from Arkansas is recognized.

AMENDMENT NO. 219

Mr. BUMPERS. Mr. President, I send to the desk an amendment proposed by Mr. McClellan, for himself, Mr. Bumpers, Mr. Muskie, Mr. Sparkman, and Mr. Allen. It is printed amendment No. 219 and I ask that it be stated.

The PRESIDING OFFICER. The amendment will be stated.

The legislative clerk read as follows:

The Senator from Arkansas (Mr. Bumpers), for himself, and others, proposes an amendment numbered 219.

The amendment is as follows:

At the appropriate place. insert the following new section:

SEC. . POSTPONEMENT OF EFFECTIVE DATE OF CHANGES MADE BY THE TAX REFORM ACT OF 1976 IN THE METHOD OF ACCOUNTING FOR CERTAIN CORPORATIONS ENGAGED IN FARMING

Section 207(c)(2) of the Tax Reform Act of 1976 is amended to read as follows:

"(2) EFFECTIVE DATES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by paragraph (1) shall appy to taxable years beginning after December 31, 1976.

"(B) SPECIAL RULE FOR CERTAIN CORPORATIONS.—In the case of a corporation engaged in the trade or business of farming and with respect to which—

"(i) members of two families (within the meaning of paragraph (1) of section 447(d) of the Internal Revenue Code of 1954, as added by paragraph (1)) owned, on October 4, 1976 (directly or through the application of such section 447(d)), at least 65 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, and at least 65 percent of the total number of shares of all other classes of stock of such corporation; or

"(ii) members of three families (within the meaning of paragraph (1) of such section 447(d)) owned, on October 4, 1976 (directly or through the application of such section 447(d)), at least 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, and at least 50 percent of the total number of shares of all other classes of stock of such corporation; and substantially all of the stock of such corporation which was not so owned (directly or through the application of such section 447 (d)), by members of such three families was owned, on October 4, 1976, directly—

"(I) by employees of the corporation or members of the families (within the meaning of section 267(c)(4) of such Code) of such employees, or

"(II) by a trust for the benefit of the employees of such corporation which is described in section 401(a) of such Code and which is exempt from taxation under section 501(a) of such Code,

the amendments made by paragraph (1) shall apply to taxable years beginning after December 31, 1977."

Mr. BUMPERS addressed the Chair.

Mr. MCCLELLAN. I yield to the distinguished Senator, my colleague, Senator Bumpers.

Mr. BUMPERS. Mr. President, this amendment is designed to correct what some of us consider an egregious error in the so-called tax reform bill which we passed in 1976.

Mr. MCCLELLAN. Mr. President, will the Senator yield for just one moment for a unanimous-consent request?

Mr. BUMPERS. I yield.

Mr. MCCLELLAN. Mr. President, I ask unanimous consent that Mr. Max Parrish of my staff have the privilege of the floor during the consideration of this bill.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. BUMPERS. Mr. President, I make a similar request for Richard Arnold.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. BUMPERS. Mr. President, in that bill, for reasons which have always eluded me, there was a provision which said that all agricultural or agribusinesses would in the future change from a cash to an accrual accounting system.

Now, this can cost a considerable amount of money in taxes. But the real clinker in it was that the Ways and Means Committee of the House put a provision in which said that any business 50 percent or more of which is owned by one family—and one family is defined in the bill—will be exempt. Here is the net effect of that: you have a business, for example—and let us take Cargill, and I do not know whether Cargill is a family-owned business or not, it is not traded and it could very well be owned by one family—and they do over $5 billion a year, and are big in my State as they are in many States—but if Cargill is, in fact, a family business owned by one family they are exempt and they continue to use the cash accounting system whereas somebody, for example, who started out in the poultry processing business 15 years ago literally selling chickens in a wheelbarrow and they get up to a fairly respectable size of several million dollars a year, they are not exempt and they must go to the accrual accounting system at a very distinct disadvantage.

Mr. President, this provision in that law never made any sense, it never will make any sense.

Let me give another example: I know the distinguished Senator from Massachusetts, who has been on the cutting edge of most tax reform or what most of us think as tax reform in this body, has a very strong feeling about people who have literally pulled themselves up by their own bootstraps, not being treated in a discriminatory manner and disadvantageously.

But let us take the case of one of the gigantic agribusinesses in this country that may be owned by one family who, indeed, inherited the business, who never gave one thing to the origin or the perpetuation or the building of the business. They are exempt under the bill as it is presently written, whereas the same person who, as I say, started out 15 years ago, is not exempt and is, thereby, placed at a very distinct tax disadvantage and cannot compete.

Let me give another example: The ninth biggest poultry processing company in the United States is the Wayne Poultry Processing Co. It, in turn, is a subsidiary of Continental Grain which is the second biggest grain company. Continental is 100 percent owned by one man, and it is exempt and does not have to go on the accrual accounting system. It can stay on the cash accounting system.

Now, where is the justice in that? Yet we are saying to some of these other people who are relatively small—and I am talking about the 30th or 40th as poultry processors who are doing somewhere between, say, $20 million and $50 million a year, just a fraction of what some of these people who are going to be exempt are doing, where is the justice in that?

Mr. President, I want this body to understand one thing: Arkansas is indeed the biggest broiler processing State in the Nation. These are all friends of mine. I support and promote the broiler processing business. It is big business in our country. It is a good cash income for many farmers. All I want is for everybody to be treated alike. Either put them on the cash basis or the accrual basis. I do not care which. They would prefer the cash system as they have always been on it, and I prefer the cash system. But let us not discriminate against some and put them at a very distinct competitive disadvantage for no earthly reason.

Mr. President, my colleagues, we are asking in this amendment for minimal relief, minimal relief simply saying let us postpone the effect of that provision of the Tax Reform Act of 1976 for 1 year and let the President submit his tax reform bill. I will tell you one thing, the President of the United States will not send anything down here as foolish as that. All we are asking for is 1 year's relief.

I am not saying that Cargill is family-owned, but I am telling you one thing, nobody knows. I do know one thing, they do over $5 billion a year. If it turns out, of course, that they are, in fact, family-owned, that is, 50 percent of the company is owned by one family, then they are exempt and they do not have to go to the accrual accounting system. It makes no sense, Mr. President.

At this time I yield to my distinguished colleague from Alabama who also favors this amendment. I was going to yield to the distinguished Senator from Arkansas but he has just left the floor.

Mr. ALLEN. Mr. President, will the Senator yield for a question before I speak? Does he feel that 1 year's delay would be sufficient in suspending the operation of the provision? The distinguished majority leader has said no tax reform measure would be brought up in the Senate this year.

I wonder if the Senator would feel that this should be modified to make it 2 years?

Mr. BUMPERS. Well, the Senator certainly makes a very valid point. Could the distinguished majority leader comment on that any further than he has already commented on it?

Mr. ROBERT C. BYRD. Mr. President, what is the question?

Mr. BUMPERS. The Senator from Alabama has made the point that the majority has been quoted in the press as saying the President's tax reform proposal, which was originally scheduled to come over here on September 1, may come over, but the majority leader was quoted as saying it would not be considered this year; is that correct?

Mr. ROBERT C. BYRD. I am not sure of the precise wording of my statement. I think I was trying to state a fact that that measure being tax reform must begin in the House. Generally, tax reform measures are very controversial, they take quite a while with hearings, et cetera, et cetera. The President has sent up his energy package, at least he has stated the principles. The package itself is not on the Hill as yet. It was my understanding the President would send up the tax reform measure in mid-summer or just before the August recess or in the fall.

Taking into consideration the fact that tax measures do have to be initiated in the House, I did not see how it would be possible for the Senate to take up the energy proposals and dispose of those, and also take on the massive job of tax reform, and that was the reasoning behind my statement.

Mr. BUMPERS. I thank the majority leader.

Mr. ROBERT C. BYRD. I think what I am saying—and I do not want to attempt to impinge upon the turf of the chairman of the Committee on Finance—is I would seriously doubt the Senate could deal with tax reform this year if it is going to take care of the energy problem, plus the many other major pieces of legislation that will be coming to the floor, to wit, clean air, mine safety, and so on, and so on. We only have 12 weeks remaining between the end of this week and the August recess, and I just cannot see how the Senate can deal with the tax reform in a major way this year. This is not to say that there might not be some small amendments that would in themselves be in the nature of tax reform that could be adopted.

Mr. BUMPERS. I thank the majority leader.

To answer the Sentor from Alabama, if he would give me an opportunity to discuss it with my colleague at least, we will modify it to extend it at least for 18 months.

Mr. MCCLELLAN. Mr. President, will the Senator yield?

Mr. ALLEN. I yield.

Mr. MCCLELLAN. May I say the purpose of this amendment was simply to delay this in order to give the Committee on Finance an opportunity to consider the bill we have introduced which would be a vehicle for them to consider in order to eliminate this inequity.

Now, we just put in a year's time. If it cannot be reached by that time then it ought to be extended because this ought to be eliminated now and an opportunity provided for the Committee on Finance and the Congress to work out an equitable tax provision.

Mr. MOYNIHAN. Mr. President, will the Senator yield?

Mr. MCCLELLAN. I would be glad to yield.

Mr. MOYNIHAN. I feel I can speak for the Committee on Finance in saying that the Senator's position is an entirely reasonable one and has our support, and we hope the Senate will work its will today in this matter.

Mr. MCCLELLAN. I thank my colleague.

I may say, if my colleague will yield to me for a moment, so far as I know those members of the Committee on Finance with whom I have discussed this immediately recognized the inequity of it and are willing to correct it.

While I am speaking at the moment, I may say I am confident that had the Committee on Finance discovered this when they were considering the original legislation they never would have imposed it. Now that we know about it I am sure the members of the Committee on Finance and every Member of the Senate will want to correct it and not let it continue until we are given an opportunity to enact legislation that does justice.

Mr. President, I am proposing an amendment which is designed to correct an inequity created under section 207 of the Tax Reform Act of 1976—Public Law 94-455—with respect to corporations engaged in farming. Senators Bumpers, Muskie, Sparkman and Allen have joined as cosponsors of the amendment.

Section 207 provided a new Section 447 of the Internal Revenue Code which, in general, requires agricultural corporations to use the accrual method of accounting. Exceptions were provided from this treatment for some small corporations, corporations in which 50 percent of the stock owned by members of the same family, or corporations for which gross receipts were $1 million or less. These exceptions were intended to allow local family-controlled agricultural businesses to continue using the cash method of accounting.

Section 447, however, contains some serious inequities. For example, some locally owned family corporations are now required for the first time to follow the new accrual rule which adversely affects their competitive position. Of two companies in one town in my State, one with 3 times the gross sales of the other is permitted to remain on a cash basis while the smaller is required to shift to the accrual method.

Mr. President, I recognize that the provisions adopted in the Tax Reform Act were intended to prevent farming operations being used as tax shelters. However, I am concerned that the remedy may have, in some instances, created an even greater harm than the abuse it was designed to curb through its adverse impact on competition, especially in the broiler industry.

Changing the accounting basis to the accrual method for some when other companies in the broiler industry are permitted to remain on the cash method impairs the competitive posture of the companies required to make the change. On cash basis accounting, a company pays taxes on its actual, in-hand earnings for the year. On an accrual basis, a company is required to pay taxes on its accounts receivable, its inventory and cash on hand. With regard to accounts receivable and inventory, accrual basis accounting requires payment of taxes on money not yet received and on stock not yet sold. The effect is to place two family-owned broiler companies in the position of using their cash to pay taxes on income they have not received. This expenditure for taxes thereby reduces amounts available for expansion and other improvements. Other broiler companies continue on cash basis accounting paying taxes only on what they take in. This is an inequity that should be remedied.

On April 5, I introduced a study bill, S. 1227, that proposes a permanent change in the law to permit the two affected companies to remain on a cash basis and have requested hearings on the measure by the Finance Committee.

The amendment which I am proposing today would delay the application of section 447 to the affected businesses for 1 year to give the Finance Committee time to study this problem and to prevent any economic harm to the companies pending the committee's review. It is an equitable proposal—one that seeks a temporary solution to the problem until a permanent one can be found. I hope the committee will accept it.

Mr. KENNEDY. Mr. President, will the Senator yield for a very brief question?

Mr. BUMPERS. I yielded, Mr. President, to the Senator from Alabama.

Mr. ALLEN. I have no objection.

Mr. KENNEDY. It is to direct a question to the manager of the bill at the present time. It is my understanding that the sick pay extension is only for a year. Am I not correct in that?

Mr. MOYNIHAN. I believe the Senator is correct.

Mr. KENNEDY. And the foreign income exclusion is just for a year as well; am I not correct on that?

Mr. MOYNIHAN. The Senator is correct.

Mr. KENNEDY. So we already have a year extension on both of those matters which are of considerable importance and great deal of interest. Those matters affected a large number of taxpayers who could not reasonably be expected to be following what Congress was doing in 1976. But in the present case, involving a major tax shelter and some of the largest poultry businesses in America, with sophisticated accountants and lawyers who were watching very closely what Congress was doing.

Am I further correct that the House of Representatives now is considering a number of technical amendments to the 1976 act, in order to deal with the question of inequities in the act? And I would expect there are valid, justified, and worthwhile changes that should be made. But we have to make a record first.

Mr. MOYNIHAN. The Senator is essentially correct. The draft is being prepared and will be introduced in the House today.

Mr. KENNEDY. It seems to me that if we are to deal with sick pay and the foreign income exclusion, we are going to have to take some action on the tax measure again within a year's period.

I thank the Senator.

Mr. ALLEN. Mr. President, I have joined with the distinguished Senators from Arkansas and my distinguished senior colleague (Mr. Sparkman), and the distinguished Senator from Maine (Mr. Muskie), in offering an amendment to H.R. 3477, inasmuch as I too believe that the serious inequity suffered by certain poultry producers as a result of the adoption last year of section 207 of the Tax Reform Act of 1976—Public Law 94-455—ought to be corrected.

As Senators will recall, section 207 dealt with corporations engaged in farming and was designed to reduce the use of corporate farming operations for tax shelter purposes. To accomplish that purpose, section 207 forces agricultural corporations to use the accrual method of accounting. Appropriate exceptions were made to the section to permit relatively small sized, family-controlled corporate farming operations to continue without coming under the new requirements set forth in the section. These exceptions recognize that many family-controlled small corporations are engaged in agriculture strictly for profit and are not utilized for sheltering of income earned from other nonfarm sources.

While there is probably general agreement in the Senate that the tax loopholes in corporate farming should have been closed, I doubt, Mr. President, that any Senator intended the result section 207 will have in actual fact when applied to certain owner-operated family corporations producing broilers and other poultry products.

In the highly competitive broiler industry, I am advised that section 447 will have disastrous conseqeunces. It is my information that of the top 36 firms in the broiler industry, only 2 that are not publicly held will be adversely affected by this provision. Thus, the impact of the provision will simply be to penalize two firms in the entire industry. Surely, a provision which extracts such a discriminatory toll cannot pass for tax reform.

Mr. President, I am advised that the broiler industry is expanding at a rate of 5 to 7 percent annually. That fact alone makes the accrual method of accounting required by section 207 undesirable. Stated simply, the accrual method would require a company to pay taxes on accounts receivable, cash on hand, and inventory so that taxes will fall due on accounts receivable which are increasing at a rate commensurate with the general increase in broiler production and income. On the other hand, the cash method of accounting, which was permitted to all broiler producers prior to the enactment of section 207, requires the payment of taxes only on in-hand cash earnings so that the projected growth aspect of the accrual method does not penalize the taxpayer.

The result, Mr. President, of forcing some broiler companies to go to the accrual method while allowing others to remain on the cash method will be simply to put at a tremendous competitive disadvantage certain family-owned operations which in actual character differ not one whit from other corporations which fit the formal exceptions set forth in section 207. Since the disadvantaged corporations are uniformly not corporations utilized for tax shelter purposes, I do not see any reason that the inequity created should be allowed to go uncorrected.

Section 207 has been codified as section 447 of the Internal Revenue Code. I nently repeal the effect of section 447 on broiler companies. However, during the time that that measure is under study in the Committee on Finance, I believe the seriousness of the situation merits adoption of the amendment proposed today by Senator McClellan in that it would delay the application of section 447 for 1 year to permit time to complete a full study of this problem and to prevent serious damage being done to companies involved as a result of the failure of Congress to foresee the full consequences of our earlier action.

I wish to comment briefly on the equity involved in this bill.

The tax bill of last year did seek to put farming operations on an accrual basis rather than a cash basis. But as to poultry producers it sought to provide that certain poultry producers could remain on a cash basis.

The exemption that was written into the bill has resulted in, as to the top 36 broiler producers that are not publicly held, of 36 such corporations, 34 of them are exempt and remain on a cash basis. Only two companies are required to move to the accrual basis. That is based on a proposition of a family-owned operation.

There is a companion bill to this amendment that would be offered later or offered as an amendment to some of these bills that Mr. Kennedy is talking about. But all this does at present is to postpone the operation of this bill for 1 year in order that this bill will have an opportunity to be considered by the Senate.

This presents a most inequitable situation because the broiler industry is highly have also joined with Senator McClellan in introducing a bill which would permacompetitive, and the impact of this provision, as it now stands, will simply be to penalize two firms out of the entire industry.

Surely a provision which extracts such a discriminatory toll cannot pass for tax reform.

So no rights are lost. That provision is not done away with by this amendment. All it does is to postpone the operation of it for 1 year in order that the inequity can be presented to Congress in the form of a bill, and that is all that this amendment does. I certainly hope that it will be passed with either the 1-year delay or 2-year delay.

I yield the floor.

The PRESIDING OFFICER (Mr. Sparkman). The Senator from Massachusetts.

Mr. KENNEDY. Mr. President, I ask the attention of the managers of the bill and ask them whether they are prepared to accept this amendment and if so what is the rationale or justification for it?

Mr. LONG. Mr. President, there is a problem here. These companies compete with other companies which do qualify for the one-family exemption, and thus these companies are placed at a competitive disadvantage. Although these companies may also compete against publicly held companies which must go on the accrual method, the publicly held companies have the advantage of greater accessibility to market financing. The revenue cost of this amendment would be less than $5 million.

There is a problem here. There is an equity basis for recommending the amendment. On the other hand, I know that the Treasury has an objection to the amendment. The amendment deals with an inequity and an injustice which, in some respects, was created in the Tax Reform Act. The issue was not given adequate consideration at that time.

Unless we can work out some way to accommodate the Treasury objection, I doubt that the House of Representatives will accept this amendment. But my inclination is, if the Senator wishes my thought about it, to accept the amendment and to go to conference and see if we can work this matter out in a way that will take care of the problem at least for the time being until we can study this problem in a broader context in connection with the tax reform bill which the administration is going to be recommending to us this year.

Of course, I will be guided by the Senate's judgment. I have not heard the Senator's argument yet.

In fairness, there are certainly two sides to this argument. On one hand, the Treasury does not like the amendment, but, on the other hand, there is clearly an inequity here that we should try to do something about.

Mr. MCCLELLAN. Mr. President, will the Senator yield at that point?

Mr. LONG. I yield to the Senator from Arkansas.

Mr. MCCLELLAN. Upon what premise does the Treasury Department object to correcting an inequity?

Mr. LONG. Basically, the Treasury simply does not like exceptions and they do not like to add one exception upon another exception.

Mr. MCCLELLAN. It is an exception that has caused the trouble. If they do not like that exception we are trying to help them correct it.

Mr. LONG. Here is the Treasury comment, if the Senator wishes to read it. I am glad to read it to him.

Mr. MCCLELLAN. I am glad to look at the letter. I am just asking.

Mr. LONG. Here is their statement:

Most taxpayers in the business of selling products are forced to use the accrual method of accounting and to accumulate production costs in inventory until the products are sold. However, certain farmers are permitted to use the cash method of accounting in order to minimize recordkeeping problems.

Access to sophisticated accounting and recordkeeping procedures is related primarily to the volume of business. This rationale is reflected in the current provisions exempting from the accrual accounting requirement those corporations with gross receipts of $1 million or less. This "gross receipts" exemption covers 93.6 percent of all farming corporations.

Large subchapter S and family-owned corporations cannot fairly claim that they lack the sophistication necessary to employ accrual accounting procedures. To extend exemptions to large multi-family corporations is a further, unwarranted departure from the underlying justification for the cash privilege.

That is the Treasury position on the matter, and I admit that there is a discrimination involved here. There is merit to the amendment, and I wish to work it out in justice to all.

But at this moment, Senator, I would think that if we want to do something about it, if the Senate votes an amendment, we can go to conference and hear the Treasury objections, and perhaps work it out. I cannot guarantee it, but we might manage to work out an answer that all would be willing to support in conference.

If the Treasury has a good case, I should think the House would insist on declining to accept the amendment.

Mr. McClellan. Mr. President, will the Senator yield?

Mr. Kennedy. Mr. President, I believe I have the floor, but I am glad to yield to the Senator from Arkansas.

Mr. McClellan. My interpretation of the letter makes it a rather weak case. If they are opposed to discrimination and inequities in the Tax Code it makes it a very weak case.

I have a letter I would like to insert in the Record from the Congressional Budget Committee. I shall read the last paragraph of it, and ask that it be printed in full in the Record.

The last paragraph reads:

The other amendment would postpone the effective date of Section 207(c) for only two classes of corporations with family ownership defined in the amendment. Because the number of corporations which would qualify for this treatment is unknown—

As Senator Allen pointed out, there are just two.

Because the number of corporations which would qualify for this treatment is unknown, no precise estimate has been made. However, it is very likely that the revenue effect of this alternative would be a small fraction of the estimate for the broader alternative discussed above.

As far as financing the Treasury is concerned, it is infinitesimal, almost, but it means a great deal to a competitor.

While I have the floor for a moment, due to the kindness of my friend from Massachusetts, let me make this further comment: I have no desire to prolong the matter, but in my State, one of those instances Senator Allen referred to, one of the companies affected is in competition with another one in the same city, in the same trade area. One company is about three times as large as the other one.

The smaller company, because there are two families involved in it instead of one—the larger company is owned by one family and the smaller company by two families—while the smaller company is one-third as large as the other one, it has to compete, and it is placed in the position of being penalized here, while the other one, the exception to which the Treasury Department seems to object, is getting the benefit in advance.

As I said a while ago, these things happen in our complex tax system in this country. Inequities do develop. They occur; we cannot foresee everything in the consequences of every provision we may enact.

It is not the intention and was never the intention, I am sure, of the Finance Committee to create such an inenquity. Now that it has been discovered, I think that the Finance Committee—and I appreciate very much the attitude of the chairman and the other members of the Finance Committee to whom I have talked, and their willingness to see this matter corrected—and now that it has developed and exists, I do not think the Finance Committee wants to perpetuate it; I do not think they want to impose it even for a single year, and I do not believe the Senate wants to impose it even for a single year.

That is all we are seeking, to establish an equitable basis. As the Senator from Alabama points out, some 40-odd companies will benefit, while 2, including 1 little company in my State, will be penalized at the same time that its larger competitor is favored.

Correction of that matter is all that we ask. The Finance Committee will have the opportunity to weigh the matter and find ever opportunity to do equity, and I have every confidence they will do so.

I ask unanimous consent to have printed in the Record the letter to which I have referred from the congressional Budget Committee.

There being no objection, the letter was ordered to be printed in the Record, as follows:

Congressional Budget Office,
Washington, D.C., April 5, 1977.

Hon. John L. McClellan,
Chairman, Committee on Appropriations, U.S. Senate, Washington, D.C.

Dear Mr. Chairman: Chairman Muskie has asked me to respond to your request for estimates of the budgetary impact of two possible amendments to H.R. 3477.

One of these amendments would postpone for one year the effective date of Section 207(c) of the Tax Reform Act of 1976 with respect to required changes in the method of accounting for corporations engaged in farming. A one-year postponement of that provision would reduce revenues in fiscal years 1977 and 1978 by $8 million and $10 million, respectively.

The other amendment would postpone the effective date of Section 207(c) for only two classes of corporations with family ownership defined in the amendment. Because the number of corporations which would qualify for this treatment is unknown, no precise estimate has been made. However, it is very likely that the revenue effect of this alternative would be a small fraction of the estimate for the broader alternative discussed above.

Sincerely,

ALICE M. RIVLIN, *Director.*

Mr. LONG. Mr. President, to react to what the Senator from Arkansas has just said, the Senator from Louisiana was the only Senator here to vote against the amendment to move the effective date forward with regard to the retirement income credit. I might say I was even criticized by my wife for doing that; she is very much interested in these aging people. I guess once in a while we ought to learn something, even from our mistakes. It was the view of the Senate that in making the retirement income credit effective on January 1, 1976, in an act which only became law late in 1976, we had acted in some respects retroactively with respect to these elderly people.

So the Senate decided that we ought to move the date forward to January 1 of this year. So we did that, adding an amendment which moves the date forward with respect to the sick pay provisions, and another amendment which moves forward to January 1 the effective date of section 911 with regard to the taxation of U.S. citizens working overseas.

Those amendments involved a lot of money. They involve about $400 million, all things considered. All we are talking about here is something involving about $5 million, having to do with an amendment involving discrimination on the face of it. The Senator is asking us to continue the old law for one more year while we take a look at the discrimination implicit in what exists at this moment, and try to work it out in an equitable fashion.

I personally think that is a fair proposition. As far as this Senator is concerned, it is perfectly all right with me, but I am willing to abide by the judgment of the Senate. If the Senate does not want to consider it, we will not consider it; it is just that simple.

Mr. MUSKIE. Mr. President, will the Senator yield?

Mr. LONG. Mr. President, I want to yield the time in opposition to someone else, because I personally am willing to accept the amendment. I ask unanimous consent that I may yield the time in opposition to the Senator from Massachusetts.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. KENNEDY. How much time remains, Mr. President?

The PRESIDING OFFICER. There is no time on this amendment.

Mr. KENNEDY. I sought recognition, but I will yield to the Senator from Maine, and make my comment later.

Mr. MUSKIE. Mr. President, I appreciate the attitude of the Senator from Massachusetts, and also that of the manager of the bill.

My attention was called to this inequity, and I am convinced it is an inequity because it impacts on a company in my State. I will describe the characteristics of that company in a moment. But first I would like to comment on the attitude of the Treasury Department.

As I understand the Treasury Department's position, in the name of opposing an exception it is defending an exception.

One of the problems in this country is that bureaucrats put blinders on when they are confronted with the real, down-to-earth problems of people impacted by Government policy. I would like to hear the Treasury Department take a position on this inequity. Just stating a general policy against making exceptions makes no impression on me, and I know it does not make any impression on the distinguished Senator from Louisiana.

I would like to hear the Treasury Department come to grips with the facts of these alleged inequities. I would be happy to meet with them off the floor in my office, to make the case that what I see as an inequity is not an inequity. Unless they are willing to do that, I am not impressed by the position of the Treasury Department.

Mr. LONG. Mr. President, will the Senator yield at that point?

Mr. MUSKIE. I yield.

Mr. LONG. May I say to the Senator from Maine that I think I may be as well qualified as anyone here for considering, at least, the equities involved in this amendment, because I have, among my qualifications, the distinction of once having been a chicken farmer. When I was a little boy, we used to raise chickens in our backyard, and I used to get the eggs out from under the old hens. As a result of that early experience, I have great sympathy for chicken farmers. It is not as simple an occupation as it may appear to some people. It involves hard work; and those old chickens do not smell all that good after a while, especially if you have a lot of them around.

So I find it difficult to write a law that treats one chicken farmer one way and another chicken farmer in a different way. That is the way the law is now. If we are talking about discrimination, it is in the law now.

I must say that at the time we considered this last year, no one explained to me why it would treat one chicken farmer different than another chicken farmer. It was just a 2,000-page bill in conference. We were in no position to advise the House or the Treasury how we were going to justify this discrimination between two chicken farmers.

Mr. MUSKIE. I appreciate the Senators comment. I might say to the Senator from Louisiana I have campaigned through many chicken processing plants.

I must say in terms of the environment, it is no different from one chicken processing plant to another. In my part of the country, they all do a pretty good job in terms of sanitation, safety, and all the rest, and they produce a good product. But I have been nothing in all of those exposures to the business which convinces me that this inequity is justified in terms of what I see as I travel around my State.

As I understand the equity in terms of my area of the country, that is, the New England marketing area, the requirement of the law imposes the accural method on one company among the five major ones which compete in that area. The others are permitted to continue on a cash basis.

Let me tell the impact on the company in which I am interested. I am interested in it only because of the discrimination.

The effect of it is this: that company's tax liability this year is $2.5 million. The effect of the accrual requirement is to add $1.5 million to that tax liability each year for 10 years. Why? Because the accrual basis requires the company to pay a tax on its continuing inventory. One of its sales of about 83 million birds a year, there are 10 million in the field at any one time, roughly 10 million, which carry over from one year to another.

To pay a tax on those 10 million birds, which is inventory, along with tax on its accounts receivable involves a total tax liability of about $15 million. The effect of that is to severely limit the companys potential for expansion because it has been plowing its earnings back into the business to expand.

(Mr. Melcher assumed the Chair at this point.)

Mr. MUSKIE. As a result of this accrual requirement which was enacted last year, the company is finding it difficult to borrow the money to expand because the potential sources of credit are disturbed that this $1.5 million additional tax liability will reduce the company's ability to repay whatever it borrows.

My State has an unemployment rate of 10 percent or more. Here is an area which needs new business; which needs the expansion of business. But here on the floor of the Senate where we are enacting tax provisions to provide incentives for business to expand we are imposing on this business, which is healthy, which has been in existence for a quarter of a century, a tax penalty of 60 percent more than its present tax liability, threatening its potential for expansion, wholly because of a tax discrimination.

As far as this company is concerned, if the accrual basis is applied across the board to its competitors, it will take that. It will take the cash basis, if it is applied across the board to its competitors. But it suffers an economic disadvantage, a competitive disadvantage, when it is picked out from the ranks of its competitors in this way.

Let me describe its characteristics in its present form. In its present form, it is 5 years old The present principal owner created the business a quarter century ago. He sold it, went to another part of the country, retired, came back, and picked up the business again. At the present time that principal owner and his brother own 38 percent of the business. All the other stockholders own 62 percent and are employees. Two are plant managers owning 22 percent of the stock and the other 40 percent of the stock is held by other employees. It is the principal owner's intention, and he has set up an agreement, to turn total ownership of the company over to his employees. This objective I know is close to the heart of the distinguished floor manager of the bill, to encourage employee ownership.

Because he embarked on this program of employee ownership it is no longer a one-family-owned corporation which would qualify for the exemption.

If that is not an arbitrary, unintended, discriminatory result I never heard of one. To have anyone urge on this floor that it is wrong somehow to take that inequity into account and to try to eliminate it I find amazing.

Mr. LONG. Will the Senator yield at that point?

Mr. MUSKIE. I yield.

Mr. LONG. We have had some people suggest that people should not hire lobbyist, that they ought to take their chances or talk to their Senator when he is visiting around the State. They would just take their chance along with everybody else and not have anybody looking after their interests down here.

What we have here is a good example of somebody who does business that way. Here is somebody sitting up in Maine running a chicken business the best he knows how, with the employees joining up and buying stock in the company, working to produce these chickens. Then the Congress is talking about a tax reform law. Nobody has them in mind, but they are willing to take their share of the burden along with everybody else.

By the time Congress gets through, somebody has hired a lobbyist and it is worked out so that various and sundry concerns have had their problem properly considered and taken care of. Here is some poor soul who never knew anything about it but was willing to take his chance along with everybody else. He finds a law which takes care of almost everybody, except for a few who were not represented here in Washington. The result is that they got the worst of it.

So, this fellow comes in complaining about discrimination against him. Everybody else has been taken care of except him. At that point he says, "How about me? You took care of everybody else who was not represented up there." At that point he talks to his Senator and at that point I guess he can be accused of being a special interest. He wants to know how he can possibly be a tax shelter and, for the life of me, I do not see how he is one.

I am sympathetic to the Senator's position. I can understand the need for closing tax shelters, but the kind of thing in mind here does not sound like one of them.

Mr. MUSKIE. May I say that this amendment does nothing more than to defer the impact of the provision we enacted into law last year so that the Finance Committee and the Senate can look at the inequity and judge whether or not it warrants some remedial action. As far as this Maine company is concerned, if the result is an accrual basis requirement across the board, they will take that; if it is a requirement for a cash basis across the board to similarly situated companies, they will take that. They are not trying to influence that result one way or another. They might have a preference but they are not asserting that preference. They are simply asking for equal treatment.

It seems to me they have made their case for a deferral so we can look at what we did and consider what ought to be done to remedy it.

I must say to the Senator from Louisiana, it is a delight to have him on my side because he has such an articulated and effective way to present a point. If he gets me used to this kind of treatment, may I say, I may be tempted to join the distinguished Senator from Louisiana more often. [Laughter.]

Mr. KENNEDY. Mr. President, I would like to raise some questions about the pending amendment.

A little over a year ago, at the beginning of the Senate debate on the 1976 Tax Reform Act, we identified a number of special interest provisions, affecting only one or two individuals or companies. The Finance Committee held a special set of hearings on these provisions while the bill was actually on the floor, and a number of the provisions was deleted. We ought to have the views of the Finance Committee. We ought to hear the views of the Treasury Department and the Internal Revenue Service; in the orderly process, we ought to find out who the beneficiaries are going to be, and how much benefit they are going to get from this change.

That is a procedure which I am very hopeful will be adopted and followed by the Senate so that we would not be taking these various special provisions to the floor in the first instance as amendments to the Internal Revenue Code.

The House Ways and Means Committee is already following that procedure at the present time. They will make recommendations in the next several weeks on many of these provisions. They are considering a number of different special interest provisions and questions that have been raised about inequities of the 1976 act.

Mr. LONG. Will the Senator yield at that point?

Mr. KENNEDY. Yes.

Mr. LONG. We are trying to accommodate that point of view in the committee. Is the Senator really contending that a Member of this body should not be privileged to offer an amendment out here on the floor which he thinks promotes justice and equity, even though it has not been considered or recommended by the committee prior to the time he raises it?

Mr. KENNEDY. I ask the Senator back, does the Senator not believe, given what happened here last year in terms of the embarrassment over the special interest provisions, the midnight provisions that were placed in the committee bill in the 1976 act, that it is a wiser procedure for the committee process to work its will first, in considering changes in the Internal Revenue Code that are going to benefit particular individuals or companies? I would be surprised if the members of the Committee on Finance did not believe that would be a better way of proceeding.

I do not, obviously, deny the right of anyone to offer a floor amendment on any particular measure. There may be exceptional cases where we should act without the benefit of committee views.

Mr. LONG. Let me make this point: There is nothing that would please the Senator from Louisiana more than for the Senate to give the Committee on Finance a closed rule the way they do on the House side, so we could study these things, work them out the way we think they ought to be worked out, and bring out the measure so the Senate can vote it up or down without the power to amend. In fact, this Senator is anxious to have a germaneness rule so we can limit to germane matters the amendment of bills we report out, and only amond where we think we need it.

That procedure did not appeal to the Senator from Massachusetts. He testified against even the germaneness requirement. He did not think the Senate ought to trust our committee the power to tell Senators that they cannot have their amendments considered.

Mr. KENNEDY. Mr. President, the chairman of the Committee on Finance may differ with the position which I am suggesting, but it does seem to me, given what happened in the case of various special interest provisions last year, that a wiser way of proceeding for the Committee on Finance, with all respect, is to consider these proposals in advance. We legislate in a broad and general way; we recognize that inequities and unfairness may result, and they ought to be remedied. But we have to know what we are doing. Senators who are raising particular issues should not have to come to the floor of the U.S. Senate and plead on special, narrow-interest issues, and have it appear that they are doing special-interest pleading. I think that demeans the position of a U.S. Senator.

The orderly way is to follow a procedure in which the Finance Committee considers the proposal in a thoughtful way, determines who the beneficiaries are, what the injustices are, and make a recommendation as to whether the matter is justified or not justified. That is the way we operate with private bills. Why should we not operate that way with private interest tax bills?

I have made this point. I should like to get into the merits. Then I shall be glad to answer any questions.

It does seem to me that there is a better way. The reason I believe that, Mr. President, is so that, first of all, we can understand who are the beneficiaries of these amendments, what are the tax implications of a particular amendment, and whether the committee, after an adequate examination, feels it is justified. With regard to this particular amendment, I understand it is going to mean that more than $1 million will go to a family-owned corporation.

Mr. President, on the merits of this provision, let us review very briefly, how this issue was handled in the 1976 act. As we debated the 1976 act, one of the major abuses was the area of farm tax shelters. It was deemed to be the better part of wisdom to attempt to deal with that complex issue. One of the ways of dealing with it was to move from the cash system of accounting to an accrual system. Use of the cash system produces a major tax shelter for farm businesses, because it provides what is essentially an interest-free loan from the Treasury. Artificial deductions are taken to reduce income. Congress went on record as saying, "We want to deal with this area of tax shelters, so we are going to require these large firms to adopt an accrual system of accounting, which properly balances income from farming and deductions used to produce that income."

Then, during the course of the debate, it was recognized that if we exact this requirement, we are affecting not only the largest farms and farm businesses, but we are also hitting the smaller farms as well. So, in an attempt to deal with that problem, we provided three exceptions to the accrual accounting rule.

One exception was for farms with gross receipts of $1 million a year or less, to try to exempt the small family farmer. The second exception was for so-called subchapter S corporations, which are entitled to be taxed as partnerships. Again, we were trying to target the exception for the small family farmer.

The third exception was for corporations in which 50 percent of the stock is owned by the members of the same family—again to try to help the small family farmer.

Now we have a situation, in this amendment, that the two Senators from Arkansas and Maine are here to argue that, because of these particular exceptions, we ought to enlarge the third exception from 50 percent of the stock owned by members of one family to corporations in which 65 percent of the stock is owned by two families.

Mr. MUSKIE. Will the Senator yield?

Mr. KENNEDY. Not just yet.

Mr. MUSKIE. That is not my position.

Mr. KENNEDY. I have not come to the Senator's part yet. I am saying what the effect of the amendment is that the Senator is cosponsoring. That happens to be the effect of it, I say.

Mr. MUSKIE. It does not.

Mr. KENNEDY. Does the Senator deny that that is included in the amendment we are considering here?

Mr. MUSKIE. The purpose of the amendment is to defer the effective date for 1 year. The amendment does not prejudge what the final policy result will be. I made very clear—I think the Senator heard me—that if the final result is accrual accounting for those in similar situations, I would accept that. If the final result is cash, I would accept that. That is a slightly different position from what the Senator has just described.

Mr. KENNEDY. It is to defer it for 1 year for one company in Maine and one company in Arkansas.

Mr. MUSKIE. For a specific reason.

Mr. KENNEDY. If the Senator will permit me to make my argument, then I shall be glad to answer questions.

The firm in Arkansas is a corporation in which approximately 65 percent of the stock is owned by two families. The exception in the 1976 act was for corporations in which 50 percent of the stock is owned by members of one family. Now, they want to broaden the exception to two families.

The second part of the amendment helps a corporation where 50 percent of the outstanding shares are owned by three families, and the remaining shares are owned by employees of the corporation. This is for Halifax Foods in Maine.

Mr. MUSKIE. Is that the Senator's understanding of that fact situation?

Mr. KENNEDY. I did yield for a brief comment.

Mr. MUSKIE. I just want to make sure that the description of the Maine corporation is accurate.

Mr. KENNEDY. All right.

Mr. MUSKIE. There was only one family to begin with. There would be one family today, but for the fact that that one family decided to convert the corporation into an employee-owned corporation. The other two families that have been added are two of the employees, the plant managers. Those are the two families. The rest of the employees make up the other 40 percent. So 62 percent is owned by employees, two of whom are regarded as the families that the Senator counts as three.

Mr. KENNEDY. I am glad to be enlightened about that particular detail of the corporation in Maine. What we cannot get away from, Mr. President, no matter how we describe it, no matter how it is interpreted, is that in the Arkansas situation, we are not talking about a small family farm. What we are talking about is a huge chicken broiler firm that is doing $65 million of business a year in sales, processing 42 million chicken. It is the 24th largest firm in the industry. We are talking about a tax benefit which will be worth $1 million to a single company that has sales of $65 million.

Of the 36 top boiler companies in this industry, 8 were on a cash basis and are going to have to switch to accrual.

Of the top 36 broiler companies, 8 of these major corporations would have to shift from cash to accrual accounting. Mr. President, I ask unanimous consent that a table analyzing the top 36 broiler companies in the United States may be printed in the Record. (See exhibit A, p. 326.)

Mr. KENNEDY. Mr. President, the amendment of the Senator from Arkansas and the Senator from Maine selects two of these eight firms and says, "We'll defer this reform for you for a period of 1 year." The language of the amendment is a fingerprint, written to fit these two firms. In one firm, two families own 65 percent of the stock; the other three families own 50 percent of the stock, and the rest of the stock is owned by the employees. We are lifting out two of the eight firms and giving them a tax break for 1 year. We closed a major tax loophole for farm tax shelters last year, but we left an exception for some firms; the exception was intended to be for small firms. And now two of the largest firms in the country are coming to Congress complaining that they are too big to fit through the loophole any more. They fall outside the exception we set.

They complain that some of their competitors still fit through the loophole and can use cash accounting, because they qualify for one of the exceptions in the 1976 act. But what about the other six firms who are left behind, if we grant the loophole to these two firms; can they not complain, too?

Why do we not simply close the loophole for all of these giant firms?

Why do not the Senator from Arkansas and the Senator from Maine say, "Well, all right, since we have some discrimination among some of these firms let us eliminate the discrimination for all and just establish a $2 million or $1 million sales limit as the exception," with the family ownership exception? I would support that approach. It would put all the big farms on accrual accounting, where they ought to be. That would meet the problems of discrimination against the Arkansas firm and the Maine firm. But they are not suggesting that. They want the loophole. They just want it opened up a little wider.

They are suggesting that two out of the eight firms should have the loophole until Congress can act again.

The other six firms, in different parts of the country, better get their Senators into action, because when they go home they are going to have to answer to those companies. They will say, "Look, fellows, you provided for the deferral for our competitors in Arkansas and Maine, but we need help, too. We are the other six. Why did you not look out for us?" Can we not have the loophole too? We, now have a two family 65-percent rule and a three family employee-ownership rule. Why not a three family 75-percent rule and a four family employee-ownership rule? Where will it end? We have to draw the line somewhere.

We do not know what additional kinds of discrimination this amendment will cause for other chicken broiler companies. No one talked about that.

Why are we saying 50 percent or three families? Perhaps there are four families than own 65 percent that would not be included.

Mr. President, in attempting to deal with this particular issue, there is a way to deal effectively with it in order to eliminate the discrimination against any of these various companies. What we could do is allow an exception for genuinely small firms, $1 or $2 million of sales. That will reach the smallest companies—which was really the purpose of the amendment last year. That would deal with the discrimination against the company in Arkansas and the Maine company that would treat them all across the board equally and equitably.

But the effect of what the Senator from Arkansas and the Senator from Maine are saying is, "We have a little change in the formula for you. We are going to select two firms from Arkansas and Maine and leave the others out."

Those companies may not have liked what was done in the U.S. Senate last year. But I imagine they say that that is the law. Congress drew the line, and they are prepared to comply with it in good faith.

Now, two of those companies say, "Well, we do not like the line there. We want to change it for our benefit." So we have this amendment to provide exclusions for them.

We can eliminate the concerns of those that propound this amendment by going to a gross sales limitation. That would treat all firms, including the Arkansas and the Maine firms, fairly. It would eliminate what the proponents of this amendment believe to be the imbalance in terms of competitive advantages and disadvantages that exist because of the 1976 act. That would be something which I believe should be supported and warrants our support.

But just even deferring action, which in one instance is going to mean in excess of $1 million to one large broiler firm, is unwise tax policy and unwise action by the Senate.

Mr. MUSKIE adressed the Chair.

The PRESIDING OFFICER (Mr. ZORINSKY). The Senator from Maine.

Mr. MUSKIE. Mr. President, it suits the Senator's indignation at one and the same time, words that Senators not be forced to special pleading, and in effect, to accuse me of special pleading.

Let me make the point to the Senate, he puts himself in the position of defending a discriminatory tax advantage for one company, or two.

The Senator stands on the floor here and gives us an emotional plea about the importance of having general tax policy and avoiding exceptions. But he is defending an exception.

Somehow he finds morality in that position and immorality in mine.

We are not proposing a final tax result. I must say, I do not know all I would like to know about the circumstances or the character of the other 36 major producers in this industry. Nor do I know, and I doubt that the Senator knows, what the impact on this industry would be of a $1 or $2 million threshold across the board. I do not know.

I tried to find out, and because I do not know I have asked for the year's deferral so that we can find out. But the Senator is so certain of the rectitude of his position that he wants to write the final policy now.

One of the reasons we have this problem is that this provision came over from the House. We knocked it out in the Senate and the House forced the conferees to take it in conference. It is because nobody knew what the consequences were that we are on this floor today, and the course that is advocated by this amendment is designed to let us know.

I do not know about the eight companies that the Senator has referred to on the list. It is my impression that all, or most of them, are publicly held companies. The exception we are talking about is a family-owned corporation exception and, as far as I know, the amendment of the Senator from Arkansas covers all of those.

Mr. LONG. Will the Senator yield at that point?

Mr. MUSKIE. Yes.

Mr. LONG. The best I can recall the history of this matter was that the House sent us a provision in this area, and various people, including the junior Senator from Arkansas (Mr. Bumpers), came before the committee and told us what was wrong with it, that it was discriminatory, that it was unfair. They pointed out certain things that would have to be changed about it if it were going to become law.

Well, when the committee saw that and all the complexities involved in it, we just concluded the best thing to do would be to drop the whole thing. So we struck out the provision from the House bill on the basis that it involved all kinds of complications and was discriminatory on the face of it.

Now then, when we passed our bill—and, incidentally, so far as I know nobody here complained about our just dropping out the whole thing because it looked to be unfair—we went to conference and the House insisted on what they had in their handiwork. So we brought back something of a compromise between what the House had started out with and the Senate judgment that we should not do anything.

So there is no doubt about it that those who were best represented, were those who had somebody up here to talk to people about how this thing was going, and to sit in that conference room and hear every decision and every discussion that went on, and to talk to people around the House and the Senate. Some had their problems considered, and those who did not have people here to have their problems considered now find themselves in the position of the Senator's little fellow producing those chickens up there in Maine.

Mr. CURTIS. Mr. President, will the Senator yield just briefly?

Mr. MUSKIE. Yes, I yield to the Senator from Nebraska.

UNANIMOUS-CONSENT AGREEMENT ON MR. CHAFEE'S AMENDMENT

Mr. CURTIS. I have followed this matter along. I think the amendment proposed is reasonable and should be adopted. I would like to ask the Senator to yield for a unanimous-consent request.

Mr. MUSKIE. I do.

Mr. CURTIS. I ask unanimous consent, notwithstanding the previous order, that following the disposition of the pending amendment that the amendment of the distinguished Senator from Rhode Island (Mr. Chafee) be in order; that the 1-hour limitation be reserved, and after the hour the vote occur.

The PRESIDING OFFICER. Is there objection?

Mr. LONG. And the vote scheduled to occur at 11:45 be postponed until that time.

Mr. BUMPERS. Mr. President, reserving the right to object—and I do not think I will—as I made the point earlier, I have to leave here at 12:15, and I am hoping we can get to vote in this before that time.

The PRESIDING OFFICER. The vote on the Bumpers amendment would still come at 12.

Mr. CURTIS. That would not interfere with the Senator's vote.

The PRESIDING OFFICER. Is there objection? The Chair hears none, and it is so ordered.

Mr. MUSKIE. Mr. President, I shall take just a few more minutes. May I say to my good friend from Massachusetts he and I have no quarrel about the basic intent behind the provision which is, as I understand it, a provision that would require substantial corporations engaged in agricultural-related activities to use the same accounting rules as any other substantial corporation with inventory. Now, that is a general proposition with which I have no quarrel.

But the inequity of which we speak arises from several exceptions to this general principle and the Senator is against exceptions because it is the exceptions that have created the inequity. Those exceptions include family-owned corporations in which one family owns at least 50 percent of the share of the corporation.

Now, in preparing this amendment we did our best to identify all of the family-owned corporations or substantially those family-owned corporations which would be impacted. We did not examine those corporations that would fall under the general principle. We were trying to identify the companies that fell under the exception and, as far as we know, we have covered them. We have not excluded any of them, not that we know all of the corporate arrangements or the ownership arrangements of the 36 top producers. That has been difficult to get. Some of them are publicly financed corporations.

There are small family-owned corporations as to which we have no difficulty in operating in this business. But what we are talking about, and the best example of the inequity, is the biggest company in Arkansas which has the fourth biggest volume in the country. It is bigger than either of the two companies we are talking about. It does a volume of about, I think, 150 million birds a year, which is roughly twice the production of the company in Maine, and it gets the advantage of the cash accounting system.

The effect of the position of the Senator from Massachusetts is to defend that advantage for that company. I doubt very much that that is his intention, but that is the effect.

The best solution we could find, geared to the fact that we do not have all of the facts and understand all of the consequences, is the proposal of the Senator from Arkansas, and I think it is a fair proposal.

Mr. KENNEDY. Mr. President, I will not take much longer. We are not talking about small family farms. It is important that we understand we are not talking about the little mom-and-pop farm or the ordinary barnyard. We are talking about tens and possibly hundreds of millions of dollars operations in terms of the two firms helped by this amendment.

Mr. President, I ask unanimous consent to have printed at this point in the RECORD an article from the current issue of New York Times Magazine, describing these giant chicken farms.

[From the New York Times Magazine, Apr. 29, 1977]

BRAVE NEW CHICKENS

(By Stephen Singular)

The Fish and Wildlife Service of the United States Department of the Interior keeps an up-to-date list of endangered species. Six hundred and eleven animals are now on it, including the Utah prairie dog, the Sonoran pronghorn, the gray wolf, the San Joaquin kit fox, the black-footed ferret, the Southern bald eagle and the Hawaiian hoary bat. None has much chance at survival. Were it not a domesticated animal, there is another creature that could be added to the list: the barnyard chicken. In 1910, there were 5.5 million farms in America with an average of 80 free-ranging chickens apiece. (In New York City, there was still one bird for every two people.) Today, 20 conglomerate businesses, each with millions of hens or broilers, dominate poultry production in this country. Many people under 25 have not only never seen a barnyard chicken, they have quite possibly never seen a live chicken.

The barnyard chicken, in other words, has gone the way of the barnyard itself. That spirited outdoor scavenger of table scrappings and night crawlers has given way to another chicken altogether, a research laboratory animal that is born in immaculate hatcheries, lives a truncated life in long, low windowless sheds and dies by machine. Today, the chicken is at the proud forefront of American agribusiness; instead of 80, the modern corporate farmer can now tend 75,000 birds at once. As the Department of Agriculture likes to put it, "During the last two decades, the U.S. poultry industry has become the most efficient producer of animal protein in the entire history of agriculture."

For consumers, this agribusiness revolution has brought about striking changes. Until quite recently, chicken had been a luxury. Herbert Hoover, running for reelection to the presidency in 1928, made the lavish campaign promise of "a chicken in every pot." Back then, meat birds—culled hens or capons or cockerels, raised only in the spring ("spring chickens")—were in limited supply. Chicken was frequently hard to get and, when it was in season, costly.

A Sunday chicken dinner carried more prestige than steak. This has, of course, all changed. Chicken is now abundantly available year round and, unlike almost everything else, costs roughly what it did 30 years ago; about sixty-five cents a pound. It is the poorer person's high-protein meat staple, offering more protein, less fat and less cholesterol than either lamb, pork or beef. The egg is similarly a blessing of nature—and inexpensive. The egg today sells for less than it did in 1920. One egg provides a person with 70 calories, all vitamins except C and one-eleventh of his daily protein requirement. Egg yolk by itself can sustain human life indefinitely. This year, each of us will eat an average of over 300 eggs and 40 pounds of chicken meat. Man could easily live by the chicken alone—and it is not too much to say that the bird has perhaps become the most important animal in our lives.

But the Agriculture Department's claim for the "efficiency" of modern poultry production has another side. Because of the way chickens are now raised, there are those who would argue that not only the barnyard chicken but the chicken itself, as we have known it for the last 5,000 years, is an endangered species. In *The Chicken Book*, Page Smith and Charles Daniel put it most strongly. "Feathered bipeds," they write, "bearing a superficial resemblance to the chicken, will continue to exist under the auspices of our technological society, but, and one must insist on this, *they will not be chickens and their eggs will not be eggs.*" Smith and Daniel go on to say that agribusiness has adversely affected the quality and possibly even the health and safety of the poultry meat and eggs we consume; and that modern techniques have altered the behavior—the very nature—of the chicken. The authors imply that something else—more complex and harder to define and determine the significance of—has also changed; our relationship to a creature raised for food.

A century ago, chickens were selected and specially bred only for their beauty. Proud owners displayed their favorite breeds at poultry shows and county fairs.

Agribusiness geneticists today can produce a ten-pound hen, flavored garlic, that lays an egg with a green yolk. In California recently, a farmer decided to breed chickens weighing 20 to 25 pounds. A fox broke into his chicken house one night and the birds quickly killed it. Robert Frost and Ogden Nash once wrote poetry to the glory and constancy of the mother hen. Currently, 280 million American hens live in wire-mesh cages. Beyond laying an unfertilized egg, they fulfilled no mothering functions. The Animal Welfare Act passed by Congress in 1970 set standards declaring that cages for animals "shall provide sufficient space to allow each animal to make normal postural and social adjustments with adequate freedom of movement." This law applies to animals in zoos, circuses, wholesale pet stores and laboratories but not to animals raised for food. In most instances the laying hens' cage is 15 inches wide and 20 inches long and there are five birds in each cage. A chicken's wingspan averages 30 inches. Also a chicken foot is not well-suited to wire mesh. The metal can cut into the toes and when this happens it is not uncommon for the wire to implant itself and for the bird to grow fast to the cage—with any luck, within reach of the food and water supply.

The transformation of the chicken began with the American "invention" of an incubator in 1844 (The ancient Egyptians had built incubators, capable of holding 15,000 eggs at once, that were surpassed technologically only 60 years ago.) A hen, left to herself, will lay about 115 eggs a year. She will lay an egg a day until there are as many in her nest as her feathers can cover. She then will sit on the eggs for 20 or 21 days, till the chicks hatch, and she will not begin laying again until her brood can fend for themselves several weeks later. Using today's incubator, the farmer can take the eggs, once laid, immediately away from the hen. If you separate a hen from her eggs, she lays more eggs. If you confine a hen, she will continue to lay regularly and you can also control her diet—to make her lay still more. In the 1930s, it was discovered that a hen's pituitary gland, located at the base of her brain, is stimulated by light. Once stimulated, this gland produces hormones, which in turn stimulate the ovaries, which produce an egg. It was believed that a hen would eat only in the light and that the more she ate, the more eggs she laid. So hens were soon being exposed to artificial light 21 hours a day.

The change from a natural and open environment to a synthetic and completely closed one followed rapidly. Hen houses were built without windows. Light bulbs and vitamins replaced the sun. Air conditioning became the wind. In place of the sprouts and worms she had once foraged for, the hen was now fed minerals and chemicals. If the bird seemed nervous or upset by all this, she was given a tranquilizer. A female chick was vaccinated for a variety of diseases at birth and debeaked soon after, to prevent her from cannibalizing her sisters in confinement. (In large-scale "egg" businesses, male chicks are nothing more than a nuisance. They are generally destroyed when born and fed to hogs.) The ageless pecking order of hens, which operates in flocks up to 90, disappeared. So, too, did countless varieties of chickens. Once it was discovered that a hybridized White Leghorn laid more and bigger eggs with thicker shells, other breeds were phased out of production. Next to go were the descriptive names. By the forties and fifties, White Leghorn had become K–42; Rhode Island Red, another survivor, was dubbed K–83. By the mid fifties, the Kimber Farms Lab in Fremont, California, had "invented" a hen guaranteed almost to double Mother Nature's egg production schedule, to 200 eggs a year. By the sixties, the average was 250, with some birds good for 300.

For chicken meat, Americans now kill, process and eat 3 billion birds each year. The evolution of the massproduced meat chicken, though it trailed behind automated egg production, is a parallel tale of agribusiness success. Forty years ago, research revealed that a Barred Plymouth Rock crossed with a New Hampshire Red produced a bird superior in the quality and quantity of its flesh. This hybrid chicken could be raised in confinement year around and fed a high-protein diet to make it eat less overall and still grow faster. When one discusses the meat chicken's diet these days, one talks in terms of feed-conversion ratios: How many pounds of chicken feed does it take to make a pound of chicken? Twenty years ago, it took about 15 weeks and 12 pounds of feed to get a 3.5 pound broiler. Now it takes only eight weeks or less and eight pounds of feed to bring a 4-pound bird to the slaughterhouse. From birth, between 95 percent and 98 percent of the broilers grown in this country are fed antibiotics for disease prevention and to make them eat more; many are given hormones to cause even more speedy growth; and some are fed the chemical xanthophyll and other dyes, which make their flesh yellow, the color most people associate with healthy chicken meat.

The most prestigious poultry science department in the United States is at Cornell University in Ithaca, New York. Jimmy Rice started this department in 1903 and Rice Hall, built in 1912, was the first building in this country devoted exclusively to the science of raising chickens. Because of the subsequent work done at Cornell in genetics, nutrition, physiology and food science. Rice is considered the father of the modern poultry industry.

In February, I visited Cornell and spent the day with two professors, Charles Ostrander and Robert Baker. The former is known for his work in light-control and waste management and the latter for his creation of many "convenience foods" made with chicken. Ostrander, who was to be my guide through Cornell's Poultry Research Farm, has been at the school 26 years. He now works in extension—"getting what we know out into the field" A stocky, square-faced man with shallow-set eyes, he wears steel-rimmed glasses and smokes a pipe. In his office are myriad pictures of chickens. A large silver egg sits on his desk, and a button on the wall says, "Think Manure."

As he drove out to the farm, Ostrander began talking about some of Cornell's recent research. "We used to believe," he said, "that a chicken would ovulate only in the light and that light affects the bird's pituitary gland through its eyes. Now we know that light affects the hypothalamus instead of the pituitary gland. The hypothalamus is a small gland at the back of the brain. You've got one, too, but we don't know nearly as much about yours. We put the chicken's head into a vice and then drill into it to find the hypothalamus. We can hit this little thing every time. Then we attach electrodes to it which measures all the bird's reactions to changes in heat and light. By stimulating the hypothalamus, our physiologists have found that we can completely control the bird's reproductive system. What we've discovered is that the bird will ovulate in the dark. It only needs a little exposure to light to trigger the hypothalamus. It's just a matter of timing the light in relation to the ovulation cycle to make the bird think it's another day. We're now keeping chickens practically in the dark and getting as many eggs as always."

At the farm, we entered a garage-like building. The room was mostly dark and cold. I heard a series of muffled moans, not sounds one would associate with a chicken. In front of us, 16 gray, square chambers were aligned in four rows. Ostrander explained that in each chamber were five cages with three birds to a cage. Inside the chambers, the lighting, food, water and air supplies are controlled by time clocks. The chickens would be kept here for a year and given five different "treatments." In this treatment, Ostrander said, the birds are given light for 2 hours, then darkness for 10, then light for 15 minutes, and then darkness for 12 more hours.

"Oops," he said, opening a chamber door. "We hit one with a mortality rate." One of the five cages was empty. Three birds had died and been removed for autopsies. The other 12 chickens looked confused, haggard. All were standing. Their combs were pale pink and their coloring seemed a little out of focus: dirty white, rather than the soft white of chicken feathers. The birds moved little because there was little room to move. They continued, only more loudly now, to make thin, eerie sounds. "The idea here," Ostrander said, "is to lower the use of electricity and food consumption. The theory is that the birds will use less energy in the dark because they will keep quiet and, hopefully, eat less. It seems to be working out well."

We left the garage and walked over to a long white shed. This building was normally lighted and held thousands of chickens, all in cages. The birds sent up waves of shrieks. The chickens looked similar to those we had seen earlier, except these were more ragged. Many had chests that were almost bare, as if they had been plucked by cagemates. As we walked down the aisle between the rows of cages, Ostrander would point out the various experiments. "These are dwarfs," he said, stopping in front of some small birds. "We select dwarf genes to make dwarf birds. Some people are getting interested in marketing this minibird because it's economical. It eats little. The problem is that it lays a small egg. We're now trying to reverse the genes and get a small bird that lays a large egg."

We observed other experiments with color patterns in chickens, with selective breeding—the rooster's back is massaged until he ejaculates and then his sperm is injected into the hen—and with the use of selenium in chicken feed. Selenium is a natural compound fed to caged chickens to prevent muscular distrophy and to promote growth. In large quantities, selenium is toxic to humans. The government allows it in the feed in small doses, and the experiments at Cornell are trying to find the maximum acceptable level of selenium use.

Ostrander told me that they can now grow a chicken on a "low-energy diet," down from 1,300 kilocalories a pound a few years to 1,000 kilocalories a pound today. "We know a lot more about the nutritional requirements of chickens than about human beings," he said. "If we regulated our own food as much as theirs, we'd be a lot better off." A chicken, he went on, doesn't need much energy now because it gets no exercise; yet even on this new diet, the hens are managing to lay a few more eggs than before. "One of the problems in poultry, though," he said, "is the loss of eggs through breakage. We're trying to put a better shell on the eggs but we're defeating our purpose by expecting the hen to produce more. She has to keep wrapping more eggs with calcium, and she only has so much calcium. This is still a management problem, a real hassle." One problem, Ostrander didn't mention is that hens without enough calcium in their bones can't stand up. They go down in their cages and stay down.

We went next to the genetics house, where chickens breed naturally. This was an old-fashioned breeder house with windows full of sunlight, large open spaces and a dirt floor. I leaned on a wood fence and watched the birds. For the first time that morning, I observed chickens behaving as I assumed chickens always had. Nothing I had yet heard could approach the insistent, satisfied clucks and cackles of the hens. They were shapely, fully feathered birds, rich white in color, that looked in command of their bodies and of their environment as they roamed about freely and preened on the edges of their food troughs. Perhaps it was an illusion, caused by their freedom of movement, but the birds looked bigger than any I had so far seen. A huge rooster strutted across the pen, crowing vaingloriously as he pawed the ground. Standing behind a hen, he mounted her swiftly, then moved away, and crowed again. He continued to strut, making those funny, jutting head and neck movements a chicken makes. "Our work here," Ostrander was saying, "is to produce a more profitable bird. By line-crossing them, we get hybrid vigor, better eggshell quality, hatchability, livability and more production. We're now looking for between 50 and 75 breeder characteristics affecting production."

At the last stop at the farm, the Agricultural Waste Management Laboratory," Ostrander was conducting further experiments with light. We've got these birds on a half foot-candle," Ostrander said. This allows them to be stimulated but not cannibalistic. I'm convinced that we don't need more than two-tenths of a foot-candle to get maximum results." Many of the birds were naked of feathers and all looked and sounded sickly, straggly, lost, and cannibalized. Their cages sat up in the air, several feet above a cesspool. Connected to their cages were feed troughs, and below them egg troughs, for the birds to lay in. As we watched, the chickens ate and defecated continually. Their droppings fell into the cesspool and were churned up into a liquid. This liquid was then being pumped back up into their feed troughs. "These birds," Ostrander said, "are drinking waste water. And they're actually out-producing some of the other birds." I stared at this process for a minute or more. Ostrander then added, with a chuckle I could only interpret as nervousness, "We call this recycling."

Back at his office, Ostrander and I discussed the taste of chicken today. Raising poultry quickly, in confinement, and on a high-protein diet has, some say, removed the flavor from the meat. The Department of Agriculture acknowledged this problem, almost 30 years ago when their scientists tried to isolate the chemical compounds that give chicken its flavor and aroma. The scientists wanted, through feeds, to put that flavor and aroma back into the new, mass-produced bird. Dr. Robert Horvat, a research chemist at the USDA-funded Richard Russell Research Center in Athens, Georgia, worked on this project for nearly five years before abandoning it. "None of our combinations of compounds has so far made it," Horvat told me. "This will be a long-term and costly project."

I asked Ostrander his opinion of the new chicken, "If you want to be frank about it," he said, "the bird we eat today has very little flavor. It's bland. We hear this in the field all the time. The old barnyard fowl was an older bird with a hard fat full of flavors from the wild things it ate. Nutritionally, the bird we eat now is probably as good. And it's more sanitary. But these new birds don't get a chance to develop a flavor. We're eating eight-week-old infants. This causes other problems besides taste because the birds grow too fast for their muscles.

They fall down and can't get up and then everything starts to happen to them. Genetic selection for better leg strength is the answer. The main gain we get from eating these young birds is that it's a cheaper product. Chicken is still the best buy on the market."

Dr. Robert Baker is the head of the Food Science Department at Cornell. For 20 years, he has been creative in poultry research, and I had been told by a USDA official that Baker's work with chicken had made him "known and respected world-wide." A large and middle-aged man, Dr. Baker, like Ostrander, is seldom far from his pipe. By the time I got to see him, it was getting late and Baker was ready to leave his office. We spoke as he drove me in his pick-up to a farmhouse near his own farm outside Ithaca. Without prompting, Baker began to talk about his work. "We've done a lot of research with the chicken," he said, "and I think we have all the bugs out of it now. In the sixties, the poultry industry was in pretty bad shape. Eggs were selling below cost. So was meat. It was terrible. It was due to a lack of convenience. The consumer today doesn't want to buy a carcas, she wants to buy a convenience. So we developed 38 convenience poultry products and marketed 23 of them.

The products Baker helped develop and market were chicken burgers; chicken sticks (Cayuga Frozen Chicken Sticks); chicken bologna (Chickalona); Western Egg; chicken chunk roll (Chunkalona); liquid eggs (Jiffi eggs, in a carton); Frozen French Toast; chicken chili; egg pies, cold cuts; chicken cutlets; chicken hash; chicken sausage (Cayuga Chick-A-Links); egg rolls; chicken salami; smoked chicken; TREN ("A Pleasant Combination of Fresh Apple Juice and Farm Fresh Whole Eggs"—"It doesn't sound too good," Baker told me, "but if you can get people to try it, it's OK"); Bake and Service Chicken Loaf; chicken franks ("People," Baker said, "had a tremendous psychological barrier to chicken hot dogs. But they got over that pretty fast"); pickled eggs; One-Day Eggs; Hi-Pro Cookies; and Catskill Egg Omelet. "Convenience foods with chicken," Baker said, "are just starting."

Because so many of these new products contain eggs, I was curious about Baker's opinion on the cholesterol question. "Everybody's down on cholesterol now," he said. "We could change the cholesterol count in the chicken a little if we wanted to. But then the bird wouldn't perform as well. If you lower the fat content, you're going to lower the protein. It all adds up to a hundred."

I wondered if the new methods of growing chickens has changed them nutritionally in any significant way. "Not much research has gone into this," Baker said. "If a vitamin has been lost, you could easily find it and put it back in. But you wouldn't get much recognition for that." And the taste, I asked? "We don't hear those complaints about taste much anymore," Baker said. "Remember, we as humans change our taste. The younger generation prefers these younger, more tender birds, regardless of whether they're tasty or not."

At first, Baker had seemed a little uncomfortable being interviewed. But as we rode across snow-covered upstate New York, he began to loosen up, to tell me about his family, about the cost of educating his six children and about his solution: the invention and marketing of "Bob Baker's Bar-B-Que Chicken and Cornell Sauce," a successful product in the Ithaca area. He was smoking his pipe and looking out over the fields, when he said that a few backyard flocks, with only eight to ten chickens, were starting to reappear around the countryside. "I'd kind of like to do that myself," he said. "Get up in the morning and go out and feed a few chickens. You know, you like to hear them crow. My dad used to keep chickens, not for meat or eggs, but for their beauty. Chickens were his hobby. And those poultry shows were a tremendous thing. We used to rig up our own little incubators and heat the eggs with a light bulb. We'd hatch them and have 50 chicks running around the yard. That was fun."

The following morning, I visited C. B. Hering's farm outside Genoa, New York. Hering is a tall, aging man, with dark hair and a lined, intelligent face. He graduated from the agricultural school at Cornell and has farmed ever since.

"I have been in chickens all my life," he said, as we walked from his house to a long, metal building out back. The building, which resembled a hangar, was enclosed. Inside, it was clean and ill-lighted. It held 30,000 hens. There were eight rows of cages, stacked three high, and each row was 215 feet long. Each cage held five birds and sat at an angle so that laid eggs would roll forward onto conveyor belts. The angle of the cage was also such that the birds would defecate, not on those below, but onto a metal plate, from which the feces would fall into a pit far below. In the pit, the manure was dried by fans and the fumes were shot out of the henhouse as exhaust. The place smelled fine to me. Hering said that the manure would eventually be used as fertilizer for his corn, which he feeds to his chickens.

All Hering's facilities were automated, run by "time switches, time fuses, magnetic starters and all kinds of other stuff." His chicken feed—a mixture of soybean meal, alfalfa meal and molasses to settle the dust—was fed into the henhouse from a large capsule outside. The feed troughs never stopped moving in front of the hens, and the hens rarely stopped bending over to peck at the passing meal. When the feed level in the troughs would get too low, this would trigger a large auger. Every few minutes, the auger would roar and begin grinding more grain for the troughs. The auger sounded like a gargantuan popcorn popper, making metal popcorn. The birds seemed inured to the racket. Here, as at Cornell, clucking was absent, replaced by something like rising and falling murmurs. Looking down the rows, I could see countless chicken heads protruding from cages, but I could see inside only a few of the wire boxes. In these, there was usually one bird who had gotten turned around in her cage and had, apparently, just given up. In the back-to-back batteries of cages, this hen would frequently be sitting face-to-face with a similarly situated bird across the way. As I was observing this, Hering told me that these chickens had been born in Indiana and sent to his farm at five months of age. He said that they would lay for a year or, at most, two—a chicken's lifespan is 20 years—and then be shipped either to Campbell Soup Co. in Baltimore or used as pet food.

Hering's building was well-insulated but had no heating system. The chicken is a hot-blooded animal, with a body temperature of 107 degrees. Each bird gives off between 50 and 55 Btu an hour. In Hering's henhouse, 1.5 million Btu were being generated every hour. "That's a pretty big furnace," he told me. "We've been able to keep it at 65 to 70 degrees in here all winter, and you know what January was like. Zero and below."

Good ventilation is critical to a chicken. The bird requires four times more air than a human. When the air in a henhouse starts to stagnate, the birds begin to suffocate. A chicken has no sweat glands, and if the temperature in a henhouse reaches 90 degrees, it will suffer. At 100 degrees, it will die. One of the features of Hering's farm was an automatic alarm system that rings if anything goes wrong. At a nearby hen farm, not long ago, the ventilating system stopped, setting off an alarm in the owner's kitchen. The alarm should have told the owner to flip another switch, substituting the back-up power supply. But the woman was out sitting by her swimming pool and never heard the alarm. Two hours later, 30,000 chickens were dead.

At another farm in upstate New York, the parents left their son home alone to tend the chickens for a day. The boy had one chore: to turn off the feed switch. He turned off the ventilating system instead, and his parents came home to a henhouse full of corpses.

As Hering and I were viewing his operation in motion, he said the birds were laying an average of 240 eggs apiece each year. "Watch this," he said, walking over to the wall and turning a light switch. Conveyor belts below the moving food troughs began to move. White eggs soon spotted these brown belts, which passed into another room beyond our view. We walked into this room where the eggs were being mechanically arranged on cardboard trays. From here, the eggs—untouched by humans—would be put in boxes and sent off to wholesalers. "There's a lot of advantages to this conveyor belt system," Hering said. "The chicken doesn't sit on the egg at all. It's kept away from the hen and her manure and this is definitely more sanitary than it used to be. I'm very conscious of making a food product here."

We went back to where the birds were and I began looking at them again. They seemed subdued and absolutely uniform in paleness of color, shape, sound and, for the most part, behavior. Hering saw me watching them. "How do these chickens look to you?" he said. "Not too unhappy? The measure of what you can do to an animal is in what you can get out of it. If there was too much wrong with this, we couldn't get this production. Birds treated this way produce as much as those raised on the floor. So it must be OK. It's economic this way and this business is all competitive. You get to get big and you got to get machinery. This mechanization throws people out of work, but the system works and that's the only test. The only danger is that you can become more of a mechanic than a farmer. You're dealing with livestock and you can't forget that. You've got to keep that hen healthy and happy so she produces. You can do anything with a chicken. If you do it right, she'll live and lay. If you do it wrong, she'll die. A lot of people in the business don't know this. It's got to be done within parameters. If you get them too hot or cold, they'll die. If you crowd them too much, they'll die. If you don't give them feed or water, they'll die. I think these birds here are pretty happy. And 90 percent production is high."

Hering's investment in the birds alone is $60,000. His equipment is worth $180,000, and he said that start-up costs were another $100,000. "Moneywise," he said, "I've been called stupid to get into this. I'm 62. Most people my age are thinking more about retiring than getting into the chicken business. But I don't feel like quitting. I took all the money I could get and borrowed some more and went back to it. If it all holds together for another ten years, then I can think about retiring. I like the business. Done it my whole life. I like chickens.

The first thing one notices about Salisbury, Maryland, is how flat the land is. Salisbury is the major city on what is known locally as the Delmarva Peninsula, an arm of land between the Chesapeake Bay and the Atlantic Ocean made up of parts of Delaware, Maryland and Virginia. Delmarva was once to broiler raising and processing what Cornell is to poultry research and development. The modern broiler industry began on Delmarva and for years it led the country in production. The area is still important but much of the industry has moved further south, to Georgia, Arkansas and even Mexico, in search of cheaper labor. Much, but not all: the second thing one notices in Salisbury is the proliferation of "Perdue" signs, Perdue cars and trucks and Perdue feed mills, farms, breeder houses and hatcheries. Frank Perdue is thriving, with a $40–50 million operation and an annual growth rate of 17 percent over the past five years. As his promotional literature says, "Build a Better Chicken and the World Will. . . ."

Perdue markets several kinds of birds, including the Rock Cornish Hen and the older, bigger rooster (or "Oven Stuffer"), but he is best-known for his specially bred strain of broiler, which he claims to be superior to all other broilers. In his extensive advertising campaigns, Perdue boasts that his chickens live in a "house that's just chicken heaven," and says, "If you want to start eating as good as my chickens, take a tip from me . . . Eat my chickens." One of the advertising posters seen throughout Perdue's plant in Salisbury shows three, pure white, beautifully built chickens, with napkins round their necks, sitting down to dine by candlelight over fine china and white wine. On each plate is a small mound of yellow meal. Another poster says, "If your husband is a breast or leg man, ask for my chicken parts."

Each week, 2.25 million Perdue chicks hatch. After one day in the hatchery, the birds are farmed out to local growers. They are immediately put on the Perdue diet: dehydrated marigold petals, corn, soybean meal, bluegrass pellets and fish meal or meat meal, which is ground-up poultry. To make them yellow, they also get doses of the cosmetic xanthophyll. On their tenth day, they are debeaked and vaccinated for Newcastle's disease and bronchitis. For three weeks, 25,000 birds are raised in one-third of an enclosed metal house, on a little over 5,000 square feet. Growers once put warm, pot-bellied stoves in these houses as surrogate mothers. Now they just keep the humidity at a level that leaves water on the surface of paper in ten seconds. The chicks spend their early days huddled together, looking like patches of shag carpet spread over a floor of wood chips, shavings and sawdust. At three weeks, they get more space, and at five weeks, they get the whole house, or 15,000 square feet. Their feeding and watering are automated. Occasionally, the grower will have to go inside the house and spread water to settle the dust, which at times makes the air no more than translucent. By seven weeks, the birds weigh about four pounds and are ready for "processing"

Perdue processes 300,000 chickens each day. Chickens are quiet in the dark, so men come before dawn to catch them by their legs. They are stuffed into wooden crates and driven to plants in either Salisbury, Accomac, Virgina, or Lewiston, North Carolina. The head of personnel, Walton Layfield, showed me the plant in Salisbury. Magnets pick the crates off the trucks and place them on conveyor belts leading into the factory. Workers, all black men at this point, stand in the near dark and grab the chickens from the crates. Because of the low lighting, all one can see of this process are yellow hard hats, lighted cigarettes and chickens going up through the air and being bound, upside down, in steel shackles that move overhead. These shackles go by fast and the men must keep pace: a chicken must be in each shackle. The sound of conveyor belts, magnets, crates and shackles is deafening. The birds hang limp and mostly silent. As they go through the air their heads are dragged through an electrified solution that is supposed to stun them. They then move into a room where a rotating bicycle tire holds their backs and shoulders in place while their necks are fit tightly between two metal bars. They are steered into a blade that slits their throats. The blade kills five birds a second, 16,000 an hour. Not all the birds are killed by this blade. A black man, holding a knife and wearing a bloody, white smock and cap, stands on the other side of the blade and kills those birds that have survived. The entire plant has a stench that is slightly heightened here. The smell must be a mixture of fresh blood and stale urine. The birds' blood drops into a vat and the birds, still in shackles, move out of the room, their heads attached but dangling.

Watching this process of slaughter was mystifying. It looked like a macabre, curiously static ballet. An endless line of upside-down chickens entered the room alive through a hole in one wall and left dead through a hole in another wall. It all seemed not only completely surreal but, more disturbing, there was no evidence that people, beyond the black man with the knife—one more machine—had anything to do with what was happening.

Next, the birds are scalded and plucked by a machine with round, rubber fingers. Steam is everywhere here and the roar of metal and water incessant. The birds then move through flames that remove any remaining hairs. A machine cuts off their heads and feet and the naked birds pass in front of another line of standing workers; almost all of them black woman, young, middle-aged and aging. Each person has a different job and a knife. Wherever people are working here, bloody, foul water runs by in troughs near their feet. One woman cuts off the chicken's oil gland. Another slits open the bird's back. The next woman widens the opening. The next reaches inside the bird and jerks out its viscera. Liver, gizzard, neck and heart are separated. A man holds a "lung gun," which sucks out the lungs of the bird. Women down the line are either "liver trimmers" or "gizzard trimmers." The liver, gizzard, heart and neck are cut up and deftly wrapped together and stuffed back inside the chicken. Two women at the line's end do nothing but tag a small "Perdue" sticker on each carcass.

During dressing, USRA inspectors stand on line and check the birds. (Perdue claims that his own inspectors are better than the government's. He says that his people can look for 48 quality specifications in the 75 minutes the bird is in the processing plant.) The federal inspectors have a few seconds in which to examine, by sight smell and touch, each chicken for tumors, breast blisters, fecal contamination, feathers, lung tissue, male sex organs and other unsanitary or diseased parts.

After dressing, the birds are plunged into ice water for 30 minutes. They are then graded, sorted, packed in ice and put back into crates. These are set on conveyor belts that take them to Perdue trucks. The chickens are ready for delivery. On each crate are the words, "Any Squawks? Call Perdue 1–800–638–0381."

On one wall of Frank Perdue's office in Salisbury hangs a photograph of Perdue and Spiro Agnew standing together on the court in their tennis togs. On the floor is a picture of Perdue with Jimmy Carter. In person, Perdue, with his longish, gray hair, appears much more sophisticated and soft-spoken than he does on television.

When Perdue and I began talking, I was surprised by his willingness to criticize the broiler industry. He said that some of the producers—he mentioned no names—tended to overscald their birds, thereby removing the epidermis and causing much of the flavor to be lost. Other companies, he said, cut economic corners in the chicken diet, lowering the birds' meatiness and nutritional value. Still others go in for cheap methods of packaging, which shorten the chickens' primo shelf-life on the supermarket counter. And still others prepackage their chickens by freezing them at their plants, a procedure Perdue is adamantly opposed to. Freezing chickens, according to him, costs the bird soluble protein and some of its natural juices; also, the bones turn black and the meat falls off. Finally, he did say, "Several other companies besides us produce a quality chicken. But there are far more that don't than do."

"Are you," I asked him, "making a better bird than was around 40 years ago?"

"Oh, God yes," he said. "Our nutritionists believe that you are what you eat, and my chickens eat better than anybody's. They are better fed now than they ever were. Their diet is computerized. We've done a fantastic job of making a meatier bird with a broader breast. We've got the broadest-breasted chicken in the business. We've got a $300,000 genetics research farm down in the Pocomoke Forest working on this. I have my own geneticists and my own gene pool. Nobody can touch my gene pool. We're trying to make a bird that's desirable in the eyes of the consumer, a bird with appeal, with meat, with good color. People will buy a yellow chicken before they will a pale, white one."

"Does this new bird taste as good as the old one?"

He took a long while to answer and, at first, spoke slowly. "There may be something to the cliche—I'm not sure what that word means—that the old bird who ran around and ate bugs and looked up trees was a better-tasting bird. There may be something to that. It took 16 weeks to grow that bird. I think I've been influenced in my thinking by our 'Oven Stuffer.' This 13-week-old bird has a better taste. So I'm not sure. Those older birds couldn't have tasted more tender. And people say our birds are cleaner than chickens used to be." He paused and seemed to be thinking about what he had been saying. Then he looked right at me and said, "How would you compare the old and new bird anyway? What are you going to do? Go back to the old methods? If the women want to pay a dollar twenty-five for chicken instead of sixty-five cents for taste. . . . This just isn't going to come to pass. She just won't want it. This fast-grown bird has resulted in great advantages for the consumer. Chicken is still a delicacy in many parts of the world. The industry is doing a fantastic job for the consumer."

That night I ate part of one of the Perdue chickens that were being served at the motel where I was staying in Salisbury. My dinner listed as "Southern Fried Chicken," had a crust a quarter of an inch thick, flavored with salt and pepper and possibly another seasoning or two. The crust was tasty, and the meat itself tender and fairly moist. But it had the texture of mush. No discernible flavor came from the meat, either as I bit into it, chewed it, or let it linger in my mouth. Nothing reverberated on the palate. It wasn't at all unpleasant, just tasteless, and it passed through more or less unnoticed.

Concerns about today's chickens, of course, reach beyond matters of taste. While consumer savings in dollars and cents are impressive, less immediate costs in terms of nutrition and health call into question the marvels of agribusiness.

Over the years, a number of debatable drugs have been fed to chickens to expedite growth and lower cost-per-pound ratios. The most notorious of these was diethylstilbestrol (DES). In Sowing the Wind, Harrison Wellford, one of the five original Nader's Raiders, wrote, "DES is the only chemical widely used as an animal drug for which there is strong evidence that it causes cancer in both animals and man." DES causes adenocarcinoma, a rare cancer of the vagina. It also upsets human hormone balance. Farmers who have breathed DES dust in chicken feed have grown small, female like breasts and showed symptoms of sterility. DES pellets used to be inserted into the necks of chickens. For awhile, one unsuspecting New York City restaurant employee regularly made a supper of leftover chicken necks. He stopped when his breasts grew large, firm and round.

"We used to add DES to chickens," Robert Baker had told me earlier in Ithaca, "but it's been declared illegal now. We manipulated the male with DES, a female hormone, in order to give him more fat. If you ate a thousand pounds of chicken a day, DES might affect you. As a matter of fact, if you ate most of the things we eat 50 times over, it would do you in. If you ate 5 times the salt, it would knock you on your fanny.

"Now the government is down on nitrites. In very high quantities, these are supposedly carcinogenic. We're taking turkey thighs that don't sell too well and turning them into ham thighs. We have to use nitrites to give them color."

Almost every broiler in America is fed antibiotics—for disease prevention and cure and for growth—from birth to death. People eating these chickens consume not the actual antibiotic but antibiotic residue. If the chicken has been given, say, penicillin—only one of the many medications currently used—the penicillin will be broken down into penicilloic acid and other compounds while in the gut of the chicken. This acid is then absorbed into the meat tissue of the animal. A person buys, cooks and eats the chicken. Those parts of the drug that survive cooking are known as thermal degradations. The human stomach is normally full of bacilli called coliform organisms. The thermal degradations we eat in chicken don't kill or affect the growth of these organisms. But they do cause antibiotic-resistant coliforms to develop in the gut of a person. In other words, the human stomach develops resistance to penicillin and possibly to other antibiotics.

I had spoken about the effects of antibiotics in chicken feed with Dr. Stanley Katz, a professor in the Department of Microbiology and Biochemistry at Rutgers University. Dr. Katz has been working in antibiotic residue research for the past 18 years. "We know very little," he said, "about what these residues are or what their biological significance is, or could be. Everybody, in the back of his mind, says, 'Well, we really don't know what happens here and it would be nice to know but. . . .' Interest in any area is proportional to the available dollars. I think that this research is gaining in importance but it hasn't yet become a cause célèbre. It should. Simply because of the whole question of what this is doing to us."

There is yet another danger in the modern chicken—the possibly cancerous effects of stress and crowding on the bird. Most chickens carry the virus of avian cancer in their blood, though it is estimated that only 2 percent grow malignant tumors from it. Even so, cancer in chickens—called Marek's disease—has already cost the industry greatly. In 1969, 37 million chickens had to be exterminated because of it. In 1971, a doctor in Michigan discovered a vaccine for Marek's disease and the problem now seems more under control. But it is generally believed that the disease itself is related to the crowded conditions under which chickens are raised. "Anytime you stress an animal," says Dr. Katz, "you're increasing its susceptibility to all type of disease."

Shortly after visiting with Frank Perdue, I traveled to Washington, D.C., to interview Dr. George Mountney of the United States Department of Agriculture about various problems with modern chicken farming. Mountney, author of *Poultry Products Technology* and a research management specialist in poultry science at the USDA ("Anything to do with chickens comes across my desk," he says), took a direct but sanguine view of Marek's disease. "There's a very definite connection," he conceded, "between stress and Marek's disease. In fact, this is the whole name of the game in management today—to modify the stress so that chickens can use all their energy for production. Our geneticists are trying to make birds that can withstand the stress and go ahead and be productive. When you crowd these birds, you're going to get dominance problems, picking, emotional stress, that sort of thing, just like with people. So the name of the game is be able to get more chickens in less housing. We're producing a different kind of chicken now, one with different characteristics. We're always trying to improve the bird."

Mountney and I talked about another controversial aspect of agribusiness chicken farming—the increasingly popular technique of "deboning" poultry. Deboning is a misnomer. In this process, the whole chicken is ground up by machine, and the end product, an extrusion containing cartilege, flesh, connective tissue and bone, is used in chicken burgers, hot dogs and baloney. I had earlier talked with Rodney Leonard, executive director of the Community Nutrition Institute in Washington, about deboned poultry. Leonard is against the industry's method of marketing these products, because he believes there is a substantial gap between what the public perceives they're buying and what they *are* buying. Studies, Leonard said, have shown that the protein vitalization value of chicken is significantly lowered by mechanically deboning the bird. "Our traditional definition," he told me, "said that when bone was in meat, the meat was adulterated, and the only reason for this adulteration was economic fraud. The very least that we need now is a different labeling system. Deboned poultry should be marked and assigned a definite economic value that is lower than meat tissue."

Dr. Mountney had told me that the department was now spending annually about $30 million on 3,000 chicken research projects. It was funding, among others, Robert Baker of Cornell, creator of products using deboned poultry meat. Did Mountney think deboning a good idea, or one that needed regulating?

"I'd like to give a plug for it," he said. "We have a world food shortage, and if you want to save the world, you'd better look to the chicken. This shortage is indirectly seen in the U.S. in the higher prices we pay for food. There are two ways to attack this problem: by producing more or making more with what we've got. The quickest way is the second. And deboned poultry is one way to do this. The big advantage is that it sells for 29 or 30 cents a pound for pure meat, or almost pure meat. You can sure get a competitive product this way. When deboning is properly carried out, the meat is of high quality, is 'wholesome,' which means fit for human consumption. Deboning is already done under USDA regulations."

I left Washington with one unfulfilled curiosity concerning the chicken: I wanted to taste an old-fashioned bird. It seemed likely that the farmers' markets in Pennsylvania would be selling home-grown chickens. But I soon learned that the federal government, for reasons of sanitation, had begun requiring Pennsylvania farmers to pay an exorbitant health-inspection fee for the right to raise and sell chickens. Most farmers' markets nowadays, I was told, are offering chickens purchased from "people like Frank Perdue."

After searching, I was lucky enough to find Bob Hofstetter, a short, bearded, bespectacled man who lives with his wife Katherine and their two children on a 60-acre farm in southeastern Pennsylvania. He works at the Rodale Organic Farm in Kutztown and, as a hobby, raises antiquated breeds of poultry, which he exhibits at state and county fairs. At his farm, he showed me his prize-winning beauties: the Redcap, a large, strutting, chestnut-colored bird with a rose comb and a half-moon red lacing on each feather; the Golden Cantine, with gold neck hackles and black barring; the Silver Cantine, all silver except for black barring; the White Belgian, small and snow white with a heavy beard and muff; and the Quail Belgian, with a chamois-colored breast, chestnut hackles and a rose comb. The Quail Belgian walks with its wings down, almost dragging, and its chest straight out. "It's a very stately little thing," Hofstetter said.

Hofstetter and his family eat eggs from these chickens and, occasionally, one of the culled chickens. I asked Hofstetter if he thought there was any difference between supermarket and organically grown eggs. "I don't remember the last store-bought egg I ate," he said. "But when you eat an egg from a bird that's been pastured, that's eaten greens and scraps, the yolk has a definite flavor. It's bright orange and you can taste it."

For our evening meal, Hofstetter butchered a five-month-old Redcap not good enough for show. Katherine, a quiet, attractive woman with a ruddy complextion, roasted the bird. The children, Robby and Susan, joined us for a chicken dinner, with mashed potatoes, sweet corn, asparagus and broccoli, all from last year's garden. The chicken had the texture of meat; firm and not mushy, chewy and yet tender, juicy but not watery—it was light red instead of the color of chalk. The flavor was not at all harsh; rather, it slowly revealed itself as sweet and subtle and made a distinct, enjoyable impression.

During dinner Hofstetter said, "If you eat something that's raised properly, it will taste properly. If it is grown in an ecologically sound environment, it will also be good for you. If you think about it, it just stands to reason. I forbid my wife to buy chicken in the store. I've had supermarket chickens that were slimy, mealy and tasteless. The meat hasn't had a chance to muscle up. It's just flabbiness. The people who push this product are in a business. Most of them *know* this is not how to raise a chicken, but they're still in a business. It's all a matter of time, and they don't have time. It's a whole system. Rush, rush, rush. Make a buck."

Bob Hofstetter, like his barnyard birds, is probably a vanishing breed. The great majority of people who work with chickens today are still searching for ways, not to preserve the original animal, but to change, modify, "improve" it. The USDA's Mountney, for one, optimistically predicts more efficiency, streamlining and cleanliness ahead. As he recently wrote in a trade journal, "Broilers will be produced in cages by an assembly line automated system . . . and marketed at seven weeks of age in the same cage they started out in as baby checks. Such birds will be under human surveillance 24 hours a day by employees who will shower before going to work in the house."

This may sound futuristic indeed, but it is not as advanced as the thinking at International Flavors and Fragrances (IFF) in New York. Chemists there have figured out a way to eliminate the chicken, while supposedly preserving its taste. They have already come up with chicken flavor, made of chemicals, which is marketed for soups, gravies, rices and bouillon. Now they are working on chicken analogs—that is, "chickens" made from soy. You take soybean or soy flour and work it, mixing in other ingredients, until it takes on a meatlike texture. Then add IFF's chicken flavor. Because chicken is so reasonably priced, these analogs are not yet widely marketed, but the chicken analog does seem to have a future. "In those areas where it's really an inconvenience to use a chicken," says Dr. Ira Katz of Research and Development at IFF, "you'll use a chicken analog instead. Say you want a chicken sandwich. You'll just slice the analog like a salami. There won't be any bone. You'll cut it, put it on bread, and have an *analog* chicken sandwich."

Mr. KENNEDY. Mr. President, it is always interesting to me when we come to the question of dealing with tax expenditures. We do not eliminate inequity by closing loopholes, reducing them and putting a limitation of $2 million on sales across the board, and treating all firms equitably and fairly. That would resolve the discrimination problem about which the Senators from Maine and Arkansas are so concerned. Rather, what we do is say we will make the exception a little larger. We will open up the loophole to those too fat to squeeze through it now. We will help an Arkansas or a Maine firm, in spite of the fact that there are a number of other companies in the same general range of sales that will not be helped by the amendment and may well be left at a competition disadvantage.

A number of those other firms are publicly owned. But as we heard so eloquently yesterday from the chairman of the Committee on Finance, they are people, too. They have shareholders who are ordinary Americans. If those firms are hurt, it is going to affect those individuals.

There is a way to deal with this particular problem in terms of the problem that exists for the companies in Maine and the companies in Arkansas. That way is to put a simple limitation on sales of $1 million or $2 million, and drop the family ownership exception, which is causing the problem here.

Let us try to reach out and actually get the small family farmer and give the exemption to that firm; $1 million or $2 million in sales is adequate. That would resolve the Arkansas problem and that would resolve the Maine problem, and that would treat all the large firms equitably and fairly as well.

But I cannot myself see how the Senate can say, "Well, there are 8 of these 36 that are caught by the 1976 act, that are going to have to shift from cash to accrual accounting. We are going to take 2 of those 8 out and let them keep the loophole, but not the other 6. For those two, action is going to be deferred, while the others must conform. That is what the amendment of the Senator from Arkansas and he Senator from Maine does, and I think that is the wrong way to write tax policy.

Mr. MCCLELLAN. Mr. President, I ask unanimous consent that the Senator from Florida (Mr. STONE) be added as a cosponsor to the amendment.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. BUMPERS. Mr. President, I wish to spend 2 minutes summarizing our position on this amendment.

Mr. MCCLELLAN. Mr. President will the Senator yield to me for just a minute?

Mr. BUMPERS. I yield.

Mr. MCCLELLAN. I have to leave the Chamber.

I want to say the answer to all the Senator from Massachusetts has said is in this proposal to submit all of this to the Committee on Finance and let it work out equity for all instead of writing it here on the floor. I do not have confidence this matter can be presented to the Committee on Finance, everybody will be heard, and that the committee, subject to the approval of the Senate, will solve this problem equitably for all.

I thank the Senator.

Mr. BUMPERS. Mr. President, two points: No. 1, the Senator from Massachusetts, I think, made a very compelling point when he said it is rather deplorable that Senators must come in here to make special pleas. I deplore it, and I regret it, and his point is well taken.

But I can tell you, Mr. President, when something as outrageous and as inequitable as this is brought to your attention, when it is so patently clear that it places innocent, hard-working people at a terrible competitive disadvantage because of some inequitable tax burden placed on them here through inadvertance or through design, I have no choice but to address it.

The Senator from Massachusetts, I believe, finds himself in the unique position. I said this morning he has been on the cutting edge of most of the tax reform that has been initiated here, but he finds himself this morning, for some sort of convoluted reason, defending one of the grossest inequities that has ever been perpetrated in this country. He says eight companies are being affected, and I do not know how he knows that. I can tell Senators we did quite a bit of research, and the only way one can find this information is if the stock is publicly traded. I can tell Senators that the 4th biggest poultry processing company in the United States and the 13th biggest processing company in the United States get to remain on the cash system because they are one-family owned.

Is that fair? Is that fair for a company, that my senior colleague pointed out a while ago, in the same city, in the same region, competing for the same growers and competing for the same markets? One of them that is three times as big as the other can stay on the cash system and the other one must convert to an accrual system at considerable tax burden to itself obviously placing it to a terrible competitive disadvantage.

The Senator from Massachusetts does not intend to defend inequities such as that. I know him too well. His point is well taken, and I agree with it. Everyone should be treated the same and the Finance Committee, after I presented this to them, said they agreed. Everyone should be treated the same.

All we are asking here is that we have minimal relief by postponing it for 1 year. I think it is fair.

I know that the Senator from Massachusetts and no other Senator in this body would feel comfortable if he thought the biggest grain company in the United States which is Cargo, with over $5 billion a year—we are not talking about peanuts; $5 billion a year—gets the advantage of this exception. I do not know whether they are taking advantage of it or not. I hate to say positively that they are. They are entitled to it. But our best information is that a substantial amount of the stock, over 50 percent, is owned by one family.

I do not intend to defend it, and I intend to try to do something about it, and that is the reason we offer this amendment.

I thank the Chair.

Mr. KENNEDY. Mr. President, I just make the comment that obviously, the intention last year was close the tax loophole for large firms, and provide some exemption for the small-family farmer. What has happened is that some large firms qualified for the exemption, and some did not.

But we cannot get away from the fact, Mr. President, that if the Senate accepts the amendment of the Senator from Arkansas and the Senator from Maine, of the 36 largest firms, 8, it is my understanding, have to move from the cash to the accrual method. This will single out two of those. The others may be publicly owned. But that does not take away from the interest of those firms being treated fairly and equitably as well. If they are competing against the two firms helped by this amendment, it does not help much to ease the discrimination to know that they are publicly owned firms.

It seems to me that this is the wrong way to deal with this problem. If we wanted to deal with the discrimination, we could put a simple ceiling on sales. That would solve the problem of Arkansas and the problem of Maine. It seems to me to be a sounder way of treating this issue.

Mr. President, I ask for the yeas and nays on this amendment.

The PRESIDING OFFICER. Is there a sufficient second? There is a sufficient second.

The yeas and nays were ordered.

Mr. BUMPERS. Mr. President, there is a present order on a unanimous-consent request that the vote will occur on this amendment at noon. I am reluctant to do this without the majority leader being here. But the Senator from Rhode Island has an amendment which is supposed to come up now. Perhaps he would prefer that we go ahead and vote on this amendment and get it over and then let him present his amendment.

Mr. LONG. Mr. President, there was to be a vote at 11:45 a.m. on the amendment of the Senator from Rhode Island. So I think Senators are on notice we will vote at 11:45 a.m. That being the case, I ask unanimous consent that we simply proceed to vote on the amendment now.

Mr. BAKER. On the Bumpers amendment?

Mr. LONG. Yes, on the Bumpers amendment.

The PRESIDING OFFICER. Is there objection? Without objection, it is so ordered.

The question is on agreeing to the amendment of the Senator from Arkansas.

The yeas and nays have been ordered, and the clerk will call the roll.

The assistant legislative clerk called the roll.

Mr. CRANSTON. I announce that the Senator from Idaho (Mr. Church) is necessarily absent.

I further announce that the Senator from Illinois (Mr. Stevenson) is absent because of illness.

I also announce that the Senator from West Virginia (Mr. Randolph) is absent attending the funeral of David Johnson of Bridgeport, W. Va., the vice president of the Claude Benedum Foundation.

I further announce that, if present and voting, the Senator from West Virginia (Mr. Randolph) would vote "yea."

Mr. STEVENS. I announce that the Senator from Oklahoma (Mr. Bartlett) is absent due to illness.

The result was announced—yeas 85, nays 11, as follows:

[Rollcall Vote No. 113 Leg.]

YEAS—85

Allen	Gravel	Metzenbaum
Anderson	Griffin	Moynihan
Baker	Hansen	Muskie
Bayh	Hart	Nelson
Bellmon	Hatch	Nunn
Bentsen	Hatfield	Packwood
Biden	Hathaway	Pearson
Brooke	Hayakawa	Pell
Bumpers	Heinz	Percy
Burdick	Helms	Ribicoff
Byrd, Harry F., Jr.	Hollings	Roth
Byrd, Robert C.	Huddleston	Sarbanes
Cannon	Humphrey	Sasser
Case	Inouye	Schmitt
Chafee	Jackson	Schweiker
Chiles	Javits	Scott
Cranston	Johnston	Sparkman
Curtis	Laxalt	Stafford
Danforth	Long	Stennis
DeConcini	Lugar	Stevens
Dole	Magnuson	Stone
Domenici	Mathias	Talmadge
Durkin	Matsunaga	Thurmond
Eagleton	McClellan	Tower
Eastland	McClure	Weicker
Ford	McGovern	Williams
Garn	McIntyre	Young
Glenn	Melcher	
Goldwater	Metcalf	

NAYS—11

Abourezk	Kennedy	Riegle
Clark	Leahy	Wallop
Culver	Morgan	Zorinsky
Haskell	Proxmire	

NOT VOTING—4

Bartlett	Randolph	Stevenson
Church		

So Mr. BUMPERS' amendment (No. 219) was agreed to.

Mr. McCLELLAN. Mr. President, I move that the vote by which the amendment was agreed to be reconsidered.

Mr. BUMPERS. Mr. President, I move to lay that motion on the table.

The motion to lay on the table was agreed to.

Mr. RANDOLPH subsequently said: Mr. President, on the four previous rollcall votes today, I was necessarily absent. I was in Bridgeport, W. Va., attending the funeral services for David Dean Johnson, a cherished friend and associate.

AMENDMENT

Intended to be proposed by Mr. BUMPERS (for himself, Mr. McCLELLAN, Mr. SPARKMAN, Mr. MUSKIE, Mr. ALLEN, and Mr. HATHAWAY) H.R. 9251, an Act Providing that until July 1, 1978, the tax treatment of certain transportation expenses between a taxpayer's residence and place of work shall be determined without regard to Revenue Ruling 76-453 or any similar ruling. At the appropriate place in the bill, add the following new section:

"SEC. ——. Section 207(c)(2) of the Tax Reform Act of 1976, as amended by Section 404 of the Tax Reduction and Simplification Act of 1977, P.L. 95-30, is further amended by striking the date "December 31, 1977" in Section 207(c)(2)(B) and inserting in lieu thereof the date "December 31, 1979."

EXHIBIT A

TOP 36 U.S. BROILER COMPANIES

Company [1]	Potential annual volume [2] (millions of birds)	Total sales volume, all products, for most recent reporting year available (millions)	Publicly or privately held	Cash basis accounting for tax or accrual [7]	Additional comments
*1 Holly Farms (Federal Co.).	229.0	[3,6] $539	Public, NYSE	Some operations cash, some accrual.	Will be affected.[7]
2 Gold Kist	224.0	[4] 733	Co-op	Not available	
*3 Valmac	152.0	[3] 157	Public, AMEX	Some operations cash, some accrual.	Will be affected.[7]
4 Tyson's	152.0	[3] 222	Public OTC	Cash	Arkansas company; not affected.
*5 J & M Poultry Packaging Co., Ltd. (Imperial Foods).	146.0	[3] ND	Public, England	Cash	Arkansas operations; will be affected.[7]
6 Central Soya	125.0	[3] 1,837	Public, NYSE	Accrual	
*7 Conagra	115.0	[3] 573	Public, NYSE	Cash	Will be affected.[7]
8 Perdue	110.0	[4] 179	Private	Cash	Not affected.[7]
9 Wayne (Allied Mills)	104.0	[4,6] 434	Private	Accrual	
*10 KFC (Heublein)	89.0	[3,6] 1,683	Public, NYSE	Cash	Will be affected.[7]
11 Swift (Esmark)	88.0	[3,6] 4,731	Public, NYSE	Not determinable	
*12 Corbett Poultry Products Co.	83.0	ND	Private	Cash	Will be affected.[7]
13 Cagles, Inc	79.0	[3] 138	Public, AMEX	Cash	Not affected.[7]
14 Marshall Durbin Co	70.0	[4] 54	Private	Cash	Not affected.[7]
15 Wilson (Jones-Laughlin).	70.0	[3] 2,050	Public, NYSE	Accrual	
16 Lane Poultry Co	68.0	ND	Private	Cash	Arkansas company; not affected.[7]
17 Fieldale Corp	52.0	[4] 50	Private	Cash	Not affected.[7]
18 Sanderson Farms	54.0	[4] 43	Private	Cash	Not affected.[7]
*19 Bayshore Foods (Kane-Miller).	50.0	[3,6] 658	Public, NYSE	Cash	Will be affected.[7]
20 Rockingham Poultry	50.0	[4] 43	Co-op	Not available	
21 Foster Farms	46.0	[4] 75	Private	Cash	Not affected.[7]
22 Cargill, Inc	46.0	[4] 5,330	Private	Accrual	Arkansas operations.
23 MFC (Collinswood)	42.0	ND	Co-op	Not available	
*24 Hudson Foods	42.0	[5] 65	Private	Cash	Arkansas company; will be affected.[7]
*25 Armour Foods (Greyhound).	39.5	[3,6] 3,733	Public, NYSE	Accrual	
*26 Banquet (RCA)	37.0	[3,6] 4,790	Public, NYSE	Accrual	Arkansas operations.
27 Pilgrim Industries	35.0	[4] 60	Private	Cash	Not affected.[7]
28 Southeastern Poultry Co.	33.0	ND	Private	Cash	Not affected.[7]
*29 Ralston Purina	33.0	[3] 3,349	Public, NYSE	Accrual	
30 State Pride Poultry	32.4	[5] 20	Private	Cash	Not affected.[7]
31 Herider Farms	27.0	[4] 25	Private	Cash	Not affected.[7]
32 O'Brien Foods	26.5	ND	Private	Cash	Not affected.[7]
33 Green Acres Farms	23.3	[4] 25	Private	Cash	Not affected.[7]
34 Zacky & Sons	19.8	ND	Private	Cash	Not affected.[7]
*35 Campbell Soup Co	19.7	[3] 1,635	Public, NYSE	Accrual	Arkansas operations.
*36 Empire Kosher	16.1	ND	Private	Accrual	

[1] Companies listed are per "broiler industry." Companies in parentheses are parent companies of operating units listed.
[2] Per "broiler industry."
[3] Per published annual reports or value line reports.
[4] Per 1977 Dun & Bradstreet reports (1976 financial results).
[5] Per 1975 Dun & Bradstreet report (most recent available with this listing).
[6] Total revenues for consolidated operations of parent corporation, including poultry operations.
[7] Based upon information supplied to Jack Frost & Co. by company accounting personnel.
[8] ND—Not determinable.

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., October 27, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Debt Management and Taxation Generally, Committee on Finance

DEAR HARRY: I am submitting as an amendment in the nature of a technical correction to Section 2(g)(1) of H.R. 6715, relating to the deductibility of expenses for certain foreign conventions.

The intent of Section 2(g)(1) was to clarify that the limitations of Section 274(h) of the Code do not apply to foreign travel incentive award programs where the individual who attends the foreign convention includes the value of the award in his gross income. This merely represents a change in language to conform to the Congressional intent in the enactment of the Tax Reform Act of 1976.

Nevertheless, the language of Section 2(g)(1) does not specifically cover so-called "three party incentive award programs." The language of the attached amendment will accomplish this purpose. The Treasury has no objection to this clarification and the Joint Committee staff has reviewed this amendment.

Best regards,

JOHN C. DANFORTH.

Amend Section 2(g)(1) of H.R. 6715 to read as follows:

(1) Deductions not disallowed to employer where employee includes amounts in gross income.—Subparagraph (D) of section 274(h)(6) (relating to application of subsection to employer as well as to traveler) is amended to read as follows: "Except as otherwise provided in this subparagraph, this subsection shall apply to deductions otherwise allowable under sections 162 or 212 to any person, whether or not such person is the individual attending the foreign convention. For the purposes of the preceding sentence, such person shall be treated, with respect to each individual, as having selected the same two foreign conventions as were selected by such individual. This subsection shall not apply to any person who is not the individual attending the foreign convention if transportation and subsistence furnished by such person is includible in the gross income of the person receiving such transportation and subsistence.

U.S. SENATE,
Washington, D.C., October 27, 1977.

HON. HARRY BYRD,
Chairman, Subcommittee on Taxation, Senate Finance Committee, Washington, D.C.

DEAR MR. CHAIRMAN: I am enclosing a copy of a bill I will be introducing today to amend the historic preservation tax incentives section of the 1976 Tax Reform Act. The change I propose is minor, but it will strengthen the financial preservation toools approved last year.

As you may remember, last year we allowed owners of historic properties (property listed on the National Register of Historic Places or located in a National Register historic district) accelerated depreciation or short term amortization of certain rehabilitation expenditures. The intent of the provision, as I recall, was to provide incentives for private investment in these properties. We did not address the question of extending this to long-term lessees, who may take deductions for other permanent property improvements, and I have been advised that the Treasury Department does not intend to extend the rehabilitation incentives to these lessees in fortrcoming regulations. My bill seeks to do this and will subject lessees to the same recapture provisions applicable to qualifying property owners.

I have discussed this change with a number of preservation groups, all of whom have indicated strong support for it. As I receive pertinent writen information from thse individuals, I will forward it along to your staff for your reference. One of the main problems these groups have brought to my attention concerns surplus Federal property, much of which is of historic value, donated to local and state governments.

Because of the many budgetary pressures, these governments simply cannot afford to undertake restoration expenditures. However, those governments often lease these properties to private developers for rehabilitation. To encourage private investment in these restoration projects, extension of these tax incentives to lessees is necessary.

I hope that, on the basis of the evidence presented to you, the Subcommittee will act favorably on this change during consideration of the Technical Amendments to the Tax Reform Act. If I can provide you with any additional materials on this matter, please let me know.

With kindest regards,

Sincerely,

J. BENNETT JOHNSTON, *U.S. Senator.*

Enclosure.

HISTORIC PRESERVATION TAX INCENTIVES

Mr. President, last year the Congress included provisions in the 1976 Tax Reform Act of critical importance to our national historic preservation movement. The changes in section 191 of the Internal Revenue Code of 1954, among other things, provide the owners of historic properties favorable tax treatment on rehabilitation expenses of certified historic structures through accelerated depreciation or short term amortization. Historic properties are defined as those included in the National Register of Historic Places or those located in a National Register district.

Problems in trying to use these preservation incentives have arisen because long-term lessees have not been allowed the same treatment as property owners, although this is not the case with similar permanent property improvements treatment in the tax code. Surplus Federal property, much of which is of historic value, is often donated to cities. We are all painfully aware of the multitude of pressures on our cities' budgets and it should come as no surprise that rehabilitation of these important parts of our national heritage is assigned a relatively low budgetary priority. Thus, the real hope for preserving these buildings lies in the hands of the private sector. If similar tax treatment is allowed to long-term lessees, then incentives to rehabilitate and save these buildings will be given.

The preservation movement has come a long way from its "monumental" beginnings which emphasized saving isolated structures, battlefields, mansions of the wealthy, museums and the like. More and more, we have come to realize that a variety of properties are worth saving and that these properties can be adapted to new practical uses such as revived shopping complexes, innovative office or residential centers, and tourist centers. A ripple effect has been seen in many urban areas undergoing extensive restoration as new jobs are created in downtown areas and as out-of-town investment is brought in—all of which brings new dollars to local treasuries. But this cannot be financed from federal, state or local budgets alone. To be successful and to encourage the growth of a broadened preservation movement, the private sector must be brought in and encouraged to invest in these properties. This was clearly the intent of the far-sighted 1976 Act which provided us with new financial preservation tools. The minor change I propose will help make these incentives more workable and useful in the efforts we have already begun.

Mr. President, the bill I am introducing also provides for the same recapture provisions that apply to homeowners and I hope this will alleviate any concerns about this change. I should also like to request unanimous consent that the text of this bill be printed at the end of my remarks.

[S. ———, 95th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 to permit long-term lessees to take the amortization deduction, in lieu of depreciation, for rehabilitation of certified historic structures

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 191 of the Internal Revenue Code of 1954 (relating to amortization of certain rehabilitation expenditures for certified historic structures) is amended by redesignating subsection (g) as (h), and by inserting after subsection (f) the following new subsection:

"(g) EXPENDITURES BY LONG-TERM LESSEES.—In the case of a certified historic structure held by a person under a lease of not less than 30 years' duration—

"(1) the deduction under this section shall be allowable to the lessee of such certified historic structure with respect to amounts expended by him in connection with certified rehabilitation, and

"(2) for purposes of applying paragraph (1), the amortizable basis of such certified historic structure is the amounts expended by the lessee in connection with certified rehabilitation.".

(b) The amendment made by subsection (a) shall apply with respect to additions to capital account made after June 14, 1976, and before June 15, 1981.

U.S. SENATE,
Washington, D.C., October 27, 1977.

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

DEAR MR. STERN: I understand that the Senate Finance Committee will be hearing testimony on Friday, October 28 concerning the Technical Corrections Act, H.R. 6715, and that written testimony will be accepted for inclusion in the record if submitted by October 31.

The Iowa State Bar Association has requested that the accompanying statement of Arley J. Wilson, Chairman of the Iowa State Bar Association's Special Committee on Probate, Property and Trust Law, be included in the record of proceedings on this matter, and I am hereby forwarding the statement to you with the request that the same be included.

I will appreciate your assistance in this matter.

Sincerely,

JOHN C. CULVER.

THE IOWA STATE BAR ASSOCIATION.

COMMENTS AND RECOMMENDATIONS ON ESTATE AND GIFT TAX, CARRYOVER BASIS AND GENERATION SKIPPING TRUST PROVISIONS AND INCOME TAX RELATING TO FOREIGN CONVENTIONS

(By Arley J. Wilson, Chairman, Probate, Property & Trust Law Committee for the Iowa State Bar Association)

This comment is limited to the area of carryover basis as provided under the 1976 Tax Reform Act, alternate methods of taxation or the possibility of a moratorium on the effective date of application of carryover basis for at least two years from and after December 31, 1976. I appeared before this Committee on the 8th day of September, 1977 and appreciate this opportunity to again appear primarily on "carryover basis". I incorporate herewith comments and recommendations on the Technical Correction Act of 1977 previously submitted by the Iowa State Bar Association for the hearing on the 8th day of September, and do not include it herein because the same would be repetitive. I would like to point out to the Committee additional matters which may be somewhat repetitive but only as necessary.

FIRST

The formulae used in the determination are extremely complex and cumbersome. See Addendum "A" attached hereto for a simple example of preparation necessary in the calculation of carryover basis for each item in an estate. Bear in mind that this formula must be applied on an item by item basis. Those of you who are knowledgeable of the farming enterprise know that there will be on the average farm probably from 200 to 400 different items upon which to calculate carryover basis and to apply the formula to each. If the farm is a breeding farm or ranch containing breeding animals such as cows or sows, the number of calculations must increase correspondingly for each sow or cow and the only limitation to the calculations is the number of breeding animals on that farm or ranch. The number of typed pages used in the calculation of carryover basis alone would look like a Sears catalog if there is only 300 items. This catalog must be delivered to the Internal Revenue Service and a copy to each heir or distributee or party in interest. The printing cost alone would exceed that cost of printing the record and brief of any case which I have taken to the United States Court of Appeals. This is the farm problem.

To those of you who are lawyers or have access to or own any law books, the matter would become exceedingly personal. If you own the series of law books entitled "Federal Reporter, 2nd Series", it deals with cases argued and determined by the Circuit Courts of Appeals and District Courts of the United States and the Court of Appeals of the District of Columbia. In my library alone, at the last reading there were 552 volumes in this set. Volume 1 was first published in 1925 and each volume thereafter being acquired by subscription bore a different cost and a different date of possession on an item by item basis.

This would require 552 calculations of carryover basis. The penalties alone for failing to calculate and return this set on an item by item basis would exceed the $5,000.00 maximum imposed for failure to return to the federal government and the $2,500.00 maximum imposed for failure to report to the distributees, that is if you calculated the basis as provided under the formulae of Addendum "A" and my estate exceeded $60,000.00.

This same problem would under the current rules, apply to every other book in a lawyer's library. The unworkability of such a calculation readily becomes apparent for the farmer and for the library of any lawyer. The current value for each such book at date of death would probably be less than $10.00. The cost of determination of carryover basis would far exceed that amount per book.

Each small business would have a similar problem according to the number of personal property items and real estate involved in such small business. Each owner of joint property even though there is no administration would have responsibility of which he might not well be aware unless he or she sought the services of a lawyer.

Even though the decedent had the best set of books imaginable, the cost attending the research and development of applicable basis material for a period of from 20 to 30 years or more would be far greater then all of the costs of the estate combined.

Iowa has a statute reading substantially as follows:

> "When any property is valueless, or is so encumbered, or in such condition, that it is of no benefit to the estate, the Court may order the fiduciary to abandon it, or make such other disposition of it as may be suitable in the premises."

Most of the states have a similar statute. The fiduciary is subject to a surcharge if he holds property which by the Court is deemed worthless. The application of negative basis and the costs of determining carryover basis may well require that personal property be abandoned and not made a part of the estate. The question arises of what provision has been made by the Congress to assume or take care of the abandoned personal property. I am sure that the abandonment of real estate poses no material problem because sooner or later it will be taken over by the mortgage holder or the local taxing authority.

Perhaps the negative basis property in our particular area where we have had a serious drought condition, a reduction in price of corn to in some instances less then $1.50 a bushel and a reduction in price of beans in some instances to less then $5.00 a bushel and a reduction in value in the market of farm real estate from $300.00 to $400.00 per acre or more poses one of the most serious of problems. Many of the farmers in the area must refinance the farm to accommodate this stressful situation and the refinancing of the farm, the amount borrowed on the land, may well exceed twice the carryover basis of the land. The death of the decedent creates an immediate problem because the assumption of debt by a Third Party in excess of basis creates a taxable event. Who pays the tax? Is it charged against the decedent? Is it charged against the fiduciary or is it a charge against the distributee? Is it an additional deduction for federal estate tax purposes and what if the borrowings are in excess of the current market value. These problems are not answerable under the present 1976 Act nor under the technical amendments proposed. The unidentifiable nature of crop whether it be shelled corn or beans stored in a common storage facility creates a problem in determining the applicability of carryover basis to crop harvested in 1977 and commingled with a crop which may have been carried over from 1974, 1975 or 1976. What is the data of the acquisition of a crop planting, ripening or harvesting.

These are matters not extensively covered in our last comments made before this Committee but are nevertheless matters of which your commitee should be totally aware.

One writer has said that the computational difficulties of the carryover basis have left attorneys and CPA's "stunned and disbelieving." We have not yet been able to find a way to compute and report carryover basis in the average farm situation to this date and one of the leading professors at Iowa Law School has for delivery an eight hour lecture addressed totally to carryover basis, and I have yet to meet a practicing lawyer who can say he understands it.

As previously stated, the problem is not only one of the United States government but it becomes mixed up with all of the statutes of distribution and taxing in all of the states and not only is it impossible to file a correct income tax on the Fiduciary Form 1041 for an estate for the federal government but it is likewise impossible to file a correct state income tax until the federal carryover basis has been finally determined. Because of the perishable nature of farm commodities and the fluctuations of the marketplace, sale or disposal at a proper market is often required before it is possible to determine with any degree of accuracy the basis.

The distribution problems in an estate are of such wide variance and difficulty of determination of tax liability, it is impossible to produce an equitable distribution that any Court can approve unless the same is made entirely in fractional shares, which in practicality produces an unworkable solution.

The cash basis taxpayer has been trapped because he will have little or no basis and his tax situation depends entirely on the accuracy of his ability to forecast with precision the accident of death. Otherwise his tax situation will be materially altered by the timing incident to when he dies. (See Addendum "B" attached hereto.)

SECOND

Alternate Methods of Taxation

It has been proposed that the increase in value of property be taxed as a capital gain at death. The same costs of discovery incident to basis would be present if such a theory were to prevail and the same unavailability of records would be present to a substantially lesser degree. Likewise the taxpayer would be subject to the same unpredictability of determination of the value of his estate and the tax which would most likely be assessed against it.

There is also the possibility that capital gains as we now know them may not exist at the time of death of the decedent and this would again change a provision he might or might not have made to provide for his death taxes.

This Committee should be advised that many items in an estate in a farm are not now subject and would not then be subject except by special definition to capital gains treatment and the acceleration of tax to the point of excess of 100 percent of the overall would still exist unless there was as a part of such method of taxation added a substantial change in the relation between income taxes and death taxes.

If the tax is not to become entirely confiscatory in nature, the estate should be accorded the same treatment the decedent would have had if the decedent had sold the property during his or her lifetime except for the accident of death. That is to say the estate should be accorded the possibility of a five year average the same as the decedent would have had if he had sold when living. The income tax created by the death and the application of gains which have been yet unrealized should be deductible from the federal estate tax or they may exceed the value of the property inherited. (See Addendum "B").

The applicability of the minimum surtax on capital gains should not be enforced because of the involuntary nature of the so called conversion on anticipated gains which have not yet been realized. Substantial adjustment would still be required in areas where there has been used special use valuation formulas for determination of value of farm or small business land.

In our office in 1942, we probated an estate in my County of 160 acres worth $200.00 an acre or $32,000.00. The total personal property value necessary to farm this farm was $20,000.00. The exemption was $60,000.00, the estate totaled $52,000.00 with its personal property and had no tax exposure to the Federal government.

In 1952, the same 160 acres was worth $350.00 an acre or $56,000.00. The value of the personal property had risen to $30,000.00. The exemption was $60,000.00 and the estate was then exposed to federal taxation on $26,000.00.

In 1962, that same 160 acres was worth $500.00 per acre and it took $40,000.00 of personal property to operate the farm, making a total valuation of $120,000.00. The exemption was $60,000.00 and there was exposed to federal estate taxation $60,000.00.

In 1972, I probated the son's estate in the same 160 acres. The value of the land was $700.000 per acre or $112,000.00 and the personal property necessary to operate this farm was $50,000.00, making a total valuation of $162,000.00. The exemption was $60,000.00 and the amount exposed to federal taxation was $102,000.00.

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January of 1977, this farm would have been $3,000.00 per acre or $480,000.00, and the minimum personal property necessary to farm would have been $100,000.00, making a total estate of $580,000.00. The equivalency of credit would have been $120,000.00, leaving exposed for taxation $460,000.00. The price at this date which is more than six months later per acre would probably be $2,500.00 an acre. If this Committee is to recommend a capital gain applicable at death, there should be an equation which would allow capital losses at the time of the conversion of the property subject to the capital gains if they were taken within a reasonable time after the application of the capital gain value.

It appears that a great deal of time and study must be made to provide an equitable solution of the capital gain proposal before it is written into law. Otherwise we will have the same unworkable problems that are now attended with on carryover basis.

One other alternate solution suggested in this Committee has been, as I understand it, the diminishment of credit against death taxes. The maximum credit allowed will be the equivalency of approximately $180,000.00 or a multiplier of three times the credit of 1942 against the value of the property. It is obvious that the multiplier of value in real estate from 1942 even to this date is at least equal to a multiplier of ten to one. Even though the ratio above set out is not of an equitable nature, most of the members of the Bar, and taxpayers with whom I have visited in the last month, would prefer a diminishment of credit against death taxes and an increase, if necessary, in the percentage of death taxes if stepped up basis were allowed and determinability of the amount of tax was restored instead of the present carryover basis rules or the application of capital gains at death.

THIRD

Moratorium

While we are not in favor of the continuation of carryover basis in its present form or in any form unless it can be substantially restricted, but anticipating that this Committee and Congress may have some problems which cannot be immediately resolved regarding carryover basis, at least a moratorium becomes an absolute necessity.

Without further comment on the feasibility from a public standpoint of the fresh start rule and particularly that part of the Act addressed to carryover basis and the manner in which Congress has seen fit to implement the rule, it can be said without equivocation that the application of the rule as it applies to farms and small businessmen creates what is virtually insurmountable difficulties and in the valuation in administration of estates, becomes at the County seat lawyer level, a totally unworkable feature of estate administration.

The carryover basis rules result in many calculations for the same item.

We have calculations of value for the date of death or the alternate valuation dates, we have calculations of basis for gain and we have calculations of basis for loss, we have calculations for the values on December 31, 1976 and we have calculations for the date of death. In addition, we also have calculations for the various state reports and there are also calculations based on further adjustment to basic items by the payment of these various taxes.

Up to this point there is a total absence of guidelines, rules, regulations, and forms available to comply with the present law. The time allowed for all of these calculations is unclear and unfixed.

The complexities of the rules prevent the public as well as the administrators from having a complete understanding of the applicability of this law and there are many technical matters which must be the concern of the Committee before there can be any workable carryover basis application. Without attempting to touch all of these matters, we would like to point out a few.

At present the cost of calculation of carryover basis if at all possible in many instances will exceed the value and will therefore become unduly burdensome to the estate.

There has been no rule yet devised which adequately protects that farmer or small businessman who had a carryover basis of less than the amount used by him on the mortgage on the property, which in all probability can create taxable event.

Even though the records are available (and many times they are not) the cost of research of the records and assembly of data will be significant in all estates over $60,000.00. The provision that persons receiving rent even on a participating basis may not use the accrual method of accounting remains to be resolved or correlated. The possibility of cash basis operators, be they owner or tenant, paying a combined tax including federal estate, state death taxes, federal income tax, and state income tax, which would cumulatively be a combined tax greater or at least equal to the amount of inherited property, is not yet solved.

There has been no consideration given to the requirements of many state laws which required abandonment of property of an unproductive nature. (The federal government does have in a bankruptcy situation, at least a provision for abandonment of such negative basis or unproductive property which has no value).

The complexities of calculation must be simplified so that they are understandable.

It is apparent that the administration is now preparing its own Tax Reform Act, which in all probability will impose new rules and new standards.

There are many other items of a highly technical nature that must be resolved before workability of carryover basis can be satisfactory achieved.

I am aware that many technical amendments have been prepared or are in the process of preparation to the elimination of some of the objections to the carryover basis portion of the 1976 Act and I commend this Committee and Congress for its effort and I hope that it will continue its dedication to that task.

A substantial portion of the difficulty lies in the assumption that records are available and are easily determined to provide a satisfactory answer.

More than that, the income tax becomes a material factor in the concept of estate and other death taxes. The income tax was conceived as one of the voluntary assessments by the taxpayer. For the most part the taxpayers have responded well to this concept. The Act requires the imposition of substantial penalties of a rather severe nature which are similar to criminal sanctions. The requirements of strict compliance and enforcement in its present state with a lack of available data to implement to carryover basis rules is staggering.

As written, the rules apply to almost every distribution of property at time of death and even that poor old fellow who dies in a nursing home with only a radio and a bunch of heirs must make arrangement for the proper reporting of basis at current market value before disposition can be appropriately made of the proceeds of the sale of the radio.

(See Addendum "C" attached.) Unless a proper election under Section 1023 has been made to exclude household property from carryover basis.

The taxpayers and their representatives have been so frustrated by the complications of the law that at least at the local level resentment has already begun to develop. If the voluntary aspect of assessment due to the severity of the penalties imposed disappears from the American tax scene, even more frustration will develop and the possibility of individual evasion will be ever present. The cost of implementing and enforcing the carryover basis rule is scarcely worth the gain in revenue realized for the next two years.

If there is and Congress deems it necessary to preserve the carryover basis concept, then I believe it is absolutely necessary that the Committee have adequate time and study for consideration in the making of this concept understandable, enforceable and above all, workable to the County seat lawyer. It is respectfully requested that if Congress in any event deems that the concept of carryover basis must be retained, that at least the general public, the fiduciaries and their representatives be accorded the privilege of a moratorium of two years, to be granted retroactively to all estates of persons dying after December 31, 1976 and prospectively for all persons dying before January 1, 1979. Thus the pre-1977 rule of stepped up basis would continue in effect from January 1, 1977 to January 1, 1979.

The Iowa Bar does not endorse the concept of carryover basis but feels that such endorsement is a congressional matter of determination. However, the Iowa Bar does wholeheartedly endorse and support in the event the concept is retained, a moratorium in which specific changes could be made to provide a workable and understandable situation at the County seat level.

Respectfully,

ARLEY J. WILSON,
Chairman, Special Committee on Probate Property & Trust Law,
Iowa State Bar Association.

Law-Econ. 177
July, 1977

ADDENDUM "A"

Carryover Basis - Adjustment for Federal Estate Tax *

Example: Returning to the example of a farm with a calculated carryover basis of $256,000 and a fair market value of $360,000, assume the decedent's federal estate tax calculations were as follows --

Gross estate	$785,000
Deductions	35,000
Adjusted gross estate	750,000
Marital deduction	375,000
Charitable deduction	10,000
Taxable estate	365,000
Tentative tax	109,900
Unified credit (death in 1981)	47,000
	62,900
Credit for state death tax	5,680
Federal estate tax due	57,220

For the adjustment process, three values must be found --

1. Federal estate tax due (no state estate tax applicable) 57,220
2. Net appreciation in value of the property in question

Fair market value	360,000	
Carryover basis	256,000	
	104,000	104,000

3. Fair market value of property subject to the tax

Gross estate	785,000	
Less: marital deduction	375,000	
	410,000	
Less: charitable deduction	10,000	
	400,000	400,000

With those three values known, the fourth, the adjustment for federal estate tax attributable to the net appreciation in value of the property can be computed --

$$\frac{\text{Adjustment factor}}{\text{Federal estate tax}} = \frac{\text{Net appreciation}}{\text{FMV of all property subject to tax}}$$

$$\frac{\text{A.F.}}{57{,}220} = \frac{104{,}000}{400{,}000}$$

$$\text{A.F.} = .26\ (57{,}220)$$

$$\text{A.F.} = 14{,}877$$

Thus, the adjustment factor for federal estate tax is $14,877, to be added to the carryover basis for the farm --

Carryover basis	256,000
Plus: adjustment factor	14,877
	270,877

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* Prepared by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

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ADDENDUM "A", Page Two

Calculating Carryover Basis*

Example: A farmer acquired a farm for $190,000 on January 1, 1971. A portion of the purchase price was allocated to the land and a portion to depreciable buildings, fences and tile lines. Depreciation of $9,000 was claimed each year on a straight line basis. At the farmer's death on January 1, 1981, the property was valued at $360,000. The calculation of carryover basis may be handled in five steps as follows --

Step 1: Determine gain at death

Fair market value	$360,000
Adjusted income tax basis at death ($190,000-(10 x $9,000))	100,000
Gain at death	260,000

Step 2: Determine appreciation of property during holding period net of depreciation, depletion or amortization

Total gain at death	260,000
Depreciation claimed to date of death	90,000
Net appreciation to date of death	170,000

Step 3: Determine net appreciation for holding period before 1977 --

Number of days in holding period for farm in total		3,650
Number of days in holding period for farm before 1977		2,190
Fraction of total holding period before 1977	2190/3650 = 315	
Net appreciation of property before 1977 3/5 x $170,000 =		102,000

Step 4: Determine depreciation, depletion and amortization attributable to the period before 1977

Depreciation for period before 1977	54,000

Step 5: Determine carryover basis adjustments to income tax basis of property

Adjusted basis at date of death		100,000
Net appreciation prior to 1977	102,000	
Depreciation prior to 1977	54,000	
	156,000	156,000
Income tax basis of property		256,000

* Prepared by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

ADDENDUM "A", Page Three

Carryover Basis - Adjustment for Minimum $60,000 *

Example I: Farmer A, a widower, dies owning three assets: a farm, a bank account and stored grain. The gross estate totals $475,000 as indicated.

Asset	FMV	Carryover basis	Federal and state estate tax adjustment
Farm	442,000	2,000	72,320
Bank Account	8,000	8,000	0
Grain (1977 & 78 crops)	25,000	0	4,410
	475,000	10,000	76,,30

No further adjustment is possible because the aggregate basis of carryover basis property exceeds $60,000.

Example II: Farmer B, a widower, dies owning three assets: a farm, a bank account and a small beef cow herd. The gross estate totals $142,500 as indicated --

Asset	FMV	Carryover basis	Federal estate and state estate tax adjustment
Land	130,000	32,000	0
Bank account	2,500	2,500	0
Cattle	10,000	0	0
	142,500	34,500	

With the aggregate basis of $34,500 on carryover basis property, the difference between that figure and $60,000 is available for allocation among items of carryover basis property --

$60,000 - $34,500 = $25,500

The amount of $25,500 may be allocated in a two step procedure as follows --

Step 1: First, determine net appreciation in value --

- For the land, the net appreciation in value is the fair market value minus the carryover basis --
  130,000 - 32,000 = 98,000

- For the bank account, the net appreciation in value is figured using the same formula --
  2,500 - 2,500 = 0

- For the cow herd, the net appreciation in value is --
  $10,000 - 0 = 10,000

The total net appreciation in value for all assets is --
98,000 + 0 + 10,000 = $108,000

* Prepared by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

ADDENDUM "A", Page Four

Step 2: Allocate the available basis amount ($25,500) among the carryover basis assets.

- For the land --

$$= \frac{\text{Net appreciation in land}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation}$$

$$= \frac{98,000}{108,000} \times 25,500$$

$$= 0.9074 \times 25,500$$

$$= 23,139$$

Thus, the new adjusted carryover basis for the land would be --

$$= \$32,000 + 23,139$$

$$= 55,139$$

- For the cow-calf herd

$$= \frac{\text{Net appreciation in herd}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation}$$

$$= \frac{10,000}{108,000} \times 25,500$$

$$= 0.0926 \times 25,500$$

$$= 2361$$

Therefore, the cow-calf herd has a new adjusted carryover basis determined as follows --

$$= 0 + 2361$$

$$= 2361$$

The income tax basis of the bank account of $2,500 is not adjusted because there is no net appreciation in that asset. To recapitulate, the income tax basis of assets in Farmer B's estate would be --

Land	$55,139
Bank account	2,500
Cattle	2,361
	$60,000

Carryover Basis - Adjustment
for State Inheritance Tax *

Example: Returning to the previous example, assume the land, the bank account and the cattle are all inherited by the son who pays a state inheritance tax of $4325. The asset value and basis are as follows.

Asset	FMV	Carryover basis	Federal estate & state estate tax adjustment	Minimum aggregate basis adjustment	Basis before third adjustment
Land	130,000	32,000	0	23,139	55,139
Bank Account	2,500	2,500	0	0	2,500
Cattle	10,000	0	0	2,361	2,361
	142,500	34,500	0	25,500	60,000

The amount of $4325 in state inheritance tax would be allocated among the assets as illustrated in the following three step procedure —

Step 1: Determine the net appreciation in value for each item of property. This is defined as the excess of fair market value above the adjusted basis including all adjustments made to this point. Specifically, it includes the adjustment for federal estate and state estate tax and the minimum aggregate $60,000 as well as the carryover basis amount.

- For the land, net appreciation would be --
- = 130,000 - 55,139
- = 74,861
- For the bank account, net appreciation would be --
- = 2,500 - 2,500
- = 0
- For the cow-calf herd, net appreciation would be --
- = 10,000 - 2,361
- = 7639

Step 2: Determine the fair market value of all property acquired by the son which is subject to state inheritance tax --

Land	130,000
Bank account	2,500
Cattle	10,000
	142,500

Step 3: Allocate the state inheritance tax among the assets

- Adjustment to land basis --
- = $\frac{\text{Net appreciation in value}}{\text{Fair market value of all property}}$ x state inheritance tax paid

* Prepared by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; Member of the Iowa Bar.

ADDENDUM "A", Page Six

$= \dfrac{74{,}861}{142{,}500} \times 4325$
$= 0.52534 \times 4325$
$= 2272$

- Adjustment to basis of bank account --

$= \dfrac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{state inheritance tax paid}$
$= \dfrac{0}{142{,}500} \times 4325$
$= 0$

- Adjustment to basis of cow-calf herd --

$= \dfrac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{state inheritance tax paid}$
$= \dfrac{7639}{142{,}500} \times 4325$
$= 0.05361 \times 4325$
$= 232$

As a final recapitulation, the income tax basis of assets in the hands of Farmer B's son would be --

Land	$57,411
Bank account	2,500
Cattle	2,593

Those figures are derived from the three overall adjustments and the carryover basis as follows --

et	FMV	Carryover basis	Federal estate & state estate tax adjustment	Minimum aggregate basis adjustment	State inheritance tax adjustment	Basis to son
d	130,000	32,000	0	23,139	2,272	57,411
k count	2,500	2,500	0	0	0	2,500
tle	10,000	0	0	2,361	232	2,593
	142,500	34,500	0	25,500	2,504	62,504

ADDENDUM "B" Page One

Jim Jones, age 55, died December 1, 1977 - a widower, a tenant farmer leaving all his property to his son, Bob Jones, age 30. Jim was on a cash basis, he farmed 1200 acres, his son worked as his hired hand.

His inventory was as follows:

1. Machinery & cash on hand net of expenses of last illness and burial and cost of administration and debt				120,000.00	
2. 100,000 bu. of corn @ 2.25 per bu.				225,000.00	
3. 20,000 bu. of beans @ 10.00 per bu.				200,000.00	
TAXABLE ESTATE ----------------------------				545,000.00	
Federal Estate Tax	500,000 @		155,800.00		
	45,000 @	37%	16,650.00		
Gross Tax (REFORMED)			172,450.00		
LESS STATE CREDIT					
	440,000 @		10,000.00		
	45,000 @	(4%)	1,800.00		
			11,300.00		
LESS UNIFORM CREDIT			30,000.00		
NET ESTATE TAX (REFORMED)					130,650.
Iowa Inheritance Tax Gross			545,000.00		
Less Federal Estate Tax			130,650.00		
Less Exemption			30,000.00		
Taxable				384,350.00	
TAX	150,000 @		7,825.00		
	234,350 @	8%	18,748.00		
TOTAL INHERITANCE TAX					+26573.(
TOTAL DEATH TAXES					157,223.

ADDENDUM "B", Page Two

INCOME TAX (SIMPLIFIED)

Corn & beans sold at inventory value		425,000.00		
Basis Fed. $\frac{425,000}{545,000}$ x 157,223.00		122,605.00		
Adj. Gross Gain Fed.			302,395.00	
Fed. Inc. Tax	100,000 @	55,490.00		
	201,795 @	70% 141,256.00		
Total Federal Income Tax				196,746
Iowa Income Tax				
Basis same as Federal		122,605.00		
Net gain Iowa			302,395.00	
	75,000 @	7,420.00		
	227,395 @	13% 29,561.00		
Total Iowa Income Tax				36,966
TOTAL INCOME TAX				233,712
TOTAL TAXES IN ESTATE (GOVERNMENT SHARE)				390,935
SON'S TOTAL SHARE ----------------------------------				154,065
TOTAL PERCENTAGE OF TAX ON LAST 45,000 INHERITED		124%		

If the gross estate had been $200,000 less, the son's total share would have been $137,951 or approximately $16,114 less. IN OTHER WORDS, OF THE LAST $200,000 INHERITED, THE GOVERNMENT SHARE IS APPROXIMATELY $184,000.

ADDENDUM "B", Page Three

COMPARISON OF PRE-JANUARY 1, 1977 TAX ACT
AS IT WOULD APPLY TO THE EXAMPLE SET OUT

Under the pre-January 1, 1977 tax law, the gross Federal Estate Tax would be $140,900.00.

The State Inheritance Tax Credit would be $11,800.00.

The net Federal Estate Tax would be $129,100.00 or $1,550.00 less than the post-January 1, 1977 tax consequence.

The Iowa Inheritance Tax would be $26,697.00 or $124.00 more under the pre-1977 tax because the Federal deduction would not have been so great.

There would be no federal income tax on the sale of inventory. There would be no Iowa income tax on the sale of inventory.

The total taxes then occuring pre-1977 for dea'h tax and income tax would be $155,797.00 or $235,138.00 less of total taxes pre-1977, farm family estate.

The Relief Act designed and reported to relieve the family farm operation of taxes in the foregoing hypothetical instance really provided that the farming family estate would be relieved of $235,138.00 additional dollars in a combination of death and income tax which was not the advertised effect of the Act and hopefully was not the Congressional intent.

ADDENDUM "C" Page One

IN THE DISTRICT COURT OF THE STATE OF IOWA

IN AND FOR MADISON COUNTY

IN THE MATTER OF THE	:	PROBATE NO. 8135
ESTATE OF	:	I.D. #42-6269433
LUCIE E. JONES, DECEASED	:	ELECTION OF EXECUTOR WITH RESPEC TO CARRYOVER-BASIS PROPERTY

Melvin H. Jones, Executor herein, hereby elects under the provisions of Internal Revenue Code Section 1023(b)(3) that the basis of the property, which in the hands of the decedent was personal effects and household effects, shall have a carryover basis of the fair market value of all of such assets, said value being determined as of the date of death of the decedent, to-wit: January 12, 1977.

Executed in duplicate at Winterset, Iowa, this ____ day of ________________, 1977.

Melvin H. Jones, Executor of the Will
of Lucie E. Jones, Deceased.

CERTIFIED MAIL

RETURN RECEIPT REQUESTED

ADDENDUM "C", Page Two

IN THE DISTRICT COURT OF THE STATE OF IOWA

IN AND FOR MADISON COUNTY

IN THE MATTER OF THE ESTATE	:	PROBATE NO. 8153
OF FRANK EASTER,	:	I.D. # 42-6271612; Dec. Soc. Sec. #483-1 -8493
DECEASED	:	NOTICE TO SECRETARY OF THE TREASUR OF THE UNITED STATES OF AMERICA WITH RESPECT TO CARRYOVER-BASIS PROPERTY

YOU ARE HEREBY NOTIFIED that the following described property, to-wit:

Personal Effects - Total Fair Market Value $100.00

had a carryover basis on One Hundred Dollars ($100) on account of election made by the executor under the provisions of Internal Revenue Code Section 1023(b)(3), and was distributed to the following persons:

NAME	AGE	RELATIONSHIP	ADDRESS	SOC.
John B. Easter	61	Son	Box 327 LeGrande, Iowa 50142	483-1
Alice Anderson	59	Daughter	1507 N. McKinley Rd. Arlington, VA 22205	579-0
Robert Easter	56	Son	8015 Suncrest Drive Des Moines, Iowa 50315	478-2
Gladys Nabors	54	Daughter	16113 N.E. 99th Redmond, WA 98052	479-2
Ruth Spencer	50	Daughter	256 Orange Avenue Chula Vista, CA 92011	478-3
Ethel Jean Swift	43	Daughter	7403 Wilden Drive Urbandale, Iowa 50322	479-3

Respectfully submitted,

Ethel Jean Swift, Executor of the Will of Frank Easter, Deceased

MAILED: Certified Mail
Return Receipt Requested
TO: Sec. of Treasury
District Director of I.R.S.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., October 26, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate.

DEAR MR. CHAIRMAN: I would like to bring to your attention a problem which has arisen in connection with Section 1207(e) of the Tax Reform Act of 1976, which provided that certain fishermen on small vessels were to be treated as self-employed persons for federal tax purposes.

Section 1207(e) was put into the law because the Internal Revenue Service had changed an administrative interpretation, and was attempting to collect withholding taxes from the small vessel owners, even though the individuals who had worked on the vessels had already paid the full tax on their income.

When Section 1207(e) became law, it applied to fishing activities performed in tax years beginning after December 31, 1971. At the time Section 1207(e) was adopted, it was thought that this effective date would solve the problem. I have recently learned, however, that several owners of small fishing vessels in my district—and presumably others elsewhere—are still being subjected by the IRS to attempts to collect withholding taxes retroactively, for tax years prior to the effective date of Section 1207(e). These attempts are creating severe financial hardships.

Consequently, I respectfully urge you to support an amendment in your committee to change "December 31, 1971" in Section 1207(f)(4) of the Tax Reform Act to an earlier effective date. I understand that Donald C. Lubick, Deputy Assistant Secretary of Treasury for the Tax Policy, proposed to your committee this morning that the date be changed to "December 31, 1954" and that Senator Hathaway is planning to offer such an amendment to H.R. 6715, the "Technical Corrections Act of 1977."

Because of the severity of the financial hardships involved, I sincerely hope you will support adoption of such an amendment to H.R. 6715, or to another bill which can become law before the Congress adjourns this fall.

With kind regards.

Sincerely,

GERRY E. STUDDS.

NATIONAL TRUST FOR HISTORIC PRESERVATION,
Washington, D.C., October 31, 1977.

Re H.R. 6715, Technical Corrections Act of 1977; and S. 2241, concerning an amendment to the Internal Revenue Code to permit long-term lessees to take the amortization deduction in lieu of depreciation for rehabilitation of certified historic structures.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance.
U.S. Senate, Washington, D.C.

DEAR SENATORS LONG AND BYRD: The National Trust for Historic Preservation in the United States is pleased to submit comments relating to the referenced bills.

As you are probably aware, the National Trust is a charitable, educational and nonprofit corporation chartered by Act of Congress (16 U.S.C. § 468a–e) to further the historic preservation policy of the United States and to facilitate public participation in the preservation of sites, buildings and objects of national significance or interest.

As we stated in our letter of September 14, 1977 to Mr. Al Ullman, Chairman, Committee on Ways and Means, the National Trust generally supports H.R. 6715 because we believe that the correction and clarification of certain of the historic preservation provisions of the Tax Reform Act of 1976, as amended by the Tax Reduction and Simplification Act (P.L. 95–30), will contribute to a better understanding and utilization of the law by the American people. As investors react to the incentives and disincentives embodied in the Act, the cause of historic preservation in the United States will benefit by the direction of private sector capital into investment in our cultural resources and by the discouragement of wanton destruction of these resources.

The National Trust enthusiastically supports Section 2(f)(3) of H.R. 6715. Limiting the recapture of depreciation or amortization deductions upon the sale of a historic structure to the excess of the deductions over straightline depreciation will correct the unintentionally improper application of Section 1245 of the Code and thus bring the treatment of historic structures into conformance with that of real property generally.

The National Trust finds appropriate the new requirements that a State or locally designated district be certified by the Secretary of the Interior as meeting substantially all of the requirements for the listing of districts in the National Register in order to be considered a "registered historic district". In this regard, the National Trust would like to note, from our contact with historic district commissions across the country, the conscientious manner in which State and local governments are designated districts containing historically and architecturally significant structures.

We further support the conforming requirement that the Secretary of the Interior certify that a structure is of historic significance to a State or local district in order to be eligible for treatment as a certified historic structure. Additionally, the National Trust is pleased that the bill in Section 2(f)(4) extends to structures located in State or locally designated districts the allowance of deductions for demolition of a structure which the Secretary of the Interior certifies is not of historic significance. It is similarly appropriate to allow accelerated depreciation on a replacement structure in a State or locally designated historic district if the demolished structure is certified to be not of historic significance by the Secretary prior to its demolition. These two provisions thus insure that structures having no historic significance located in State and locally designated historic districts will receive treatment equal to that given to such structures in Federally designated historic districts for the purposes of depreciation or deduction of demolition costs.

Inasmuch as S. 2241 will make clear that Section 191 of the Code, added by the Tax Reform Act, is available to long-term lessees who invest in the rehabilitation of historic structures, the National Trust strongly supports its enactment with the Technical Corrections Act. Permitting long-term lessees to take advantage of the amortization deductions afforded by Section 191, with the safeguard of recapture in the event of disposition of the lease, will undoubtedly further the goal of rehabilitating historic buildings, many of which are not presently being put to use.

Through our advisors and member organizations across the country, the National Trust has become aware of many cases in which a long-term lease by a private developer offers the most appropriate, or only, means by which a historic building will be rehabilitated for commercial use. This is especially the case of historic buildings now in State or local government ownership, including surplus Federal buildings conveyed by the General Services Administration. The uncertainty of the ability of a long-term lessee to utilize Section 191, and the expected delay in the issuance of implementing regulations by the Department of the Treasury, makes this statutory clarification the more necessary.

Rehabilitation will have a particularly beneficial effect on the economic viability and prosperity of deteriorating downtown business districts and declining residential neighborhoods in our nation's towns and cities.

Our cities remain in desperate need of rejuvenating forces. Rehabilitation and restoration of existing historic buildings is one such force, for rehabilitation and restoration contributes considerably more jobs per dollar expended than per dollar expended on new construction and conserves critical resources which would otherwise be spent in demolition and the construction of replacement buildings. Moreover, a newly rehabilitated and recycled commercial building, which may have been at one time an economic liability to the community, will foster the community's economy by reinstating the property on the tax rolls and by attracting people and businesses to the area. This, in turn, should inspire subsequent similar rehabilitation efforts achieving a multiplier effect in the community.

As important, improved downtown business districts and residential neighborhoods will contribute to the communities' sense of identity and pride. Hopefully, these factors will prevent recurring deterioration and decline.

The National Trust believes that H.R. 6715, with the inclusion of S. 2241, will further enhance the general welfare, particularly in that their enactment should be beneficial to our towns and cities. We can make no higher an endorsement.

We appreciate the opportunity to submit these comments. If the National Trust can be of further assistance, please let me know.

Sincerely,

DOUGLAS P. WHEELER,
Executive Vice President.

STATEMENT OF NATIONAL ASSOCIATION OF HOME BUILDERS ON TECHNICAL CORRECTIONS ACT OF 1977

The National Association of Home Builders ("NAHB") is the trade association of the homebuilding industry, consisting of approximately [illegible] members in 650 affiliated state and local associations. Its members build approximately two-thirds of the residential construction in the United States including multi-family housing.

Many members of NAHB own improved and unimproved real property used in the conduct of their business as well as for investment. Such ownership may be direct or through interests in partnerships, joint ventures or corporations. In most instances, such real property and interests therein constitute a significant portion of the gross estate of the NAHB members. As a result, our membership is quite concerned about the application of the carryover basis rules enacted by the Tax Reform Act of 1976 to real property transferred at death. While H.R. 6715, the "Technical Corrections Act of 1977" does not contain a specific amendment respecting the application of the carryover basis rule to real property, it does contain a number of amendments with respect to the application of such rule to other types of property. In view of our concern that the carryover basis rule as enacted is inequitable in its application to real property, NAHB believes that it is appropriate for the Finance Committee to consider our comments and suggestions respecting the carryover basis rule as applied to real property in connection with its consideration of the provisions of H.R. 6715.

1. CARRYOVER BASIS RULE

Section 1023 of the Internal Revenue Code of 1954, added by section 2005 of the Tax Reform Act of 1976, makes the fair market value basis provisions of prior law inapplicable in determining the basis in the hands of a transferee of property acquired from a decedent dying after December 31, 1976. Property subject to this rule is classified as "carryover basis property" owned by the decedent on December 31, 1976, and will receive a basis in the hands of the transferee equal to the adjusted basis of the property immediately before the decedent's death, increased by certain adjustments provided in section 1023(h). One of such adjustments, referred to as the "fresh start" adjustment, is intended to increase the basis of carryover basis property to take into account the appreciation in value of such property accrued before January 1, 1977 for purposes of measuring gain upon a subsequent disposition of such property. While the "fresh start" adjustment is applicable to any property held by the decedent which reflects the basis of that property on December 31, 1976, the nature of the adjustment is dependent upon the type of property involved.

In the case of carryover basis property which is other than a marketable bond or security, a mandatory "fresh start" adjustment is made by assuming that any appreciation in value occurring between the date of acquisition of the property and the date of the decedent's death occurred at the same rate over the entire time that the decedent is treated as holding the property. Under the adjustment for such property, the amount of the increase in basis is equal to the sum of (1) the amount of all depreciation allowed or allowable with respect to the property during the period the taxpayer held such property before January 1, 1977, and (2) the portion of the appreciation assumed to have occurred during the period the taxpayer held the property prior to January 1, 1977. The appreciation assumed to have occurred prior to January 1, 1977 is determined by multiplying the total amount of appreciation over the entire period during which the decedent is treated as holding the property by a ratio determined by dividing the number of days the decedent held the property before January 1, 1977 by the total number of days the decedent held the property.

NAHB submits that application of the "fresh start" adjustment described above to real property or interests in entities which own real property will produce substantially inequitable results. The reason is the fundamental error in the assumption underlying such adjustment as applied to real property that the appreciation in the value of property occurs ratably over the holding period for such property. Such assumption disregards the actual facts in those situations wherein a substantial portion of the appreciation in real property prior to death was economically attributable to the period prior to January 1, 1977. This is particularly true with respect to improved real property such as a multi-family rental project constructed within the last five years. The value of such property increased significantly during the early years of operation but will likely increase at a lesser rate in subsequent years as a result of wear and tear. Real property of this type clearly does not appreciate ratably and treatment of such project in this manner is economically unsound.

Moreover, the assumption of ratable appreciation as applied to real property ignores the variances in the rate of inflation in our economy which have a direct impact upon the valuation of real property. The spiraling increase in the rate of inflation which has been experienced over the last five years produced a dramatic appreciation in the value of real property at December 31, 1976. However, there is obviously no certainty that the rate of inflation in the foreseeable future will continue to increase. In the event of a decline in the rate of inflation, the "fresh start" adjustment would preclude the transferees of real property from a decedent from obtaining the increase in basis to reflect the appreciation in value at December 31, 1976 resulting from inflation to that date.

In addition, the "fresh start" adjustment unfairly discriminates as between types of property. For example, if the decedent owned shares of stock in a corporation listed on a stock exchange, the "fresh start" adjustment under section 1023 (h)(1) would be determined on the basis of the listed price of such stock on such exchange at December 31, 1976. If the taxpayer instead owned improved real property and secured an independent appraisal of the value thereof at December 31, 1976, section 1023(h)(2) would disregard the existence of the appraisal and determine the "fresh start" adjustment on the basis of the assumption of ratable appreciation. NAHB submits that here is no policy justification for different rules based solely upon the type of property held by the taxpayer, particularly where there is a recognized method of valuation of real property (i.e., independent appraisal) other than a listed price on a stock exchange.

A further problem is created by the fact that section 6093A of the Code, added by the Tax Reform Act of 1976, imposes a requirement upon executors to furnish the Service with information concerning carryover basis property, including computation of the "fresh start" adjustment, and section 6694A of the Code imposes penalties upon an executor for failure to provide such information to both the Service and the beneficiaries. While a standard of reasonableness is provided for the executor's actions in this regard, there is obviously no certainty as to what is reasonable in a given circumstance. Furthermore, the executor could be exposed to liability to the heirs of the decedent for any error in computation of the "fresh start" adjustment for real property.

It is submitted that the inequities which result from requiring the "fresh start" adjustment for real property based upon the assumption of ratable appreciation in value over the holding period make it imperative that the Code be amended to eliminate such results. Accordingly, NAHB recommends that this Committee amend secion 3(c) of H.R. 6715 to provide an option to establish the fair market value for real property (or interests in real property) on December 31, 1976 by independent appraisal. This would be applicable to real property owned directly or interests in entities substantially all the activities of which relate to the holding of real property for sale or rental. Such appraisal would be required to be in writing and be filed with the Internal Revenue Service in accordance with rules to be established in regulations. Such amendment would provide taxpayers with an option to establish the fair market value of real property on December 31, 1976 in a manner which more accurately reflects the appreciation in value of the specific property which was economically attributable to the period in which the taxpayer held the property before such date. Moreover, such amendment would eliminate the inequity between the treatment of real property and marketable bonds or securities. We respectfully urge that the committee adopt such proposal in order to provide a more equitable result for members of NAHB as well as thousands of other taxpayers who owned real estate, either directly or through interests in other entities, at December 31, 1976.

2. INTERRELATIONSHIP OF CARRYOVER BASIS RULES AND AMORTIZATION OF CONSTRUCTION PERIOD INTEREST AND TAXES

NAHB also recommends that the Committee amend H.R. 6715 to correct we believe was a technical oversight in the Tax Reform Act of 1976 arising from the enactment of the carryover basis provision described above. Section 189 of the Internal Revenue Code, also added by the Tax Reform Act of 1976, provides for the amortization of construction period interest and taxes with respect to real property. Under section 189, construction period interest and taxes with respect to real property otherwise currently deductible would instead be amortized, subject to certain phase-in rules, over a ten-year period beginning with the year in which the property is ready to be placed in service or is ready to be held for sale. It is therefore necessary that an unamortized construction period interest and taxes account be maintained for each owner of real property; in the case of a partnership or Subchapter S corporation, a separate account would be maintained for each partner or stockholder. Where the property is later sold or exchanged, the unamotized balance of the construction period interest and taxes would be added to the basis of the property for purposes of determining gain or loss on such sale or exchange. In the case of the non-taxable transfer or exchange (e.g., a transfer to a partnership or controlled corporation, a like-kind exchange, or a gift), the transferor would continue to deduct the unamortized balance over the amortization period remaining after the transfer.

A serious problem, however, arises in the case of death of an owner of real property having an unamortized balance of construction period interest and taxes. Neither section 189 nor the Conference Committee Report specifically provides for the treatment of the unamortized balance at death. It therefore appears that the decedent's unamortized balance may not be added to the basis of his interest in the real property (or his interest in the partnership or Subchapter S corporation which owns such property), and may not be deductible by the estate, thereby resulting in a permanent loss of such deductions.

NAHB submits that such result is inequitable and should be corrected in H.R. 6715. It appears clear that the Tax Reform Act of 1976 failed to coordinate the carryover basis provisions of section 1023 with the provisions of section 189 so as to provide for the treatment on death of the unamortized balance of construction period interest and taxes with respect to real property. The potential loss of deductions for such unamortized balance either by the transferee (through a basis adjustment) or the estate to which the decedent was clearly entitled may well deter construction of substantial residential projects.

NAHB therefore recommends that a provision be added to H.R. 6715 to amend section 189 to provide that upon the death of a taxpayer, his unamortized balance of construction period interest and taxes with respect to real property will be added to his basis in determining the basis of such property in the hands of the transferee under section 1023 of the Code.

MERRILL LYNCH, & CO., INC.,
Washington, D.C., October 24, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Senate Finance Committee, Subcommittee on Taxation and Debt Management, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I invite your attention to a serious deficiency in H.R. 6715, the Technical Corrections Act of 1977 which is now before the Senate Finance Committee.

As you know, the Tax Reform Act of 1976 provides for a continuation of the six-month holding period for long-term capital gains for *all* commodities futures contracts. The legislative intent, as we read it and the House affirmed it in unequivocal language, was to provide an exception for "futures transactions in any commodity."

I believe you will appreciate our dismay upon learning that H.R. 6715, nominally a "technical corrections" bill, would now drastically alter the substance of the original legislation. Section 2(u) of the bill would insert the word "agriculture" so as to apply the six-month holding period *only* to agricultural commodities futures contracts.

We note that this discriminatory provision was enacted by the House without benefit of hearings. We further note the recorded dissenting views of seven members of the House Ways & Means Committee who oppose H.R. 6715 "not only because some of its amendments undermine important changes in the tax code made by the Tax Reform Act of 1976, but because the process followed in compiling these amendments is a faulty mechanism for making necessary refinements in the law."

Merrill Lynch feels strongly that the Senate should tolerate no discrimination between agricultural and other types of commodities traded on the futures exchanges of this nation. Whether by accident or design, Section 2(u) of H.R. 6715 "undermines" both the Tax Reform Act of 1976 and the foundations of futures markets in America.

We fear that with discriminatory legislation and diminished incentives, speculative capital will not be drawn to non-agricultural commodities markets. Without liquidity and the attendant risk-transfer mechanism, consumers will ultimately pay more.

We see these consequences of Section 2(u) of H.R. 6715 as profound and punitive, especially so in the manner of their emergence without public hearings and by the flawed contrivance of a "technical corrections" bill. We ask your assistance in remedying error and restoring strength to a free and fair futures market system by voting against Section 2(u) of H.R. 6715.

We are grateful for your attention to this matter and are available to answer your questions at any time.

Very truly yours,

David A. Lefeve, *Vice President.*

STATEMENT OF NEW YORK COFFEE AND SUGAR EXCHANGE AND NEW YORK COCOA EXCHANGE

The New York Coffee and Sugar Exchange and the New York Cocoa Exchange —which trade only agricultural commodities—are not directly affected by Paragraph (u) of H.R. 6715 which would effectively increase to twelve months the holding period required for capital gain and loss treatment for all non-agricultural commodities. As representatives of those exchanges, however, we wish to express our views that the proposed change is unfair and not in the best over-all interest of the commodity markets.

The retention of the six-month holding period for commodity futures in the Tax Reform Act of 1976 stemmed from the recognition that, unlike other capital assets, commodity futures have a limited life and that the result of a requirement for an increased holding period would be the reduction, and perhaps elimination, of the possibility of capital gains treatment for commodity investors. Commodity futures exchanges require broad public participation for the liquidity which results in a fair marketplace and it was recognized by Congress that reducing investor interest (by increasing the holding period to 12 months) would directly and adversely affect the efficiency of the market.

We understand that some have argued that the absence of seasonal considerations for non-agricultural commodities justifies an increase in the holding period. We do not agree: moreover, our own experience has been that commercial interests who use the commodity markets for hedging purposes establish their hedge positions in relatively near months and in order to promote maximum liquidity, commodity investors must be encouraged to similarly place their position in those months.

With the advent of the Commodity Futures Trading Commission and a unified system of regulation, the commodity industry has become less fragmented. We have found that developments on exchanges other than on our own have an impact on our operations. We believe that an increase in the required holding period with respect to non-agricultural commodities will be an adverse development for futures trading in those commodities; such a change would tend to encourage increased speculative interest in agricultural commodities at the expense of the other traded commodities. While at first glance this may appear to be in the self-interest of our own exchange, we firmly believe that non-market bases for selecting one commodity over the other (such as artificial distinctions in tax treatment) will tend to weaken the liquidity of the marketplace of the less favored commodity and thereby ultimately affect the industry as a whole.

We hope these views have been helpful.

TAX SECTION,
NEW YORK STATE BAR ASSOCIATION,
New York City, October 28, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: In a letter dated September 20, 1977 to the members of the House Ways and Means Committee and Senate Finance Committee, the Tax Section of the New York State Bar Association recommended that there be a deferral of the effective date of the carryover basis rules of Section 1023 of the Internal Revenue Code of 1954, as amended by the Tax Reform Act of 1976 (Public Law 94–455) from December 31, 1976 to December 31, 1978 to provide an opportunity for further substantive review of those rules. Accordingly, the Tax Section supports S. 2227 introduced by you and Senator Dole for the purpose of effecting that deferral and requests that this letter be included in the record of written testimony at the public hearing on the Technical Corrections Bill (H.R. 6715) on October 28, 1977 before the Subcommittee on Taxation and Debt Management.

The carryover basis provisions raised many complex issues the resolution of which will require considerable study. Further, the carryover basis rules complicate the administration of decedents' estates and the administration of the income tax laws to the degree that they may be essentially unworkable. Testimony regarding the inordinate technical and practical difficulties in applying the carryover basis provisions was presented at the hearings of the Subcommittee on Taxation and Debt Management which you held last summer and more recently before the House Ways and Means Committee in the hearings on H.R. 6715 and the carryover basis provisions.

We are greatly encouraged that the companion bill which you have co-sponsored, S. 2228, contains many provisions that would appear to greatly simplify the operation of the carryover basis rules. However, we and other interested practitioners have not been given time to study the effect of these provisions in various factual settings. For example, the formula for computing the estate tax attributable to unrealized appreciation at marginal rates would not operate fairly where the decedent has made bequests entitled to the marital or charitable deduction. Under S. 2228 a portion of the basis increase attributable to death taxes would be allocated to property not subject to such taxes by reason of such deductions and hence would be lost to the recipients of bequests subject to death taxes who should have the full benefit of that increase.

We are not prepared without study and consideration in depth to approve or recommend changes in S. 2228 or any other proposed solution to the carryover basis problems that departs widely from current provisions of law. We earnestly request that Congress not repeat the 1976 mistake of hastily enacting such complicated legislation, without giving the tax and probate bars an adequate opportunity to review the legislation and to report back to the Congress. We believe that an effective date deferral to provide the time needed for study is highly preferable to hastily enacted remedial legislation.

Respectfully submitted,

RENATO BEGHE,
Chairman, Tax Section.

STATEMENT OF TRUSTS AND ESTATES LAW SECTION,
NEW YORK STATE BAR ASSOCIATION

This statement has been prepared on behalf of the Trusts and Estates Law Section of the New York State Bar Association. The Association has a current membership of 28,029 attorneys, of whom 2,879 are members of the Trusts and Estates Law Section. It is submitted to the Subcommittee on Taxation and Debt Management in connection with its hearings on H.R. 6715—the Technical Corrections Act of 1977 ("TCB"), and carryover basis, particularly the carryover basis provisions of S. 2228—the Estate and Gift Tax Amendments Act of 1977 ("EGTAA").

Summary of Principal Points

CARRYOVER BASIS

1. Carryover basis should either be repealed in its entirety or be substantially modified to make it workable and equitable.

2. If carryover basis is not repealed in its entirety, fairness demands that taxpayers be relieved of the often insurmountable administrative burdens involved in ascertaining the cost of assets acquired long ago. Such relief would be afforded by sections 3(a)(1) of the EGTAA, excluding assets held on or traceable to assets held on December 31, 1976 from carryover basis treatment, and we recommend that this provision be passed by the Congress.

3. Under the current carryover basis provisions, computational complexities will needlessly result in substantial increases in the cost of estate administration. Such complexities can be significantly reduced if:

(*a*) The adjustments for Federal and state death taxes were computed, as provided for in section 3(c)(2) of the EGTAA, at the marginal rather than the average estate tax bracket and if they are not made sequentially; and

(*b*) In order to relieve the estates least able to afford increased administration expenses where no significant revenues are likely to be involved, the $60,000 minimum basis adjustment should be increased to correspond with the amount which must be exceeded, in order to require the filing of a Federal estate tax return. This change would be accomplished by section 3(b) of the EGTAA and we recommend passage of this section. In the alternative, if section 3(b) does not pass, noninvestment assets should be excluded from the definition or carryover basis property up to a significant dollar amount.

4. To the extent carryover basis remains the law, consistency and equity demand that unused capital losses realized during a decedent's lifetime should be carried forward (except that if the grandfather provision of section 3(a)(1) of the EGTAA is adopted, loss generated by an asset that would not have been carryover basis property had it been held until death should not be carried forward).

5. Capital gain treatment under section 303 should be extended to redemptions of stock to pay income taxes resulting from a qualified redemption to pay estate taxes and admnistration expenses. This would be accomplished by section 7(a) of the EGTAA.

6. Appreciation Estate Tax, Capital Gains Tax at Death and deferral of the effective date of carryover basis should be rejected.

LIFE INSURANCE TRANSFERS

TCB section 3(f), relating to transfers with respect to life insurance within three years of death, is seriously ambiguous and could lead to substantive changes in the law that were not intended by the 1976 Act. The TCB approach should be rejected in favor of section 4 of the EGTAA, which would establish a sound workable rule with respect to life insurance transfers.

DISCLAIMERS

The disclaimer provisions of the Tax Reform Act of 1976 ("TRA") were defective in many respects. The TCB only partially corrects one of these defects. We propose that Code section 2518 be amended to permit:

(*a*) Renunciation of an outright bequest, the effect of which would be to increase a trust in which the disclaimant has an interest;

(*b*) Renunciation of a power;

(*c*) Renunciation of dollar amounts;

(*d*) More reasonable notice requirements; and

(*e*) Availability of the benefits of the section in those states where disclaimers are ineffectual under local law.

GENERATION-SKIPPING TRANSFER TAX

1. A major criticism of the new generation-skipping tax is the treatment of individual trustees as trust beneficiaries for generation-skipping tax purposes. The TCB endeavors, but fails, to meet these criticisms. Inasmuch as the identity of a trustee has, in almost all cases, absolutely nothing to do with the transmission of wealth from one generation to the next, the individual trustee rules have no useful tax purpose and serve only as a trap to the unwary. Therefore, we recommend that the individual trustee rules be repealed in their entirety.

2. A major inequity of the new generation-skipping tax was the imposition of a May 1, 1976 effective date. On that date practitioners could not have known of the drastic tax effect of innocent, non-tax-motivated changes by codicil or other amendment in pre-May 1st instruments. Fairness and equity demand that, in order to prevent the unjust imposition of tax as a result of such changes, the effective date of the generation-skipping tax should be postponed until January 1, 1977, or at least until October 4, 1976.

Discussion

CARRYOVER BASIS

A. Background

No part of the Tax Reform Act of 1976 has occasioned as much confusion, consternation and criticism as the carryover basis provisions.

The criticisms have been based upon one or more of the following:

That carryover basis is unfair because it results in double taxation;

That carryover basis presents a nearly impossible administrative burden to estates;

That carryover basis will result in excessive costs for legal, accounting and fiduciary services;

That carryover basis will adversely affect the economy; and

That carryover basis is inequitable in its treatment of taxpayers.

As a result of this clamor, various persons and groups are now urging one or more of the following:

Complete repeal and a return to the law with regard to the basis of inherited assets as it existed prior to January 1, 1977;

Substantial modification of section 1023, the principal carryover basis section;

A new estate tax on appreciation, which is known as the Appreciation Estate Tax ("AET");

The imposition of a capital gains tax at death which would, apparently, treat death as a realization event; and

A suspension of the effective date of carryover basis, the date most often suggested being January 1, 1979.

We believe that carryover basis should either be repealed in its entirety or be substantially modified to make it workable and equitable. For the reasons set forth below, we oppose AET, capital gains tax at death and suspension of the effective date.

B. *Administrative burdens*

Carryover basis, AET and, presumably, capital gains taxes at death all require the determination of the adjusted basis of the property subject to tax immediately prior to death. This "search for basis" is perhaps the major problem confronting taxpayers and their representatives. The nine-month experience thus far has demonstrated that obtaining the requisite information will usually be difficult and costly and will often be impossible. The attempts to educate the public to the need for compiling the requisite information have been largely unavailing and, in most cases, it will be the burden of personal representatives and beneficiaries to attempt to establish facts which in many cases even the decedent did not know. It is, of course, true that if a carryover basis asset had been disposed of during the lifetime of the decedent, he, as a taxpayer, would have been required to report and substantiate his basis, but it is also true that most taxpayers feel that, if called upon to do that, they would be able to respond when the time comes and do not prepare in advance.

Even among conscientious persons, many may not be able to amass the required information. For example, the property may have been inherited and the individual never advised of the estate tax value, if, indeed, an estate tax return was required in the prior estate. Similarly, property may have been received by gift without the donee being informed of the donor's basis. In the case of a collector, the property may have been transmuted into like property; for example, even though the collector might at one time have known the date of purchase and cost of a particular toy soldier, that soldier might have been traded to another collector for one representing another regiment and his records might not reflect the substitution of the prior basis.

To some extent, the provisions of the Technical Corrections Act of 1977 would ameliorate this problem with regard to tangible personal property held on December 31, 1976. However, this provision is arbitrary because it imputes post-1976 appreciation at a fixed rate to an asset when none may in fact have occurred. Moreover, it does not solve the problem even in this limited area because it remains incumbent upon a conscientious fiduciary to attempt to determine whether a higher basis is available than that arrived at by following the prescribed formula.

Recommendation.—We propose that, unless the carryover basis provisions are repealed in their entirety, the Congress should pass EGTAA section 3(a)(1) amending section 1023 to exclude assets held on December 31, 1976, or assets traceable to such assets, from the definition of carryover basis property so that the impact of section 1023 would be prospective only. This would reduce substantially the burdens and costs of the "search for basis" and, at the same time, eliminate the need for the fresh-start adjustment, the problems concerning which are discussed below.

C. *Computational complexity*

Commentators have noted the computational complexities and unresolved problems of the section. It becomes increasingly clear that in all but the most simple cases it will prove difficult, even impossible, to do the required computations without the aid of a computer. It is true that many individual taxpayers require this sort of aid in the preparation of their personal income tax returns but we anticipate that a larger percentage of fiduciary returns will require such aid than is true of individual returns.

For example, using the forms contained in a recently published volume entitled "Carryover Basis Under the 1976 Tax Reform Act",[1] in order to determine the basis of a marketable security owned on December 31, 1976 which is subject to Federal and state death taxes, it would be necessary to make computations based upon 39 arithmetic entries if the security were sold at a gain and 40 such entries if it were sold at a loss. And this assumes that the entire block of securities was acquired at the same price.

Again, based upon the same forms, if the asset was rental property owned on December 31, 1976 in which depreciation had been taken and on which Federal and state death taxes were payable and if the aggregate basis of all carryover property was less than $60,000, the number of arithmetic entries would be 58.

A witness before this Subcommittee has testified that the computations for one hypothetical holding of mutual fund shares having a total value for estate tax purposes of $20,000 had taken an experienced lawyer-CPA 17 hours where the assumed gross estate was $525,000 and 12 hours where the assumed gross estate was $70,000.

Two particular considerations are suggested by the foregoing. First, in many situations the cost of compliance will exceed the tax paid. Second, and a function of the first, there is the real risk that voluntary compliance with the provisions will break down.

RECOMMENDATIONS

1. We propose that the administrative burdens and costs could be substantially lessened if the fresh-start adjustment (unless the proposal to exclude from the definition of carryover basis property assets held on December 31, 1976 is adopted) applied, whether the asset was sold at a gain or a loss. It would thus become unnecessary to maintain records with regard to two different bases. It would become possible in situations where the $60,000 minimum basis adjustment is available to determine, before all the appreciated carryover basis property has been disposed of, whether the fresh-start adjustment may be used at all.

In part, the Technical Corrections Act and the temporary regulations have attempted to obviate the problem. The partial solution provides that the fresh-

[1] McGrath and Blattmachr (Journal of Taxation, 1977).

start adjustment is initially made for all carryover basis assets but that, if the property is sold at a loss, the basis so arrived at is reduced by the amount of the fresh-start adjustment. This solution is inequitable since the subsequent adjustments build upon the fresh-start adjustments and, in the event that the property is sold at a loss, the basis for the purpose of determining loss is less than it would otherwise have been.

2. To simplify further the arithmetical processes, we recommend that section 1023 be amended as provided by section 3(c)(2) of the EGTAA to require that the adjustments for Federal and state death taxes be at the marginal increase in estate tax attributable to net appreciation in carryover basis property subject to the tax, rather than the average rate of tax on all property subject to tax.[3]

At present, and under the proposed Technical Corrections Act, a change of even $1.00 on the audit of an estate tax return will affect the average rate of tax and will result in the need to amend income tax returns which were filed on the basis of the estate tax adjustments being computed in accordance with the estate tax return as filed. This, in turn, means that careful lawyers, accountants and fiduciaries will accompany all income tax returns filed by estates, testamentary trusts and beneficiaries with protective refund claims, at least until the Federal and state death taxes have been determined. Providing for the adjustment at the marginal rate will reduce the number of occasions for such recomputation since the marginal rate of estate tax will often remain the same even though there have been adjustments on audit.

3. Again, to eliminate computational problems for smaller estates, we propose that the $60,000 minimum basis adjustment be increased, as provided by section 3(b) of the EGTAA, to an amount equal to the amount which must be exceeded in order to require the filing of a Federal estate tax return. Thus, estates which are not burdened by the filing of an estate tax return would similarly be immunized from the carryover basis provisions. It is hoped that this would lead to a reduction in the costs of administration for these smaller estates.

Alternatively, assets which are not investment assets might be excluded from the definition of carryover basis property up to a stated dollar amount (which, realistically, should be significantly higher than the present $10,000 exemption for household effects).

D. *Fiduciary problems*

The relationship of carryover basis with local law governing fiduciary relationships has not been recognized. Even more than before, the fiduciary who is empowered under the will or state law to distribute assets in kind will be faced with the possibility of disparate treatment of beneficiaries. Not all estate assets are susceptible of being divided "across the board". We anticipate many years of litigation in the state courts while judges attempt to fashion yet another body of state law responsive to the problems occasioned by carryover basis and the resulting conflicts between fiduciary and beneficiary and among beneficiaries.

Recommendation.—We propose that the fiduciary be empowered, when so authorized by the governing instrument or local law, to elect to adjust the basis of any carryover basis property to reflect the average basis of such assets (even though the assets are unlike). Such an election could minimize the problems the fiduciary would otherwise face in allocating, distributing and disposing of carryover basis assets.

E. *Equitable considerations*

All tax legislation has an impact upon the expectations of taxpayers. This is clearly the case with regard to carryover basis where, prior to its enactment, taxpayers accepted or rejected investment opportunities on the basis of the then-existing law. However, there is at least one special circumstance which must be mentioned.

Assume a buy-sell agreement between partners or coowners of all of the stock of a corporation entered into in 1976 under which the survivor is to acquire the interest of the first to die at a fixed or formula price. That price was in part predicated upon an estate tax being paid on the value of the decedent's interest. To that estate tax there is now added, in most cases, the tax imposed because of carryover basis. Certainly, agreements can be renegotiated, but in the inter-

[3] We believe that the approach taken in the Technical Corrections Act of sequential adjustment for Federal and state death taxes is inequitable and that the adjustments should both build on the same base.

vening period of time the bargaining positions of the parties have almost certainly changed and the result may well be something in the nature of a tontine—with survivor taking all and the interests of the first decedent's beneficiaries being substantially reduced.

Again, this unfortunate result would be avoided if property held on December 31, 1976 was excluded from definition of carryover basis property.

Another equitable problem arises because section 1023 makes no provision for the carry forward of losses realized by the decedent during his lifetime. There is no netting out to achieve true appreciation.

Recommendation.—We recommend that the Congress pass section 6 of the EGTAA to provide for the carry forward of the decedent's unused capital loss to the estate or beneficiaries. Of course, if the recommendation that assets held or traceable to assets held on December 31, 1976 be excluded from the definition of carryover basis property is adopted, then carryforward should apply only to loss on assets which, if held by the decedent until his death, would have been carryover basis property.

F. *Closely held stock*

RECOMMENDATIONS

1. We propose passage of section 7 of the EGTAA providing that capital gain treatment under section 303 be extended to redemptions of stock to pay income taxes resulting from a qualified redemption to pay estate taxes and administration expenses.

2. We further propose passage of section 3(a)(2) of the TCB to provide that the taint be removed from "section 306 stock" by providing that capital gain treatment applied to its redemption, if such redemption meets the requirements of section 303.

G. *Economic impact*

As lawyers, we do not presume to evaluate the economic impact of carryover basis. We assume that this has been evaluated by Congress and its staff.

We note, however, that carryover basis may affect the conduct of the investing public.

Some have forecast that, because the "reward" of running a closely held business has been diminished by carryover basis, entrepreneurs will be more conscious of the "risk" and will actively seek, by some sort of tax-free exchange, to transmute a closely held business into a more broadly based public corporation.

It is also forecast by some that the additional tax on appreciation will make investment in equities less attractive and that investors will seek current income, perhaps tax-exempt, rather than heavily taxed appreciation. This possibility would be enhanced if there is a general reduction of the income tax rate. Many commentators have forecast that persons with substantial funds to invest would be well advised to acquire life insurance rather than securities because the former is not carryover basis property.

If these forecasts are accurate, the economic health of the nation might well require the repeal of carryover basis.

H. *Repeal*

Unless carryover basis can be made to work in some manner which is not an administrative horror which does not result in substantially increasing the costs of administering estates, which is equitable and, particularly, which is not potentially injurious to the nation's economic well-being, we join those seeking its total repeal.

I. *AET and capital gains tax at death*

We have reviewed proposed legislation which would establish an AET. We have not been given the opportunity to review proposed legislation establishing a capital gains tax at death. We believe that both these alternatives would create the same administrative difficulties at the present carryover basis provisions. If the purpose of any of this legislation is to equate the pre-death and post-death consequences of a disposition of property, both of these alternatives fail. Even if they could be modified in the ways suggested above, we join with those who have opposed their adoption because both would require payment of a tax on an unrealized appreciation. As difficult as carryover basis is, it bears some relationship to the consequences of a disposition during lifetime.

The proposed AET has special provisions concerning the marital and charitable deductions, the orphan's exclusion and property qualifying under section 2032A. It would still impose a tax upon such assets as art objects and interests in closely held businesses even though the proceeds of sale were not likely to be available to pay the tax. It would in many instances require the sale of marketable securities which investment judgment might otherwise dictate should be held.

No tax should be imposed on unrealized appreciation.

J. Deferral of effective date

We believe the issue should be faced at this time. Carryover basis should be repealed or modified now. The potential for disruption is too great to permit a further hiatus during which it would be unclear whether there will be carryover basis as we now know it or in a modified form, an AET or something else. The existing confusion should not be prolonged.

LIFE INSURANCE TRANSFERS

Background

The TCB section 3(f) introduces a new exception to the general rule of Code section 2035 with regard to the treatment of gifts of life insurance policies. Pursuant to the TCB, even though a gift tax return was not required when a life insurance policy was transferred, the value of the policy on the date of death would be included in the decedent's gross estate. This exception is clearly intended to cover the situation where a group life insurance policy is assigned by the decedent, at which time no gift tax return would be required because of the nominal value of the policy on the date of the gift. If the general rule provided in the TCB were to apply to this situation, a group life insurance policy having a face value of $100,000, for example, would entirely escape taxation should death occur within three years of transfer.

This new exception is by no means technical, but is instead a substantive amendment which brings into the taxable estate an asset which would have entirely escaped taxation under the TRA. Even if this change were accepted as appropriate in a bill of a technical nature, the language of the TCB goes far beyond the common situation outlined above. The TCB states that the general rule ". . . shall not apply to any transfer *with respect to* a life insurance policy" (emphasis supplied). Some practitioners believe that this language might result in the revival of the premium payment test which existed under old law since the payment of a premium within three years of death on a policy transferred 20 years ago might be deemed a "transfer *with respect to*" the policy and result in total or partial inclusion of the proceeds.

The Joint Committee Staff's Report on the TCB specifically states that this exception to the general rule was intended to refer "to the gift *of a life insurance policy*" (emphasis supplied) (at p. 25).

Recommendation.—In order to eliminate doubts as to the effect of the amendment, we believe it to be important that this intended result be made explicit by passage of section 4 of the EGTAA which makes it clear that only the gift of a policy or other release of incidents of ownership within three years of death would subject the policy proceeds to inclusion in the gross estate. We further recommend passage of the other limitations on the three-year transfer rule of section 2035 as provided for in section 4.

DISCLAIMERS

Background

Code section 2518, as amended by the TRA, introduced Federal standards to determine the validity of a disclaimer for estate and gift tax purposes. That section now provides that a disclaimer is a "qualified disclaimer" if it is an irrevocable and unqualified refusal to accept an interest in property, in writing; *received* by the transferor or his representative within *nine months* after the transfer was made or the transferee reached 21; the transferee has not accepted any benefits of the transfer; and a result of the refusal the *interest passes* to another person without direction by the disclaimant. Code section 2518 also provides that a "power" with respect to property will be treated as an interest in such property, and that a disclaimer must be of an undivided portion of the interest which the disclaimant received.

RECOMMENDATIONS

1. *Renunciation of outright gifts.*—One major criticism of Code section 2518 has been that the section appears not to authorize renunciations of an outright bequest the effect of which would be to increase a residuary trust in which the disclaiming legatee had an interest. This problem has been resolved by the TCB, but only in the case of the surviving spouse.[3] For example, if a will provided for a legacy to a son of $10,000 and for the residuary estate to be held in trust with income to the son for life, the son's disclaimer of his legacy would not seem to be covered, although a surviving spouse's disclaimer under similar circumstances would be. It is submitted that no reason of policy or revenue supports a distinction between surviving spouses and other persons for this purpose.

2. *Renunciation of powers.*—A second major criticism of Code section 2518 not corrected by the TCB involves the language of subsection (b)(4), which provides that a power "shall be treated as an interest in such property". This subsection might be read to require, for qualification purposes, that a disclaimed power must pass to a person other than the disclaimant. A power, such as a power of appointment over trust property, when disclaimed, may be viewed in two ways—either it disappears in which case it does not pass to someone else or, because of the disclaimer, the property which was subject to the power passes to someone else. A fiduciary power, such as the power to allocate items of income or principal, if disclaimed, clearly disappears. The indicated limitation in connection with the disclaimer of an interest in property should not be applied to the disclaimer of a power.

3. *Legislation as to (1) and (2).*—We submit that the ambiguities discussed above should be resolved by a new subsection 2518(b)(4) providing that disclaimers will qualify if:

"(4) As a result of such refusal, the interest, if it passes at all, passes to a person other than the person making the disclaimer (without any direction on the part of the person making the disclaimer). For the purposes of the preceding sentence, an interest will be considered to have passed to a person other than the person making the disclaimer if, as a result of the disclaimer, the person making the disclaimer has an interest in the disclaimed property different in nature from the interest which has been disclaimed."

4. *Renunciation of dollar amounts.*—The TRA has been criticized because the disclaimer under section 2518 must be of an undivided portion of the interest to which the disclaimant is entitled. The proposed amendments do not afford a remedy. Thus, an individual who wishes to disclaim a residuary bequest in part might not be able to renounce a dollar amount but would have to compute that amount as a fraction of the bequest. Assume a residuary estate of $100,000—the disclaimant could not disclaim $25,000 thereof but would have to disclaim one-fourth. In most estates, the fraction or percentage equivalent would be difficult to equate with a dollar amount intended to be disclaimed and disclaimer of a dollar amount should be permitted.

5. *Notice requirement.*—A further criticism of the disclaimer provisions of the TRA not remedied by the TCB is that section 2518 provides that a "qualified disclaimer" must be in a writing which is received by the transferor of the interest or his legal representative within the date specified in the provision. Thus, the mere mailing of such a disclaimer would not be operative. We submit that "postmarking" on a properly addressed cover in which the notice is enclosed should be sufficient. Such a provision would conform with the "postmarking" rules of Code section 7502 relating to timely mailing of elections, returns and proofs of claims and proofs of receipt should not be required.

6. *Purported uniformity.*—Despite the statements in the Committee Reports that uniformity of treatment of renunciations was intended to be achieved by section 2518, this goal was not achieved. Transfers subject to the laws of jurisdictions which do not recognize the renunciation concept cannot be renounced, notwithstanding Code section 2518. This is so because if a person who is a legatee refuses to accept a transfer in such jurisdiction the interest will not pass to another person without direction on his part within the meaning of section 2518(b)(4). We suggest that the TCB provide that an assignment of interests, within the time frame and other requirements of section 2518, to those persons who would have received the interest if the legatee had predeceased the decedent will qualify as a disclaimer whether or not a disclaimer would be effective under local law.

[3] See TCB section 3(m).

GENERATION-SKIPPING TRANSFER TAX

A. *The individual trustee rule*

One of the most controversial provisions of the new generation-skipping tax introduced by the TRA arose from the treatment of individual trustees as trust beneficiaries for generation-skipping tax purposes. Because of this provision, the tax might be imposed as a result of the death or resignation of an individual trustee, an event which in most cases would bear no relationship to transfers of wealth from one generation to the next. This provision constituted a serious trap for those who were not expert in the extreme complexities of this new tax.

On the other hand, those fully familiar with the rules appear able, by the adroit selection of trustees having the correct generation level, to achieve significant generation-skipping tax benefits by deferring imposition of the tax beyond the time when all actual trust beneficiaries in the same generation level as the trustee have died. Code section 2613(e) provided a very limited exception to beneficiary treatment of individual trustees which applies in the case of a trustee who is (i) in a higher generation level than all of the beneficiaries of the trust and (ii) only if all such beneficiaries are lineal descendants of the grantor.

The TCB preserves the limited subsection (e) exception of the TRA (redesignated as subsection (e)(1)) and adds a broader exception intended to apply to "independent trustees."[4] Under new Code section 2613(e)(2), a trustee having no interest in the trust (present or future) who is not a "related or subordinate trustee" will not be treated as having any power in the trust. He or she will therefore not be considered a beneficiary whose death or other termination of trusteeship would trigger a tax.

There are serious definitional problems in the new exception. In addition, its application may lead to irrational results. For example, it would not apply to a trustee who has a relative or spouse who is a "beneficiary" of the trust. The term "beneficiary" is defined by Code section 2613(c)(3) as any person who has a present or future interest or power in the trust. One of the most common will provisions is the special power of appointment which enables a person to appoint trust property by will or deed to any person other than the power holder, the power holder's estate, or creditors. It would seem that practically no individual could meet the requirements of the new exception under any will containing such a power since every living individual has a future interest in the trust. Thus, the exception is meaningless in such trusts.

Irrational results will also occur in trusts which contain no special power of appointment. For example, a "related or subordinate" trustee is defined to include the brother or sister of the grantor or of any beneficiary but not the spouse of that brother or sister. Thus, a grantor who might otherwise wish to use the blood kin of his or her children as trustee for the children would instead have to look to the spouse of the blood kin. A grantor could not use a brother as trustee for his or her children but would have to use a sister-in-law as trustee.

Recommendation.—For these reasons, we believe that the TCB's solution to the problem is ill conceived. While it might be possible to draft a new exception meeting some of the objections we have raised, it is almost certain that such a provision would be extremely complex and would contain hidden tax pitfalls as well as hidden tax benefits. We believe the treatment of a trustee as a beneficiary solely by reason of his or her trusteeship is conceptually wrong because of its irrelevance, in most cases, to the passage of wealth from one generation to the next, and should be eliminated. This could be done by redefining "power" in Code section 2613(d)(2) to provide that the term does not include a power held as a trustee.

B. *Transitional rules relating to the generation-skipping transfer tax*

1. *Background*

Although the generation-skipping tax is much more limited in its impact than carryover basis, the opportunity for the inadvertent ruination of an estate plan due to lack of knowledge of, inattention to, or inability to comprehend the transitional rules contained in section 2006(c) of the Tax Reform Act is a problem which the Congress, out of elemental fairness, should address. The transitional rules are unfair in their effective dates, they are too complicated, and they are too rigid; and no sound policy of which we are aware justifies any of these faults.

[4] TCB section 3(n)(1).

2. *Unfairness*

The effective date of April 30, 1976 is unfair. The Ways and Means Committee bill was not even announced until May 24, 1976. The effective date provisions in the original Ways and Means Committee bill were changed substantially prior to final enactment in October, 1976.

The generation-skipping tax relates to individual taxpayers, not sophisticated corporations. The advisors to these taxpayers were, for the most part, not even aware that tax reform was in the offing and, in many cases, did not know there was a generation-skipping tax proposed until the time of enactment or even later. As to those who had advisors who were aware of the generation-skipping provisions, the originally announced transitional rules provided so little protection "grandfathering" protected instruments only until January 1, 1977) that often the protection was intentionally given up in order to make relatively inconsequential dispositive changes.

Recommendation.—We propose that, to cure most of the inadvertent triggering of the tax on generation-skipping transfers, the effective date for transitional rule purposes set forth in section 2006(c) of the Tax Reform Act be changed to January 1, 1977 or, at the very least, October 4, 1976. For individuals with sophisticated advisors, such deferral of the effective date would probably be of no particular advantage; the advisors were probably aware of the pending legislation and "frozen" those estate plans. For individuals with less sophisticated advisors, the change in the effective date would provide justifiable relief from the consequences of inadvertent, and non-tax oriented, changes.

3. *Complication*

Th transitional rules are unduly complicated. In the more than one year which has elapsed since the enactment of the Tax Reform Act, the Internal Revenue Service has not issued Regulations on the transitional rules. We understand that this delay has not been occasioned by competing priorities but rather by an inability to determine what is permissible and what is not. Commentators have devoted pages of closely reasoned text to discussions of the unanswered questions.[5]

These complications probably cannot be entirely eliminated. However, significant simplification could be achieved.

RECOMMENDATIONS

1. We propose that, in place of the Draconian total tainting of all dispositions when there is an increase in the amount or duration of a generation-skipping trust, there be substituted a rule of proportional tainting; where there has been an increase in amount, tainting should be proportional (perhaps to be determined in the same manner as currently applies to additions to trusts which were irrevocable on April 30, 1976); where there has been an increase in duration, tainting should relate only to the period of extension (and not to the base period).

2. Indirect or non-substantive modifications of protected instruments should not result in tainting. Such modifications are illustrated by:

(*a*) Administrative changes (*e.g.*, a reduction in the number of executors which could result in reducing the commissions payable and thus increasing the residuary estate);

(*b*) Changes in non-dispositive provisions (*e.g.*, changes in tax allocation clauses); and

(*c*) Changes occasioned by the Tax Reform Act itself (*e.g.*, changes made to comply with the requirements of the orphan's exclusion provisions or to provide that a marital formula provision not take into account the artificial increase in the adjusted gross estate occasioned by the testator being the deemed transferor of a generation-skipping trust).

4. *Rigidity*

The transitional rules do not take into account problems under local law and the legitimate, non-tax aspirations of taxpayers.

In our State, New York, a change by codicil rather than by a new will almost inevitably increases the problems and expense of probate since it will usually

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[5] *See*, for example, Kalik & Kartiganer, "Generation-Skipping: An Analysis of the New Law and A Discussion of Planning Approaches", 29 S. Cal. Tax Inst. 249, at 296–303 (1977) (copy annexed).

require joining as parties persons who would not otherwise have any interest in the probate proceeding. For example, if a codicil replaces one pre-residuary legatee with another (which may have no generation-skipping tax consequence), the replaced legatee must be made a party to the probate of the codicil; on the other hand, if the change is made by a new will, the replaced legatee need not even be given notice of the probate proceeding.

Finally, perhaps in response to the imagined or real evils of the probate system, because of a desire to protect against possible disability, or for other reasons, many clients wish to replace wills by inter vivos trusts; we see no policy reason which requires that the inter vivos trust terminate on the death of the taxpayer and "pour up" to a testamentary estate rather than continue under the terms of the inter vivos trust agreement.

RECOMMENDATIONS

1. We propose that, where any protected instrument is superseded by a will or trust having substantially the same substantive provisions as to generation-skipping, there be no loss of protection.

2. We propose, particularly if there is no change in the effective date for transitional rule purposes, that the resurrection of a protected instrument by codicil or amendment republishing the pre-effective date provisions be permitted.

Respectfully submitted on behalf of the Trusts and Estates Law Section of the New York State Bar Association.

IRA H. LUSTGARTEN, *Secretary.*
WILLIAM B. WARREN,
Vice-Chairman, Committee on Taxation of Gifts, Estates and Trusts.

EXHIBIT REFERRED TO IN FOOTNOTE 5

EFFECTIVE DATE PROVISIONS

Section 2006(c) of the Tax Reform Act of 1976 provides that the provisions of Chapter 13 will apply to all generation-skipping transfers which are made after April 30, 1976, with two exceptions. A transfer from any trust (or trust equivalent) which was irrevocable on April 30, 1976, is excluded from the generation-skipping tax if the transfer was not made from additions made after April 30, 1976.[153] Transfers from trusts (or trust equivalents) created by any person who dies prior to January 1, 1982, will not be subject to generation-skipping tax if the trust (or trust equivalent) was created under a will or revocable trust agreement which was not amended after April 30, 1976 in any respect which resulted in the "creation of, or increasing the amount of, any generation-skipping transfer."[154] Trust falling under either of these exceptions will be referred to in this article as protected trusts and the instruments creating them will be referred to as protected instruments.

Protected irrevocable trusts—treatment of post-April 30, 1976, additions

An irrevocable trust created prior to May 1, 1976 cannot be a generation-skipping trust except to the extent of additions made after April 30, 1976. The term "addition" is not defined in the statute. Thus, there may be interpretation problems in certain situations, such as the lapse of a power of withdrawal or the accumulation of income after April 30, 1976; it would seem that, if the lapse or accumulation would not be treated as a taxable event for gift or estate tax purposes, the protection should not be lost.[155]

When there is an addition, the identification of the property attributable to the addition may be difficult. Thus, in the case of an irrevocable insurance trust it is not clear whether the effect of adding cash to enable the trustee to pay premiums will be to cause all proceeds attributable to such premium payments to be considered post-April 30, 1976, additions. Also, when distributions are made from

[153] Tax Reform Act of 1976, § 2006(c)(2)(A).

[154] Tax Reform Act of 1976, § 2006(c)(2)(B). This period may be extended for individuals incompetent on April 30, 1976.

[155] In the case of a lapse of a power, the rules of I.R.C. § 2041(b)(2) ("$5,000 or 5%") should apply. An accumulation of income should be treated as the exercise of a limited power of appointment by the trustee. See text at N. 167, *infra*.

protected irrevocable trusts to which post-April 30, 1976, additions have been made, it is not clear whether the distributions will be deemed to be made first from the tainted additions and then from the protected property, or vice versa, or whether there will be a pro rata allocation.

Protected revocable instruments

If the grantor dies prior to January 1, 1982, a trust created by him under a will or revocable trust agreement executed before May 1, 1976 is a protected trust if the governing instrument was not amended after April 30, 1976 in any respect which resulted in the "creation of, or increasing the amount of any generation-skipping transfer."[156] The Conference Report deals at some length with problems relating to these provisions,[157] but many questions remain.

The Conference Report does not indicate whether an amendment must be in the form of an amendment to the protected revocable trust or a codicil to the protected will or whether it may be by a restatement of the trust or by a new will. It does not deal with whether additions made to a protected revocable trust can be made if it is a trust into which property will pour from the grantor's protected will; from a policy point of view, this should be permissible since it only anticipates what will happen at death. Similarly, it does not deal with whether a grantor can create a revocable trust with the same substantive provisions as a protected will and then have all property pour over to the new revocable trust on the grantor's death. Nor does it indicate whether an increase in the amount of the generation-skipping trust resulting from an amendment causes the trust to lose protection entirely or whether only the increase is tainted; in contrast to the situation where there is an addition to an irrevocable trust, the entire trust may lose protection.

The Conference Report does give some guidance with respect to the changes which may be made to a protected trust without causing the "creation of, or increasing the amount of, any generation-skipping transfer."[158]

A change of trustee is stated to be a permissible change.[159] Presumably, a change of executor would also be covered. However, changes of fiduciaries might disqualify a trust if a reduction in the number of fiduciaries or the substitution of an individual trustee (who may not take commissions)for a corporate trustee, resulting in reduced commissions being payable from the trust, is deemed to cause an increase in the amount of the generation-skipping trust, or if the addition of an individual trustee who as a Younger Generation Beneficiary results in the "creation" of a generation-skipping trust.

According to the Conference Report, the identity of the beneficiaries and the size of the share for any particular beneficiary may be changed, provided that the number of levels of younger generations which may benefit is not increased and the total value of all interests of all beneficiaries of the generation-skipping trust is not increased.[160] In making changes which are designed to fit within these guidelines, there are a number of pitfalls to be avoided. For example, if a trust provides that income is payable to *A* and the remainder is payable to *A's* issue, *per stirpes*, an amendment which substitutes *B* and *B's* issue, *per stirpes*, may run afoul of the proscription because distribution to *B's* issue, *per stirpes*, might result in distribution to a younger generation than would distribution to *A's* issue, *per stirpes*. As the Conference Report states that the number of generations which *may* benefit cannot be increased, it seems that the mere chance that there would be an increase in the number of generations (even if there is, in fact, no such increase) will cause the trust to lose protection.

Certain amendments to provisions of a protected will or trust agreement, other than those provisions creating the generation-skipping trust, might increase the amount of the generation-skipping trust and result in a loss of the protection. This result will normally occur where the generation-skipping trust is in the residue and the discussion of this problem will focus on residuary trusts.

One type of amendment which might result in loss of protection is the substitution of one preresiduary legatee for another. If a testator wants to substitute *B* for *A* as the beneficiary of a preresiduary legacy, consideration should be given to providing that the legacy should be to *B* if *B* survives or, if *B* does not survive,

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156 Tax Reform Act of 1976 § 2006(c)(2)(B).
157 Conference Report, N. 3 *supra*, at 620–621.
158 *Ibid.*
159 Conference Report, N. 3 *supra*, at 620.
160 *Ibid.*

to *A* if *A* survives. This would guarantee that the substitution of *B* for *A* could never increase the value of the residuary trust.[161]

If a protected will provides that estate taxes are payable from the residue of the estate, then, assuming the retention of the protection of the effective date provisions is the overriding consideration, no change should be made which could cause a decrease in the amount of the estate taxes payable (and a concommitant increase in the amount of the generation-skipping trust). For example, a pre-residuary legacy to a charity, to the grantor's spouse or to a child, which would not otherwise have qualified for the charitable, marital, or orphan's deduction, should not be altered to secure qualification. Nor should the amount of the charitable or marital bequest or of the orphan's exclusion bequest be increased if the increased amount is not payable from, or will not decrease the amount of, the residue.

The Conference Report gives no guidance with respect to the effect of an ademption which increases the amount of the generation-skipping trust. Thus, a sale of specifically devised real property which results in an increase in the size of the residuary trust may (but should not) cause loss of protection.

The Conference Report states that a protected trust will lose its protection if there is an amendment which creates a power of appointment which could possibly be exercised in a way which could increase the number of levels of generations that might benefit.[162]

Exercises of powers of appointment

Property subject to a *general* power of appointment created under a pre-May 1, 1976 irrevocable trust will probably be treated as property owned by the holder of the power so that an exercise creating a generation-skipping trust would only be protected if the instrument exercising the power was executed prior to May 1, 1976 and the holder of the power died before January 1, 1982.[163] However, there is no guidance with respect to the treatment to be given to a generation-skipping trust arising as a result of a post-April 30, 1976, instrument which changed a nonexercise to an exercise or vice versa. Similarly, if the holder of a general testamentary power of appointment over a protected trust has exercised the power in a post-April 30, 1976 will and thereafter tears up the will and dies intestate, will the trust which arises in default of appointment be a protected trust?

In any case in which the holder of a general power of appointment dies after December 31, 1981, regardless of whether the instruments creating and exercising the power are pre-May 1, 1976 instruments, the trust probably would not be protected after the death of the holder of the power because the Congressional intent appears to have been that assets subject to estate tax after December 31, 1981, would not be protected.[164] However, this is not entirely clear.

It is not clear what the effect would be of the exercise of a general or limited power of appointment by a protected instrument if the power is over a trust which was in place and revocable until after April 30, 1976;[165] or if the instrument exercising a power is protected, but the power was created by an instrument executed after April 30, 1976.[166]

According to the Conference Report, a limited power of appointment created under a protected irrevocable trust may be exercised after April 30, 1976, to pass the property into further trust for the benefit of additional younger generations, provided the exercise cannot result in the postponement of the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust.[167] Although it is not entirely clear, such an exercise would probably be permissible if the power is created under a protected revocable instrument which became irrevocable due to the death of the grantor prior to January 1, 1982.

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[161] If there were merely a substitution of *B* for *A*, without a gift-over to *A* in the event *B* predeceases, if *B* did predecease the testator and *A* survived the testator, the generation-skipping trust would have been increased by the substitution of legatees.

[162] Conference Report, N. 3 *supra*, at 620.

[163] Cf. Conference Report, N. 3 *supra*, at 620.

[164] Conference Report, N. 3 *supra*, at 620; House Committee Report, N. 3 *supra*, at 59.

[165] Does it matter whether or not the trust over which the power was exercisable becomes irrevocable due to the death of the grantor prior to January 1, 1982?

[166] For example, consider a pre-May 1, 1976 will of a spouse (who dies prior to January 1, 1982) exercising all powers of appointment she may have over any marital deduction trust under her husband's will where the husband executes a post-April 30, 1976 will creating such a trust and predeceases his spouse.

[167] Conference Report, No. 3 *supra*, at 621.

Summary

The most important pitfall to avoid is the accidental destruction of the protection given to generation-skipping trusts by the effective date provisions. It is now more important than ever to examine existing wills, trust agreements and similar documents before recommending any changes in the estate plan.

STATEMENT OF EDWARD T. MITCHELL, PATTON, BOGGS & BLOW, ON BEHALF OF ARMCO STEEL CORP.

This statement is submitted in response to your Committee's Press Release dated October 20, 1977 in connection with H.R. 6715, the "Technical Corrections Act of 1977." The technical correction we propose is consistent with the purpose of Section 2(t)(2)(C) of H.R. 6715. Specifically, we propose to treat as foreign source income under Section 904 of the Internal Revenue Code of 1954, as amended, (the "Code") any gain realized upon the redemption of stock of a foreign corporation where more than 50 percent of such foreign corporation's income for the 3 years preceding the redemption is from foreign sources.

THE TAX REFORM ACT OF 1976

The Tax Reform Act of 1976 (the "1976 Act") provided as a general rule that gain on the sale or exchange of personal property outside the United States which is not subject to a foreign tax of at least 10 percent will not be considered foreign source income for purposes of this rule, as explained by both the House Ways and Means Committee[1] and your Committee[2] in reporting these amendments, "is to prevent taxpayers from selling their assets abroad primarily to utilize any excess foreign tax credits. . . ."[3]

The 1976 Act has the inequitable and apparently unintended effect of treating the gain on certain foreign transactions that take place in the foreign country of incorporation as United States source income simply because such foreign country does not impose a tax of at least 10 percent on such gain. Section 2(t)(2)(C) of H.R. 6715, as passed by the House of Representatives, provides that the 1976 Act rule does not apply with respect to gain from distributions in liquidation of a foreign corporation if such corporation derives a majority of its income from foreign sources. The Report of the Committee on Ways and Means stated its reasons for this provision as follows:[4]

The 1976 Act provision applies to liquidations as well as to other types of exchanges. However, the potential for artificially arranging a sale in a low-tax country does not exist in the case of liquidations because under the normal source rules any gain from a liquidation has its source in the country of incorporation. Consequently, the need to recharacterize any income resulting from a liquidation as domestic source income is limited to cases where the corporation is incorporated abroad but doing its business within the United States.

PROPOSED CORRECTION

The House provision, Section 2(t)(2)(C), should be amended to also treat as gain "from foreign sources" gain derived from the redemption of stock in a foreign corporation doing the majority of its business abroad. The 1976 Act amendment to Section 904(b) of the Code was directed at artificially arranged sales of personal property in low-tax jurisdictions. The redemption of stock in a foreign corporation is taxed in accordance with the law of the county of incorporation, is not susceptible to artificial arrangements and was not intended to be covered by the 1976 Act.

The House provision correctly treats as foreign source income gain attributable to liquidations of certain foreign corporations. We submit that there is no reason to distinguish between gain attributable to the liquidation of a foreign corporation and gain attributable to redemption of stock in a foreign corporation. Both transactions would occur in the country of incorporation and both should be governed by the same source of income rule. Accordingly, we urge your

[1] H. Rep. No. 94-658, 94th Cong. 2d Sess. 234 (1976).
[2] S. Rep. No. 94-938, 94th Cong. 2d Sess. 245 (1976).
[3] Congress enacted certain exceptions to this general rule to exclude other situations in which a sale or exchange was not made in a particular country purely for tax reasons.
[4] H. Rep. No. 95-700, 95th Cong. 1st Sess. 48 (1977).

Committee to amend Section 2(t)(2)(C) of H.R. 6715 to provide for consistent treatment of redemptions and liquidations of foreign corporations which derived 50 percent or more of gross income from foreign sources. We believe such a change is consistent with the House approach of correcting unintended results of the 1976 Act. A proposed form of statutory language to achieve this result is attached hereto as an exhibit.

EXHIBIT

Amend Section 2(t)(2)(C) of H.R. 6715 as follows:

"(C) SOURCE RULE FOR LIQUIDATIONS OF CERTAIN FOREIGN CORPORATIONS.—Paragraph (3) of section 904(b) (relating to source rules for gain from the sale of certain personal property) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"'(D) GAIN FROM LIQUIDATION OF CERTAIN FOREIGN CORPORATIONS.—Subparagraph (C) shall not apply with respect to a distribution in *partial or complete* liquidation of a foreign corporation to which part II of subchapter C applies *or in redemption of stock in a foreign corporation to which section 302 applies* if such corporation derived less than 50 percent of its gross income from sources within the United States for the 3-year period ending with the close of such corporation's taxable year immediately preceding the year during which the distribution occurred.' "

STATEMENT OF THE BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Mr. Chairman and members of the committee. This statement is submitted by the Building Owners and Managers Association International (BOMA).

The Building Owners and Managers Association International (BOMA), through its 65 local associations in the major cities of this country, represents the owners and managers of high-rise office buildings. These men and women have made a substantial investment in the health of the Nation's urban areas. The 4,000 high-rise buildings managed or owned by BOMA's 3,700 members contain 500 million square feet of commercial space, a majority of downtown high-rise office space.

BOMA appreciates this opportunity to comment on the carryover basis provisions of the Tax Reform Act of 1976.

1. Carryover basis provisions of the Tax Reform Act of 1976

The Tax Reform Act of 1976 provides that the basis of most property which passes from a decedent dying after December 31, 1976 is to be the same as the decedent's basis immediately before his death (with certain adjustments). Under previous law, the basis of property acquired from a decedent generally was "stepped-up" to its fair market value at the date of death.

As a transition rule, the 1976 Act provides a "fresh start in regard to appreciation in value occurring before January 1, 1977."

Thus the Act provides that the basis for computing gain (but not loss) of inherited property that a decedent is treated as holding on December 31, 1976, is increased by the excess of the fair market value of the property on December 31, 1976 over its adjusted basis on that date. The adjusted basis, however, cannot be increased above its estate tax value.

This fresh start rule applies to any property held by the decedent, and the adjustment is supposed to reflect the basis of that property on December 31, 1976.

To arrive at the "fresh start" adjusted basis, the December 31, 1976 value of marketable bonds or securities must be determined by their fair market value on that date. The December 31, 1976 value of property other than marketable securities is determined by a special valuation method designed to avoid the necessity of obtaining appraisals. The special valuation method assumes a uniform rate of appreciation for the property for the entire period from acquisition to date of death. Thus, appreciation is deemed to occur ratably over the entire period that the decedent held the property until his date of death.

2. Problems created by the carryover basis provision

The carryover basis provisions are complex and discriminatory in their impact and costly and burdensome to administer.

Until the 1976 Tax Reform Act, taxpayers did not have notice that records would be required of the cost or basis of their purchases of property. This is particularly troublesome for property which taxpayers purchased and intended to hold until their death and pass on to their heirs.

Now, for many assets taxpayers are without records and must spend considerable time and effort in attempting to determine their initial cost or basis in property which they acquired many years ago.

For shareholders of family or closely held corporations and investors in real estate, the new provision is particularly severe and discriminatory. Although shareholders of publicly traded securities are permitted a basis determined by the market quotation on December 31, 1976, shareholders of other securities and real estate are forced to assume an arbitrary basis which often misrepresents the value of their securities on that date.

Real estate projects and closely held corporations often experience their largest growth in value in their formative years, and the "fresh start" rule penalizes the owners of such property by assuming a ratable appreciation from the date of acquisition of shares to the date of death.

Moreover, the "fresh start" rule ignores the very high rate of inflation occurring in the years immediately preceding the end of the calendar year 1976.

Rather than encouraging the development of small business and economic growth, the impact of this new rule is to encourage heirs to either (a) merge with larger companies to avoid adverse tax consequences, or (b) hold their business assets until the date of their death. As an economic policy, this will limit the flow of investment capital and decrease revenues to the Federal government.

The arbitrary nature of the tax consequences of the "fresh start" rule are demonstrated in the following example, disclosing an increase in tax which penalizes the survivor of a realty owner.

Assume that construtcion on an office building begins with 100 days remaining in 1976. Its value is $100.000.

It is completed on December 31, 1976, and has a value of $1 million dollars.

A. Case 1

The owner dies 200 days into 1977 and the estate value is $1 million dollars. The carryover basis is computed as follows:

Estate value (FMV at death)	$1,000,000
Less cost	100,000
Total	900,000
Appreciation: $900.000 times 100 (period prior to 1977) over 300 (total holding period)	300,000
Plus cost	100,000
Stepped up basis	400,000

If the property is sold at FMV (1,000,000), then a capital gain of $600,000 is realized ($1,000,000 less $400,000 equals $600,000).

B. Case 2

The owner dies 400 days after December 31, 1976, and the property has a value of $1 million dollars.

The carryover basis is computed as follows:

Estate value	$1,000,000
Less cost	100,000
Total	900,000
Appreciation: $900,000 times 100 (period prior to 1977) over 500 (total holding period)	180,000
Plus cost	100,000
Stepped up basis	280,000

If the property is sold at FMV ($1,000,000), then there is a capital gain of $720,000.

C. Case 3

The owner dies 800 days after December 31, 1976, and the property has a value of $1 million dollars.

The carryover basis is computed as follows:

Estate value	$1,000,000
Less cost	100,000
Total	900,000
Appreciation: $900,000 times 100 (period prior to 1977) over 900 (total holding period)	100,000
Plus cost	100,000
Stepped up basis	200,000

If the property is sold at FMV, then a capital gain of $800,000 is realized.

3. Recommendation for repeal for amendment of the carryover basis provisions:

The complexity and unfairness of the carryover basis provisions are such that they should be totally repealed as provided for in S. 1954, introduced by Senator Curtis.

If the provision is not repealed the approach adopted by Senators Byrd and Dole in S. 2228 should be adopted. This legislation would provide that property held by a decedent prior to December 31, 1976 would be subject to the provisions of the old law. In addition, the bill contains other provisions which make the law more reasonable.

Short of these steps, the effective date of the carryover basis rules should be extended to a date sufficiently far in the future to allow the Congress to review these provisions and determine what should be done about them. Such a suspension should extend to at least December 31, 1978 as provided for in S. 2227, introduced by Senators Harry F. Byrd, Jr. and Robert Dole.

At the very least, the carryover basis rules should be amended to allow a taxpayer to establish a "fresh start" basis that represents the actual fair market value of the property as of December 31, 1976.

VENABLE, BAETJER & HOWARD,
ATTORNEYS AT LAW,
Baltimore, Md., October 29, 1977.

Senator HARRY FLOOD BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I submit the following comment on H.R. 6715 (The Technical Corrections Act) passed by the House of Representatives and presently under consideration by your subcommittee:

Section 3(i) of the Act proposes an amendment to Section 2036 of the Code. This amendment is supposedly designed to clarify the amendment to Section 2036 enacted by the Tax Reform Act of 1976, the so-called anti-Byrd amendment dealing with retained voting rights of transferred stock. Instead of clarifying the amendment, however, it creates new ambiguities.

In my view, Section 3(i) of the Act exemplifies "tax reform" at its worst; it is yet another example of the reason why the Tax Reform Act of 1976 has been aptly referred to as the "Lawyers and Accountants Relief Act". Indeed, I imagine that the provision, if passed into law as drafted, will cause a substantial revenue loss to the government since the technical advice taxpayers will procure in order to deal with and interpret the new Section 2036 will cost a great deal of money, all of which is deductible from their Federal income taxes. In addition, the government may incur substantial expense in interpreting and litigating the application of this statute.

As originally drafted, Section 3(i) of the Technical Corrections Act would arguably have subjected to estate taxation previously transferred stock whether it was voting or non-voting stock, and whether or not the decedent had the right to vote the transferred stock, so long as the corporation was a controlled corporation at any time within three years of the decedent's death. As originally drafted, Section 3(i) could have led to the absurd result of estate taxation of shares of stock transferred by a decedent, when he retained 1 percent of the voting stock of a corporation, and gave away 99 percent of the stock many years before his death.

This result was severely criticized by numerous individuals, including Jacques T. Schlesinger, the senior tax partner of the law firm of which I am an associate. A copy of Mr. Schlenger's comment on H.R. 6715 is enclosed for your reference; it also appears at page 314 of Ways and Means Committee Print 95-40. (Mr. Schlenger is presently out of the country; he has asked me to comment to you on the bill in his absence.)

If read literally, Section 3(i) of the Technical Corrections Act, as passed by the House, accomplishes all of the same retroactive results as the original proposal. Section 3(i) provides as follows: "... the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property."

A controlled corporation is defined as one in which the decedent owned, with the application of Section 318, 20% or more of the voting stock at any time within three years of his death.

Suppose, for example, that X owns all 200 shares of the issued and outstanding voting stock of a corporation. On August 1, 1976 (before the Tax Reform Act was passed by Congress), X gave 198 shares of the stock to his son, Y. Read literally, Section 3(i) of the bill would require all of the stock of the corporation to be included in X's gross estate if Y owns the stock at X's death, since X would have retained the right to vote "shares of stock"; the corporation would be a "controlled" corporation, through the application of the attrbutable rules, at X's death; and X would be considered to have the enjoyment of transferred property. Consequently, X's estate could be subjected to tax in a way not even imagined when the gift took place!

It is conceivable that Section 3(i) was intended to apply only where the decedent retained the right to vote the shares of stock of a controlled corporation which he *transferred*. If this was the intention, then one of the ambiguities contained in Section 3(i) could be removed by amending it to read as follows: "... the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation *which are transferred by a decedent* shall be considered to be a retention of the enjoyment of transferred property."

The Ways and Means Committee Report suggests that it is this latter meaning which was contemplated. The Committee Report explanation provides, for example, that "[t]he rule requiring inclusion in the gross estate of stock of a controlled corporation applies where the decedent retained the voting rights of the stock which was directly or indirectly transferred by him." This language strongly suggests that inclusion is contemplated only where a decedent has retained the right to vote the shares of stock of a controlled corporation which he has actually transferred.

Although an attempt has perhaps been made in the Committee Report to clarify an ambiguity contained in the statutory language, I question the propriety, logic, and practicability of a law which depends solely on Committee staff interpretation to accomplish a result not found in the statute itself. For an example of the problems which develop under this approach, I need only point to the Code provisions allowing the "fresh start" increase in basis; the Conference Committee Report on the Tax Reform clearly states that the fresh start increase may not raise the basis of an asset above its estate tax value, while Section 1023 of the Code contains no such restriction. In recently issued regulations (see Temp. Reg. § 7.1023(h)-1 the Treasury has decided to follow the statute rather than the original staff interpretation. This incident serves as a reminder that legislative history will not always be used as the sole foundation of a law's interpretation when such history is in conflict with the statutory language.

As additional evidence of the ambiguities involved in Section 3(i) and the Committee Report, the statute, as passed by the House, arguably does not accomplish one of the results that the Committee Report says it accomplishes. For example, the Committee Report implies that estate taxation will be incurred when the decedent acquires voting rights in stock previously transferred. The statute, however, does not state that the *acquisition* of voting rights in previously transferred stock causes estate taxation; it only states that the *retention* of the right to vote stock causes estate taxation. Even if the word "acquired" is read into the statute, the lack of clarity in Section 3(i) is perhaps best typified by the example of when it will apply given in the House Report. That example states that if a decedent transfers cash to a trust of which he is trustee, which then purchases stock from him, the value of the stock will be included in his gross estate; yet that example is clearly wrong even under the proposed amendment, since such a transfer would be for a full and adequate consideration, which is excepted from the operation of Section 2036.

It is possible of course, that the transaction outlined in the Committee Report would be viewed not as a gift of cash, but as a gift of stock; but if this is the case, existing law, which elevates substance over form, would subject the value of the stock to estate taxation whether or not Section 3(i) is passed into law.

On the other hand, the Committee Report might be viewed as subjecting the cash gift to transfer tax, as well as the value of the stock; if this is the case, the decedent would be subjected to double taxation, since the cash will be taxed both as a gift and as part of the decedent's taxable estate under Section 2033. In my view it is doubtful whether Congress really desires such double taxation; it is in direct contravention of the unified system of taxation so recently enacted.

It is apparent, therefore, that Section 3(i) is so confused in its application as to be unmanageable; and even if the literal reading of the statute is ignored, and the Committee Report followed, it is still not clear how the Section is to be applied. For example, suppose decedent X gives one-half of the stock in his family business to his wife, without retaining the right to vote the stock; his wife predeceases him and leaves the stock to their children, but names her husband as Executor of her estate. As Executor he will have the right to vote the stock. Does this mean that if the husband dies while serving as Executor the value of the stock will be included in his gross estate? The Committee Report gives no guidance on whether the indirect retention (or acquisition) of voting rights must be planned at the time of the initial transfer in order to subject the value of stock to estate taxation. It would seem that there is no policy reason why the husband's estate should be subjected to tax; yet the Committee Report implies that it might be.

The result of all this is that the practitioners who must work with this statute will, if it is enacted by Congress in its present form, have no idea what it does mean until there have been numerous rulings or cases interpreting it; and yet this change is supposedly intended to clarify the law! When this uncertainty is coupled with the retroactive date of the provision (it applies to all transfers after June 22, 1976), it is easy to see why our tax system has been labelled a "disgrace".

This whole problem may be easily solved by limiting any change to a substitution of the word "transferred" for the word "retained" in the present Section 2036, and an exception for retained voting rights in non-controlled corporations. If further change is desired (i.e., the expansion of Section 2036 so that it will apply to acquired voting rights) the statute should state this clearly and unambiguously. Needless to say, such a change should not be retroactive since it would not be a "technical correction".

I suspect that Section 3(i) of the bill has been structured in this fashion because the Committee staff is worried that taxpayers might seek to avoid the present anti-Byrum rule by giving stock and then receiving back a planned gift of the right to vote that stock. If this is the case, there is no need for a clarification of Section 2036 since normal "substance over form" taxation principles will cause Section 2036 to apply whether or not the Technical Corrections Act is enacted into law. I would suggest that any further change not be made under the guise of a "technical correction" having retroactive effect. At the very least, I would suggest that the Committee coordinate what Section 3(i) is intended to do with what it in fact does.

Sincerely,

JOHN K. BARRY.

VENABLE BAETJER & HOWARD,
ATTORNEYS AT LAW,
Baltimore Md., June 9, 1977.

Hon. AL ULLMAN,
1136 Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN ULLMAN: This letter is a comment on the so-called Technical Corrections Act of 1977, and a description of some of the major defects contained in the proposed legislation. Before I begin my analysis, I believe that a few general comments on the nature of the legislative process are in order.

My understanding is that a Technical Corrections Act is supposed to be precisely what its name implies, a correction of technical mistakes or ambiguities contained in earlier legislation, without any substantive change. The very first line of the Bill states "To correct technical and clerical mistakes". The "Technical Corrections Act" which you recently introduced for consideration by the Ways and Means Committee contains a number of major changes, which leads to very serious questions about both the Act and the present tax legislative process as practiced by your Committee:

(1) Are the members of your Committee aware, or have they been advised about, the difference between a technical correction and a substantive change?

(2) Have the members of your Committee been fully advised of the contents of the Act, and are they aware of its contents and ramifications?

(3) Has your Committee depended on staff who have not fully or adequately disclosed the substantive aspects of this bill?

Although some possibilities may be more palatable than others, none of them make those who attempt to administer our self-assessing tax system very confident about the legislative process in general, or the Committee's role, in particular. The difficulties and inequities inherent in substantive changes enacted under the guise of "technical corrections" are compounded by the fact that they are evidently intended to operate retroactively. The enactment of retroactive substantive change under the cloak of a technical correction can only promote disrespect for our government, our representatives, and our tax agencies; and that loss of respect will, in the long run, greatly increase the difficulty of administering our revenue laws and be far more costly than any one-shot revenue increase. Our system is based on self-reporting, which presupposes a fundamental trust between the people and its government; and when that trust is dissipated by retroactive substantial changes, the amount of revenues collected will certainly be lessened across the board.

My hope is that you and your fellow members of the Committee will personally review the bill, require the staff to explain and justify it, and eliminate the retroactivity of all substantive changes. In hindsight, the Tax Reform Act of 1976 is subject to severe criticism on the grounds of technical and substantive competence, the rushing of the legislative process receiving primary responsibility. One hopes that the same mistakes are not repeated and compounded by the appearance of deception or unfairness.

The substantive changes proposed to be made by the Act are as follows:

§ 2036. Section 3.(i) of the Act amends § 2036 to provide that "the direct or indirect retention of voting rights with respect to a controlled corporation shall be considered to be a retention of the enjoyment of transferred property." Section 3.(i) goes on to define a controlled corporation as any corporation in which, during the three (3) year period ending on the date of the decedent's death, the decedent owned, or had the right to vote, stock possessing at least 20% of the total combined voting power of all classes of stock. In determining the 20% requirement, the attribution rules of § 318 apply.

At present, § 2036 provides that the retention of the right to vote transferred stock will cause the value of the transferred stock to be included in the donor's gross estate (one would have assumed that a proper correction, at worst retroactively, would be confined to substituting the apparently intended "transferred" for "retained", a prime example of the regrettable haste in the 1976 Act). If the doner does not retain the right to vote the transferred stock, the value of that stock will not be included in his gross estate under § 2036. The value of the stock at the date of transfer will, of course, be subject to transfer tax as if it were included in his gross estate, due to the unified system adopted by the Tax Reform Act of 1976.

The proposed amendment creates and applies a conclusive rule of what constitutes the right to vote stock and will tax appreciation in the value of the stock after the date of the transfer, even if the donor-decedent has no interest in or control over the value of the transferred property. Because the attribution rules of § 318 apply, such stock will be taxed in the donor's estate even if the donor retains no voting stock and has no control over the corporation. As such, the statute as proposed introduces several fundamentally new concepts into the field of estate and gift taxation:

(1) It conclusively subjects to estate taxation property over which the decedent may not have any control over or economic interest in merely because it was once owned by him and is now owned by other members of his family.

(2) It is the first application in the history of estate and gift taxation of conclusive attribution rules borrowed (and very confusingly on a technical level) from the field of income taxation.

The broad effect of the proposed amendment may easily be seen by the following suggested statutory language, which accomplishes the same result as your proposed amendment but is more straightforward in its effect. For purposes of brevity, I have included only the attribution rules of § 318(a)(1); your bill is actually somewhat broader in scope.

§ 2036A.

(a) *General Rule.*—The value of the gross estate shall include the value of any stock, voting or nonvoting, which was at any time owned by the decedent, and transferred by him for less than an adequate and full consideration in money or money's worth, if the decedent, his spouse, children, grandchildren or parents, or any of them, own voting stock in the same corporation, either on the date of the decedent's death, or at any time within three (3) years of the decedent's death.

(b) Subsection (a) shall apply even if:

(1) The stock transferred by the decedent was not voting stock;

(2) The decedent never owned any voting stock, or any stock, voting or non-voting, other than the stock which was transferred by him.

(3) The spouse, children, grandchildren or parents acquired their stock for an adequate and full consideration in money or money's worth, or from a person other than the decedent, either before or after the transfer made by the decedent.

(c) Subsection (a) shall not apply unless the total combined voting power of the decedent, his spouse, children, grandchildren and parents was, at any time during the three (3) year period ending on the date of the decedent's death, equal to or greater than 20 percent of the total combined voting power of all classes of voting stock."

§ 2036 will presently subject to estate taxation the value of stock which was transferred by the decedent if he retained the right to vote the transferred stock. The proposed amendment to § 2036 provides that the decedent will be subjected to estate tax even if he never owned any voting stock, or any stock other than the stock he transferred. This unusual result is achieved because: (1) the bill refers to "transferred property" rather than "voting stock'; (2) the voting control of other individuals is conclusively attributed to any decedent who at one point in time owned any interest in the corporation. The foregoing result has a greater effect than a mere technical correction. It goes quite a bit farther than a mere overruling of the *Bryum* case. The result becomes even more bizarre when its retroactive date (June 22, 1976) is taken into account.

For example, assume that an individual with two children proposed in January, 1977, to organize a corporation, which would have as its initial capital the sum of $12,000 in cash, all contributed by him. The individual would receive in return 60 shares of 6 percent cumulative non-voting preferred stock, $100.00 par value, and 100 shares of common stock. He proposes to give the common stock to his two children, who will use the invested funds to start a small business. The individual would take no part in the management of the business, and in fact lives several thousand miles away from his children. Any additional funds would be supplied by the children themselves, or by borrowing which the children, but not he, will guarantee. The individual would have been advised of the tax consequences as follows:

(1) The gift of the common stock would not be a taxable gift because the annual exclusion of § 2503(b) would apply.

(2) The value of the preferred stock will be included in his gross estate for estate tax purposes.

(3) The value of the common stock would not be included in his gross estate for estate tax purposes. Even if he died within three years of the gift, none of the value of the common stock would be included in his gross estate unless it were worth more than $6,000 at that time. If it were worth more than $6,000, all of it might be excluded, or only $6,000 might be excluded, depending upon the interpretation one made of the recent amendment of § 2035. The individual is not too concerned on this last point, for he is certain it will take a good many more than three years to get the business off the ground, and in any event he is relatively healthy.

Various other alternatives would be discussed by the client and his lawyer, including a gift of cash, a loan to the children, or the retention of some voting stock by the client. The preferred stock route is selected as the best alternative, since the client wants to get some return on his money if the business is successful, but at the same time wants his children to make it on their own without too many debts hanging over their heads.

Pleased that the transaction is relatively painless, the client decides to go ahead and everything takes place as planned.

The client next stops into his lawyer's office in the middle of May, 1977. His lawyer, who has just finished reviewing the proposed "Technical Corrections Act of 1977", advises him that if the Act passes, the entire value of the corporation will be included in his gross estate, unless his two children sell more than 80 percent of their stock more than three years before his death.

The client is somewhat perplexed at this result. Suppose, he asks, the children make a tremendous success of the business, and it is worth $500,000 at his death twenty years hence? What will be the effect on his estate, which amounts to $200,000? His own estate would be wiped out by an estate tax bill of $182,000, the lawyer would reply.

The client might then ask why his estate should be taxed for something he does not own. He would be told that Congress thinks it appropriate for the person who controls a corporation to have its value included in his gross estate. But he does not control the corporation, he says, and never did. Doesn't that make a difference? The lawyer would reply that it does not make a difference, as he is automatically deemed to "control" his children.

The client is now ready to strangle the first person he can get his hands on. Why wasn't I told about this when I gave the stock, he screams? The lawyer replies that the original law in effect at the time of the gift did not say what the proposed bill says, nor could anyone have anticipated this particular change, but the new law is intended to operate retroactively. How can this be called tax reform, the client asks. To which, of course, he does not receive a reply; because there isn't any.

I would also like to note that the proposed amendment creates a direct conflict with § 2040. Evidently it did not occur to the persons drafting the statute that the creation of a joint tenancy in stock with a spouse is a transfer of "property" with in indirect retention of control, "in conjunction with another person." Consequently, the proposed amendment to § 2036 would overrule the change enacted last year which requires that only one-half of the value of the joint property be included in the estate of the first spouse to die. This is another illustration of the old maxim that when a closed group (committee staff, Treasury staff, etc.) proceeds in haste, they succeed in producing waste and worse.

Recourse to the report on your new bill prepared by the staff of the Joint Committee on Taxation, page 27, reveals that the explanation set forth bears scant resemblance to the contents of the bill. If the provisions about controlled corporations are really intended to relieve a taxpayer who gives away voting stock in a non-controlled corporation, please spare the taxpayer anymore such help. It is Orwellian the way these provisions penalize, not help. The gap between the report and the bill raises serious questions of candor and competence.

Another problem area is presented by Section 3(f) of the Bill. The revision of Section 2035(b) now would include the following sentence: "Paragraph (2) shall not apply to any transfer with respect to a life insurance policy." Before the end of calendar year 1976, as part of normal year end estate planning made by estate and tax lawyers, decisions had to be made with respect to annual gifts to children and grandchildren. In many instances, in prior years, a pattern of giving away the ownership of insurance polices had become a custom. At the end of 1976, however, a great many lawyers decided that because of the provisions of the Tax Reform Act of 1976, it would be desirable not to make any gifts of the ownership of insurance policies until January, 1977, because such gifts would, if the fair market value of the policy at the time of the gift was less than $3,000, not be included in the gross estate. Therefore, a not insignificant number of lawyers did not make transfers of insurance policies at the end of 1976 but waited a few days until January, 1977.

The retroactive change in this rule will penalize lawyers and clients who relied on the law as it existed in December, 1976, and will render all of the advice based on laws existing on December, 1976 completely invalid. If a transfer had been made in December, 1976, it would still have been open to argument, even if the decedent died within a 3 year period after the transfer, that the transfer was not made in contemplation of death, either because it followed a pre-existing pattern of gifts or for any number of other reasons. Now, however, because the gift was postponed for a few days until January, 1977, as to any decedent who dies within 3 years after the transfer, the gift is automatically included in the gross estate without the availability of the arguments that could have been made if the gift had been made at the end of 1976.

This result is both harsh and unfair; the problem can be solved by one very simple measure. If the effective date of Section 3(f) were changed so that the section would only apply to transfers made after the date the bill was introduced by you (April 28, 1977), no one would be subjected to the adverse and harsh effect of the proposed retroactive amendment. Indeed the unfairness of the retroactive provision is compounded by the misleading staff description of the change, which implies that the only reason for the change is to remove a burden from the Executor of the decedent's estate. In fact, the new provision is more restrictive than the original and is clearly intended to be so; therefore, the change should only be adopted prospectively.

In addition to the above described substantive changes, there are other problem areas of the bill.

One problem is presented by the proposed amendments to § 306 and § 303. As far as § 306 is concerned, the proposed bill provides for a reduction the amount realized by the basis of such stock on December 31, 1976, and the "fresh start" increase in basis under § 1023(h). Would it not be appropriate to also reduce the amount realized by the increase in basis for Federal and State estate taxes? If this is not done, the § 306 stock will be subjected to double taxation, without the relief granted other assets through either the increase in basis because of such taxes, or the deduction allowed to income in respect of a decedent.

As far as § 303 is concerned, I question the logic of allowing § 306 to override § 303. The purpose of § 306 is to prevent the taxation of dividend income at capital gains rates, and the purpose of § 303 is to allow the taxation of what might otherwise be dividend income at capital gains rates, in order to provide for the payment of death taxes and administrative expenses. If this be the case, there is no harm in allowing § 303 to override § 306, because there is no more tax avoidance than there would be if the § 306 stock were never created in the first place. Why adopt a doctrine of original and irredeemable sin?

The short time that has elapsed between introduction of your bill and the writing of this letter does not permit a more comprehensive analysis. But one can guess that the foregoing sampling is not atypical and that the errors of substance or of disguising retroactive substantive changes as technical corrections are considerably more numerous.

In any event, I know that I express the sentiments of many, if not most, experienced tax practitioners in respectfully requesting that you and your brethren announce as promptly as possible that:

(1) The provisions of the bill will be subjected to examination publicly by interested taxpayers and the Senate Finance Committee, and that adequate time will be allowed for this purpose.

(2) In the review of the bill, the staff persons responsible for various proposals will be made publicly available at the hearings for questioning.

(3) No retroactive changes will be made other than to correct narrow technical or clerical mistakes.

(4) The bill will be divided into two separate bills, the first restricted to correcting technical and clerical mistakes and the second, to new, prospective substantive changes. The first bill will be taken up first, and the second bill will be delayed until consideration of the first is completed.

If the Committee decides to proceed in a fair, deliberate and open manner, I should think it would receive not only the appreciation but the cooperation of those outside of government.

Sincerely yours,

JACQUES T. SCHLENGER.

AMERICAN COUNCIL OF LIFE INSURANCE,
CHIEF COUNSEL, FEDERAL TAXES AND PENSIONS,
Washington, D.C., October 31, 1977.

HON. HARRY F. BYRD, JR.,
Chairman, Senate Finance Subcommittee on Taxation and Debt Management Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: The purpose of this letter is to present the views of the American Council of Life Insurance regarding H.R. 6715, the Technical Corrections Bill of 1977, and also with regard to a proposal made by the Treasury Department in its testimony on S. 2228. Our comments relate particularly to the carryover basis provisions which were added to the income tax laws by the Tax Reform Act of 1976 (Section 1023 of the Internal Revenue Code). Specifically, we strongly urge that in your consideration of S. 2228, as it provides for an increased minimum basis for carryover basis property (section 3(b) of the bill), you reject the Treasury Department's proposal that the increased minimum basis under the bill be reduced by the proceeds of life insurance included in the decedent's estate. Additionally, we urge that you adopt the Treasury Department's recommendation that legislation be enacted to correct a technical, but significant tax problem created by the Tax Reform Act in the case of stock buy-out arrangements.

The American Council of Life Insurance has a membership of 471 life insurance companies which have in force approximately 92 percent of the life insurance written in the United States. We would appreciate having this letter included in the printed record of the hearings being held by your Subcommittee on H.R. 6715 and various proposals relating to carryover basis.

Minimum Tax Basis

One of the amendments included in S. 2228 (section 3(b)) would increase, from $60,000 to $175,000, the minimum tax basis available under the carryover basis rules with respect to assets included in a decedent's estate. When these assets are subsequently sold by the heirs, only the selling price in excess of this basis represents taxable income.

In a marked departure from present law, the Treasury Department (in testimony before your Subcommittee on October 27, 1977) proposed an offset against this "minimum basis" for life insurance, which offset would have the indirect effect of imposing an income tax on part or all of the proceeds of the life insurance where the decedent is otherwise entitled to use the "minimum basis" provision. This would occur despite the fact that such proceeds are clearly—and have historically been—exempt from income tax under section 101(a) of the Code. Therefore, we strongly urge that the Treasury's proposed offset be rejected.

Specific Example of Treasury Offset.—Assume a taxpayer dies with securities valued at $175,000 and with a tax basis of $25,000. Under S. 2228, the tax basis of those assets would be increased to $175,000 and the decedent's heirs would not owe any tax on a sale of the assets, except with respect to subsequent increases in their value.

However, the minimum basis allowance for a decedent in the same situation, except that he also owns $75,000 of life insurance, would, under the Treasury proposal, be reduced by the $75,000 of life insurance. Thus, the tax basis of the securities in the hands of his heirs would be only $100,000 and they would own income tax on a $75,000 gain when the assets are subsequently sold.

In other words, the $75,000 of life insurance would produce an additional $75,000 of potential taxable gain for the heirs—despite the long-standing Congressional policy specifically reflected in the tax laws of excluding the proceeds of life insurance from the income tax base.

Moreover, this indirect taxation of life insurance proceeds would fall unevenly on decedents and their heirs depending on the composition and size of the decedent's estates. It would fall most heavily on those with relatively small estates consisting at least in part of appreciated assets. Decedents with large estates will most likely have a tax basis in their assets above the minimum and, thus, would not be affected one way or the other by the ownership of life insurance.

Therefore, if it is decided to amend the minimum basis rules, we urge that the Treasury modification be rejected and that the treatment of life insurance as presently reflected in the minimum basis rule be retained.

Stock Buy-Out Arrangements

A very common method of retaining control of a corporation in the hands of the surviving shareholders on the death of one of the shareholders, especially in small, closely-held corporations, is a stock buy-out arrangement. Such an arrangement has historically taken one of two forms and, in either form, is usually funded with life insurance on the lives of the shareholders. Under one alternative—a stock redemption agreement—the corporation owns the life insurance policies on the lives of the stockholders and uses the proceeds of the policies to purchase and retire the stock of deceased shareholders. Under the other form—a cross-purchase agreement—the shareholders own the life insurance policies on the lives of each other and use the proceeds to purchase the stock of deceased shareholders.

Prior to the enactment of the Tax Reform Act of 1976, the basis of property acquired from a decedent generally was the fair market value of the property at the date of the decedent's death. (Section 1014(a) of the Internal Revenue Code). The Tax Reform Act of 1976 added section 1023 to the Code which eliminated the "stepped-up" basis rule for property of decedents dying after December 31, 1976. Section 1023 provides that generally the basis of property acquired from a decedent is the decedent's basis in the property immediately before his death ("carryover" basis). The result of this change is to put the stock redemption agreement form at a significant tax disadvantage to a cross-purchase agreement in a substantial number of cases where before there were no tax disadvantages, in these cases.

The following examples illustrate the problem created by the Tax Reform Act of 1976:

Assume co-shareholders A and B each own 50 percent of the stock of Corporation X. The value of the corporation at all times is $1,000,000. Each shareholder owns 1,000 shares of stock with a tax basis of $10,000. Each shareholder is insured for $500,000 under a buy-out arrangement where the stock of a deceased shareholder is to be purchased at its value at the date of death. If the arrangement is in the form of a stock redemption agreement, Corporation X would receive $500,000 of life insurance proceeds upon A's death and would purchase A's stock for $500,000. B would now be the sole owner of the corporation. His basis in his stock in the corporation would still be $10,000. The potential gain on the sale of the stock after B's death (under the new carryover basis rules) would be $900,000 ($1,000,000 value—$10,000 basis in the stock).

Assuming the same facts except that a cross-purchase arrangement is utilized instead of a stock redemption agreement, B[1] (who owns the life insurance policy on A's life), would receive the $500,000 life insurance proceeds upon A's death and would purchase A's shares for $500,000. As in the first case, B would be the sole owner of the corporation. However, the basis for all of B's stock in the corporation would be increased to $510,000. ($10,000 original basis plus $500,000 basis for A's stock.) Therefore, the potential gain on the sale of the stock after B's death would be only $490,000 ($1,000,000 value of the corporation—$510,000 basis in the stock).

Prior to the 1976 Tax Reform Act changes, the basis of the stock would, on B's death, be stepped up to its value at that time with the result that the tax consequences of its sale thereafter would be the same under either arrangement.

The simple solution to the problem is to change existing stock redemption plans to cross-purchase plans. However, if the corporation in the example either sells or distributes the policies to the shareholders to accomplish this result, a portion of the life insurance proceeds will lose its tax-exempt status under section 101(a) of the Code. The reason is, as explained below, that such a transfer runs afoul of the transfer for value rule (Section 101(a)(2) of the Code). [It should be noted that a change the other way, that is, from a cross-purchase arrangement to a stock redemption plan, can be accomplished without adverse tax consequences since there is an exception to the transfer for value rule for this type of transfer under section 101(a)(2)(B) of the Code.]

Section 101(a)(2) of the Code provides generally that if a life insurance contract is transferred for a valuable consideration, only the actual value of the consideration and subsequent premiums paid by the transferee are excluded from

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[1] While we recognize that a similar difference in realized gain will occur if the stock is sold before B dies, as a practical matter, the stock of shareholders in closely-held corporations is rarely sold prior to death.

the beneficiary's gross income on the death of the insured. The legislative history of this provision indicates that Congress was concerned that a full exemption for life insurance proceeds in a transfer for value situation could result in trafficking of insurance policies and, thus, encouraging speculation on the death of the insured. (S. Rept. 1622, 83rd Congress, 2d Sess., p. 14 (1954)). Congress recognized, however, that transfers for value could take place for certain legitimate business reasons and therefore provided certain exemptions to the transfer for value rule. Accordingly, complete exemption is provided for life insurance proceeds paid under a contract which has been transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is a shareholder or officer. However, no exception is provided where the transfer is from a corporation to a co-shareholder of the insured.

If such an exception is not provided, the only way shareholders will be able to change from a stock redemption to cross-purchase arrangement without incuring the adverse tax consequences flowing from section 101(a)(2) will be to let the corporation policies lapse and to purchase new policies on the lives of their co-shareholders. We do not believe such an approach should be encouraged since it is an inefficient and expensive way to achieve the desired result. Moreover, because of a change in circumstances between the time the corporation originally bought the insurance and the change to a cross-purchase arrangement is to occur, one or more shareholders may have become uninsurable and, therefore, ineligible for the purchase of new life insurance.

We believe that the unequal application of the new carryover basis rules to stock redemption plans and cross-purchase arrangements was an unintended result of the Tax Reform Act of 1976. Thus, we strongly support the Treasury Department's recommendation (in its testimony before your Subcommittee on October 27, 1977) that legislation be enacted to amend section 101(a)(2) of the Internal Revenue Code to remove the tax impediment to changing from a stock redemption to a cross-purchase arrangement by adding to the exceptions to the transfer for value rule an exception for a life insurance contract which is transferred from a corporation to the co-shareholder of the insured.

We would be happy to attempt to furnish any additional information which you or your Subcommittee might think helpful.

Sincerely,

WILLIAM T. GIBB.

ALEXANDER & GREEN,
New York, N.Y., October 31, 1977.

Re Technical Corrections Act of 1977—Excise Tax on Excess Contributions to IRA's.

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

DEAR SENATOR LONG: In view of your involvement over the years in pension reform, and in connection with the pending hearings before the Subcommittee on Taxation and Debt Management on H.R. 6715, the "Technical Corrections Act of 1977", I would like to propose for the Committee's consideration an amendment to section 4973(b) of the Internal Revenue Code of 1954, as amended by the Tax Reform Act of 1976 (the "Code"). To the best of my knowledge, this proposal has not previously been proposed for inclusion in H.R. 6715, but it is clearly of a technical nature, as explained below.

Section 4973(b) of the Code currently provides only limited relief from the application of a 6% excise tax on excess contributions to individual retirement accounts, annuities or bonds ("IRAs"). The purpose of the amendment proposed herein is to broaden such limited relief by making clear that the 6 percent excise tax would not apply (under the circumstances described in the next sentence) to contributions which were intended to qualify as rollover contributions described in sections 402(a)(5), 403(a)(4), 408(b)(3) or 409(b)(3)(C) of the Code but which, due to unintentional failure to meet the technical requirements of such sections, do not in fact qualify as rollover contributions. The excise tax would continue to apply unless such contributions are distributed in accordance with the requirements of section 408(d)(4) of the Code. While I believe this would have been the result under Code section 4973(b)(2) as it existed prior to its amendment by section 1501(d) of the Tax Reform Act of 1976 (the "Act"), that Act introduced more restrictive language which has the effect of precluding avoidance of the excise tax by compliance with Code section 408(d)(4) unless the excess contribution is considered to arise in one of two circumstances.

Prior to the Act, the last sentence of Code section 4973(b) (2) provided that any contribution which was distributed from an IRA would not be treated as an excess contribution provided it met the requirements of section 408(d)(4). Under section 408(d)(4), as it existed both before and after amendment by the Act, a distribution from an IRA which had been contributed as a rollover contribution, but which, through failure to satisfy the technical requirements of a rollover contribution, was ineligible for rollover treatment, was nevertheless eligible to be treated under section 408(d)(4), assuming the requirements of such section were otherwise satisfied. Thus, prior to its amendment by the Act, a person who made an unauthorized rollover contribution (because of lack of five years of qualified plan participation, for example) could avoid imposition of the excise tax under section 4973 by causing the amount of the rollover to be distributed within the time and in accordance with the procedures set forth under Code section 408(d)(4).

As amended by the Act, however, such excise tax may now be avoided only if the excess contribution occurred because the taxpayer either (i) contributed in excess of 15 percent of his compensation includable in his gross income or (ii) was covered under a qualified plan and thereby failed to satisfy the requirements of Code sections 219(b)(1) or 219(b)(2), as applicable. The legislative history makes clear that the reason for this change was ". . . to permit a timely withdrawal of excess contributions to be made without penalty where a contribution made by an individual to an IRA becomes an excess contribution because of circumstances which the individual may not be able to control or foresee. (An employee may not know, at the time he or she makes an IRA contribution that his or her employer will establish a qualified plan later in the year or make a further plan contribution.) This exception to the excise tax rule would not apply if the amount of the excess contribution exceeded $1,500 (the maximum amount that could be contributed to an IRA)." H.R. Rep. No. 94-658, p. 352, 94 Cong., 1st Sess. (1975).

Because the typical unauthorized rollover contribution arises as a result of circumstances which are frequently unforseeable or beyond the taxpayer's control, I believe it should also be eligible for treatment under the last sentence of Section 4973(b)(2).

Accordingly, I propose that the Committee consider amendment of the last sentence of section 4973(b)(2) to read as follows (the words of the amendatory language have been underscored):

For purposes of this subsection, any contribution which is distributed from the individual retirement account, individual retirement annuity, or bond in a distribution to which section 408(d)(4) applies shall be treated as an amount not contributed if such distribution consists of an excess contribution solely because of (i) employer contribution to a plan or contract described in section 219(b)(2) or by reason of the application of section 219(b)(1) (without regard to the $1,500 limitation) or section 220(b)(1) (without regard to $1,750 limitation) and only if such distribution does not exceed the excess of $1,500 or $1,750, if applicable, over the amount described in paragraph (1)(B), or (ii) inadvertent failure of an amount contributed as a rollover contribution to be a rollover contribution described in section 402(a)(5), 403(a)(4), 408(d)(3) or 409(b)(3)(C).

Due to the fact that my attention has only been recently directed to this problem, and in view of the time constraints involved in bringing it to the Committee's attention, the background information relating to this proposed amendment has been presented somewhat summarily. If it would be helpful, more detailed information could be provided upon request.

Sincerely yours,

STEPHEN T. LINDO.

OCTOBER 31, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your press release dated October 20, 1977 soliciting written statements and comments on H.R. 6715, the proposed Technical Corrections Act of 1977, the following comments on section 2(g)(1) thereof, pertaining to foreign conventions, are hereby submitted by Business Incentives, Inc., E. F. MacDonald Travel Company, Maritz, Inc., S & H Motivation and Travel, Inc., International Travel Associates, Inc. and Premium Corporation of America.

SUMMARY

Section 274(h) of the Internal Revenue Code, as added by the Tax Reform Act of 1976, should be amended to insure that it is not misinterpreted to disallow the deduction, by an incentive program sponsor, of expenses for incentive foreign travel awards which are includible in the gross income of the award recipients. For example, a dealer who exceeds a sponsoring manufacturer's sales quota may earn a foreign trip, and that foreign trip will then be includible in the dealer's gross income under section 74 of the Internal Revenue Code. The Technical Corrections Act should clarify that the expenses of such incentive awards are deductible by the manufacturer, without changing the rules of section 274(h) which deny or limit deductibility by the award recipient.

ANALYSIS

Section 274(h) of the Code was enacted by section 602 of the Tax Reform Act of 1976. Its purpose, as you know, was to cure administrative problems which the Internal Revenue Service was encountering in determining whether the expenses of attending a foreign convention were primarily related to the individual's trade or business and therefore deductible or were personal and therefore nondeductible. In an effort to deal with these administrative problems and to curb foreign convention abuses, the Congress limited deductible business expenses to attendance at no more than two foreign conventions. It also imposed limitations on deductions for transportation costs and subsistence associated with foreign conventions and required certain substantiation of expenses.

Although the foreign convention rules of section 274(h) were added by the Tax Reform Act of 1976, section 274 was originally enacted by the Revenue Act of 1962 to curtail abuses in the travel and entertainment areas generally. It is significant that the legislative history of section 274 makes it clear that the section was not enacted to disallow the deduction of normal, proper, business expenses. In this regard, the legislative history states that the Congress was—convinced that expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenues for the Treasury. Sen. Rep. No. 1881, 87th Cong., 2d Sess. 25 (1962). See also H. Rep. No. 1447, 87th Cong., 2d Sess. 19 (1962).

Thus, where travel and entertainment abuses were not deemed to be present by the Congress, the restrictions of section 274 were not made applicable and business expenses continued to be deductible.

One example of a situation expressly found not to be abusive is contained in the Regulations interpreting section 274 which were promulgated under the Revenue Act of 1962 and which are still in effect. The Regulations hold that an expenditure is deductible if it is "paid as a prize or award which is required to be included as income under section 74 and the regulations thereunder." To illustrate this point, the Regulations set forth the following example:

> [I]f a manufacturer of products provides a vacation trip for retailers of his products who exceed sales quotas, as a prize or award includible in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer's [the manufacturer's] trade or business [and therefore tax deductible]. Reg. § 1.274-2(c)(5).

At no time during consideration of section 274(h) under the Tax Reform Act of 1976 was there any indication by the Congress that allowing a manufacturer or other sponsor to deduct his expenses for the type of vacation award illustrated in the Regulations had given rise to abuse or should no longer be considered an appropriate deduction. Section 274(h), as previously stated, was solely intended to cure abuses arising out of attendance at foreign conventions by restricting the deduction allowed for attending such conventions.

Unfortunately, however, section 274(h) creates uncertainty whether the sponsor of a foreign incentive trip designed to compensate outstanding performance will continue to receive a business deduction for his expenses in connection with such travel awards. Naturally, in some cases the recipients of the award attend one or more meetings while on the foreign trip for the purpose, for example, of getting better acquainted with each other and with various techniques used in the sale of the sponsor's product.

Uncertainty concerning the deductibility of the sponsor's expense arises because section 274(h)(6)(A) defines the term "foreign convention" as any "convention, seminar, or similar meeting" held, generally, outside the United States. Thus, it is not clear what falls within the purview of a "similar meeting." The uncertainty concerning deductibility is further created by section 274(h)(6)(D) which provides that:

(D) Subsection to Apply to Employer as Well as to Traveler.—This subsection shall apply to deductions otherwise allowable under sections 162 or 212 *to any person*, whether or not such person is the individual attending the foreign convention. (Emphasis added.)

This language is extremely broad and could be construed erroneously as an intent on the part of the Congress to disallow to the sponsor a deduction for his expenses, notwithstanding he is not the person enjoying the benefit of the foreign travel, and the award is merely one way of paying a form of bonus compensation—taxable compensation—to the award recipient.

It is obvious, of course, that the awarding manufacturer or other sponsor has merely used a method of marketing promotion which is based on the premise that his salesmen or dealers will put forth greater effort to excel if they are presented with the incentive of earning a foreign trip. Alternatively, the sponsor could award cash or merchandise prizes to those earning the foreign trip and there would be no question concerning the deductibility of the prizes by the sponsor.

It is clear that any potential abuse of the type which gave rise to section 274(h) would involve the recipient of the travel award who is required by section 74 of the Code to include the value of the foreign trip in his income. The recipient, however, cannot deduct any amount with respect to the trip except to the extent the requirements of section 274(h) are satisfied. Thus, the purposes of section 274(h) are completely carried out without limiting the sponsor's deduction. Indeed, if section 274(h) should be misconstrued to apply to incentive travel awards, it would have the anamalous result of imposing a double tax on such awards—once at the sponsor's level and a second time at the level of the award recipient.

The uncertainty concerning the application of the broad language of section 274(h)(6)(D) has created a deterrent to incentive programs involving foreign travel awards. This uncertainty has an adverse effect on the undersigned companies which are significantly engaged in the business of conducting, for sponsoring companies, incentive programs which offer travel and merchandise awards to persons who attain high levels of achievement.

Accordingly, it is requested that the Technical Corrections Act of 1977 preclude this obviously unintended interpretation of the Tax Reform Act of 1976. This could be accomplished by amending section 274(h)(6)(D) to make it clear that a deduction is not disallowed to any sponsor who is not the individual attending a foreign convention, if transportation and subsistence furnished by the sponsor is includible in the income of the recipient. Section 274(h) would, of course, remain applicable to a person who pays for the expenses of a foreign convention under circumstances where the individual attending the convention is not required to include such expenses in his gross income.

Respectfully submitted.

WILLIAM M. SHUMATE,
Vice President, Travel Business Incentives, Inc.
JAMES B. GOODMAN,
Director, Administration, E. F. MacDonald Travel Co.
HENRY S. STOLAR,
Vice President and Associate General Counsel, Maritz, Inc.
WILLIAM E. MARLING,
Vice President, S&H Motivation and Travel, Inc.
J. E. TRABERT,
President, International Travel Associates, Inc.
JOHN HEIM,
Vice President and General Counsel, Premium Corporation of America.

98-902—77——25

STATEMENT SUBMITTED ON BEHALF OF BRENT M. ABEL, SAN FRANCISCO, CALIF.; M. BERNARD AIDINOFF, NEW YORK, N.Y.; EDWIN S. COHEN, WASHINGTON, D.C.; HEWITT A. CONWAY, NEW YORK, N.Y.; PETER L. FABER, ROCHESTER, N.Y.; WILLIAM M. GOLDSTEIN, WASHINGTON, D.C.; RICHARD J. HIEGEL, NEW YORK, N.Y.; GORDON D. HENDERSON, NEW YORK, N.Y.; JAMES O. HEWITT, SAN DIEGO, CALIF.; WALLER H. HORSLEY, RICHMOND, VA.; JOHN B. HUFFAKER, PHILADELPHIA, PA.; ELLIOTT MANNING, NEW YORK, N.Y.; HARRY K. MANSFIELD, BOSTON, MASS.; DONALD SCHAPIRO, NEW YORK, N.Y.; FREDERICK A. TERRY, JR., NEW YORK, N.Y.; AND GORDON M. WEBER, SAN FRANCISCO, CALIF.

(Statement Re Proposed Legislative Changes To Alleviate Defects in Carryover Basis Rules)

The above lawyers, who have clients who will be affected at death by the consequences of the carryover basis rules and who are in general concerned about the effect of those rules, have previously submitted statements on the House side in connection with H.R. 6715 on September 8, 1977 and in connection with carryover basis on October 6, 1977. Our spokesman was Edwin S. Cohen, Esq., former Assistant Secretary of the Treasury, who regrettably is unable to appear before this Committee on this occasion.

Our written statement, which appears on pages 200–214 of Ways and Means Committee Print 95–46, points out the particularly adverse effects the new carryover basis rules have on estates whose major assets consist of closely-held businesses. We respecfully ask leave to submit that statement for the record in this hearing. The statement includes four suggestions to alleviate the problem to some degree. These suggestions are:

1. To allow estates to allocate to assets sold to pay death taxes part or all of the upward adjustment for estate taxes given unsold assets included in gross estate;
2. To broaden Section 303 so that it would apply to redemptions to pay income taxes caused by Section 303 redemptions;
3. To provide a fresh start basis for fixed preferred stock depending, as in the case of marketable securities, on their 12/31/76 values, in place of the arbitrary and wholly unrealistic declining fresh start basis now provided in Section 1023, which automatically decreases as the decedent survives beyond 1976; and
4. To provide that Section 306 stock issued before January 1, 1977 should lose its Section 306 status upon the death of the holder, and be eligible for Section 303 treatment.

As passed by the House, H.R. 6715 follows only part of one of the above suggestions, namely, that Section 306 stock issued before the death of the holder be made eligible for Section 303 treatment. This modification reduces the amount of "income" on a redemption meeting the requirements of Section 303, and changes its character from ordinary income to capital gain. While welcome, this change goes only a small part of the distance we feel must be traveled if the family business is to survive beyond the first generation. To give small businesses some chance of coping with their immense liquidity problems under carryover basis, we urge your adoption of our other suggestions, particularly that basis be shifted to sold assets from unsold ones and that Section 303 be expanded to include redemptions to pay income as well as death taxes.

Time has not permitted the circulation of this statement to all the lawyers for whom I speak. The following comments are, therefore, necessarily my own, though I have no reason to doubt that they also reflect the views of our group as a whole.

In recent weeks, many different proposals have been made for taxing or ~~not~~ taxing appreciation that was not realized during life. One plan calls for the substitution of a capital gains tax at death for carryover basis, possibly coupled with a general elimination of preferential treatment for capital gains. Another suggestion is the outright repeal of carryover basis and a return to pre-1977 law. Somewhere between the proponents of those two extremes are those who urge a two-year postponement of the effective date of carryover basis to permit further study of this extraordinarily complex problem and those who would simply change the present carryover basis rules to make them as workable as possible.

In our written comments, we stated on page 202:

"The preferable approach would be to eliminate the new carryover basis rule. We recognize, however, that this would require reversal by the Congress of a policy position it adopted (though with only a short time for consideration and public comment) in the Tax Reform Act of 1976, and thus may be considered beyond the scope of a technical corrections bill. Consequently, this statement discusses changes that might be made, as part of a technical corrections bill, without the need to reverse previously adopted policy positions."

Consistent with this approach, we believe that Congress' and this Committee's first priority should be to enact a corrected carryover basis law that would utilize and build upon the experience of the past year under the 1976 Act.

Many improvements can now be made that in our view are entirely noncontroversial. Congress now has what was so sadly lacking in 1976—the input of experienced and responsible tax and estate practitioners speaking individually and through organized bar groups. Yes the carefully prepared testimony and statements of these practitioners concerning H.R. 6715, as introduced in the House, have been almost entirely ignored by the Ways and Means Committee in its consideration of that bill. We perceive no policy reason why the following complexities and inequities should be retained in the law:

1. Requiring (if Section 3(c)(5)(B) of H.R. 6715 is enacted) that the adjustment for the state tax be computed on unrealized appreciation minus the adjustment for the federal tax thereon and that the adjustment for the transferee tax be computed after deduction of both the federal and state tax adjustments. All three taxes are imposed on 100% of unrealized appreciation.

2. Requiring that the fresh start computation for nonmarketables and (if Section 3(c)(1)(A) of H.R. 6715 is enacted) that the minimum basis computation for tangible personal property be made using date of death value, rather than estate tax value (date of death or alternate value).

3. Requiring the use of the excessively high 8% assumed annual compound rate of appreciation in computing the minimum basis for tangible personal property under H.R. 6715.

4. Requiring that the adjustments for death taxes be made at the average rate rather than the marginal rate of tax. This requirement is contrary to the tax policy underlying Sections 691 and 1023, that the combined income and estate taxes payable should be the same (assuming the same income tax rates for the decedent and those who take the property by reason of his death) whether the income tax is deducted in computing the estate tax or the estate tax is deducted in computing the income tax.

5. Requiring that the death tax adjustments to basis be lower for a decedent with cash and debts than for the same decedent who has satisfied his debts before death. This difference is eliminated when marginal rates are used.

6. Not permitting the carryover to the decedent's estate of unused net operating, capital loss and other carryovers.

7. Requring (if Section 3(c)(7) of H.R. 6715 is enacted) that basis for loss be adjusted for estate taxes in the same amount basis for gain is adjusted. This is unfair to the taxpayer who sells at a loss because the fresh start adjustment (after which the estate tax upward adjustment is to be computed) is not available in determinining carryover basis for loss. Moreover, particularly as a result of carryover basis, many decedents will in the future have a much lower basis for loss than for gain in property they leave. In such cases, the difference between basis for loss and estate tax value will be substantially greater than the difference between basis for gain and estate tax value (net appreciation). Because estate taxes are paid on full estate tax value, whether the property is later sold at a gain or a loss, the upward adjustment for estate taxes in computing carryover basis for loss should be computed on the full difference between the decedent's basis for loss and estate tax value.

We are greatly encouraged that S. 2228 contains many of these noncontroversial changes plus other provisions that would greatly simplify the operation of the carryover basis rules. However, we and other interested practitioners have not been given time to study the effect of these provisions in various factual settings. We do note that the formula for computing the estate tax attributable to unrealized appreciation at marginal rates does not operate fairly where the decedent makes charitable and/or marital deduction gifts. A portion of the basis increase attributable to death taxes is allocated thereunder to untaxed property, and hence is lost to the taxpayer who should have it.

As much as revisions are needed in the carryover basis provisions of the 1976 Act, we cannot without study and consideration in depth approve or recommend changes in any proposed solution to the carryover basis problems that departs drastically from current provisions of law. We earnestly ask that Congress not repeat the 1976 mistake of enacting complicated legislation in this field without giving the tax and probate bars an adequate opportunity to report back to the Congress concerning it. We believe that an effective date deferral to provide the requisite time for study is much to be preferred over hastily considered remedial legislation.

Respectfully submitted.

HEWITT A. CONWAY.

BEFORE THE COMMITTEE ON WAYS AND MEANS

Re H.R. 6715—Technical Corrections Bill of 1977

STATEMENT RE PROPOSED LEGISLATIVE CHANGES TO ALLEVIATE LIQUIDITY PROBLEMS CAUSED BY THE CARRYOVERS BASIS RULE ADOPTED IN THE TAX REFORM ACT OF 1976

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INTRODUCTION

This statement deals with the liquidity problems created for estates and closely-held businesses by the new carryover basis rule adopted by the Tax Reform Act of 1976, including the effect of this rule on Sections 303 and 306. It is being submitted in connection with consideration of the Technical Corrections Bill of 1977 (H.R. 6715) by the following lawyers, who have clients who will be affected at death by the consequences of the carryover basis rule and who are in general concerned about the effect of that rule:

Brent M. Abel, San Francisco, Calif.
M. Bernard Aidinoff, New York, N.Y.
Edwin S. Cohen, Washington, D.C.
Hewitt A. Conway, New York, N.Y.
Peter L. Faber, Rochester, N.Y.
John B. Huffaker, Pepper, Hamilton & Sheetz, Philadelphia, Pa.
Elliott B. Manning, Cleary, Gottlieb, Steen & Hamilton, New York, N.Y.
Harry K. Mansfield, Boston, Mass.
William M. Goldstein, Washington, D.C.

Richard J. Hiegel, New York, N.Y.
Gordon D. Henderson, New York, N.Y.
James O. Hewitt, San Diego, Calif.
Waller H. Horsley, Hunton & Williams, Richmond, Va.
Donald Schapiro, New York, N.Y.
Frederick A. Terry, Jr., New York, N.Y.
Gordon M. Weber, San Francisco, Calif.

PART I.—SUMMARY

The need to raise funds to pay death taxes has always posed a liquidity problem for estates, particularly those whose major asset is a closely-held family business. Assets must be sold to pay the death taxes; and where the estate is illiquid, the estate may be faced with a need to sell these assets within a relatively short period of time, perhaps at distress prices.

Where a major asset of the estate is a colsely-held family business, the liquidity problem of the estate can also become a liquidity problem for the business, since the capital available to the business may have to be reduced to redeem stock held by the estate or the business may have to be sold or merged with a larger company.

Congress has taken steps through the years to try to reduce the hardship that such circumstances can produce. Examples are Section 303, which allows stock redemptions to pay death taxes to be treated as sales or exchanges rather than as dividends, and Sections 6166 and 6166A, which allow an extended period of time to pay death taxes under certain circumstances. Indeed, Congress acted, in Section 2004 of the Tax Reform Act of 1976, to liberalize the latter provisions.

However, at the same time, the Tax Reform Act of 1976 made other changes that work in the opposite direction. These sharply increase, rather than ameliorate, the cash demands on estates and closely-held family businesses to pay taxes. These are changes in the income tax provisions, not the estate tax provisions of the Code, which impose sharply increased income tax liabilities on sales of property required to be made by the estate to pay Federal and State death taxes.

Because they affect income tax rather than estate tax liabilities, their impact on the liquidity of estates and closely-held family businesses may not have been fully appreciated by Congress. However, their existence will operate to undermine the objectives of Sections 303 and 6166 and similar provisions. And, unless corrective action is taken by Congress, they will prevent achievement of the policies that lie behind these provisions.

These changes all relate (a) to the adoption of the new 'carryover basis" at death concept in place of the market-value-at-death concept, (b) to the way the new basis rule relates to Section 303, and (c) to the way the transition rules for this new policy have been drafted.

A. THE PROBLEM

The problem is that in addition to the need to sell property as before to provide funds to pay death taxes, the new carryover basis rule means that new income taxes will have to be paid as a result of these forced sales, thereby resulting in still further forced sales to pay these income taxes, which in turn will result in more income tax liability resulting in still more forced sales, and so on. The consequence is that the taxes that have to be paid at death have been greatly increased, as have the liquidity problems that result.

The problem can be illustrated by the example, contained in more detail in Part III of this statement, of a widower who leaves to his sons who are active in the business all the stock in the family corporation worth $1,500,000 and having a carryover basis (before adjustment for death taxes) of $500,000. The Federal estate tax would be 509,000. However, the Federal income and preference taxes on the redemptions made to provide the funds (net after income tax) to pay this estate tax can be as high as an additional $297,000 (higher, if the beneficiaries of the estate have earned income). In effect, in such a case the immediate Federal tax impact of death has been increased by 60% as a result of the 1976 Act.[1] And the impact is even greater when State taxes are taken into account.

[1] Aside from the immediate impact at death caused by the need to raise funds to pay Federal estate taxes, the new carryover basis rule also substantially increases the income taxes that will have to be paid if the remainder of the business is later sold.

The impact on the liquidity of estates and closely-held family businesses can obviously be severe. The problem will exist for the estates of all decedents dying after December 31, 1976. And the problem will increase in severity the longer the decedent survives that date, because except for marketable securities the "fresh start" basis rule, as now written in the Code, results in a steadily diminishing "fresh start" basis the longer the person lives. The impact at the death of a taxpayer seems especially harsh, particularly when it is remembered that much of the "gain" to be taxed really represents not economic gain but the effects of inflation.

B. SUGGESTIONS TO ALLEVIATE THE PROBLEM

Since these problems are created by adoption of the carryover-basis-at-death rule in place of the previous market-value-at-death rule, they could be solved by eliminating the new carryover basis rule and returning to the old rule. Or they could be lessened, though not eliminated, if an increase in basis were allowed for the full amount of Federal and State death taxes, not just the portion attributable to appreciation. Substantial arguments could be made in support of either such change. The preferable approach would be to eliminate the new carryover basis rule. We recognize, however, that this would require reversal by the Congress of a policy position it adopted (though with only a short time for consideration and public comment) in the Tax Reform Act of 1976, and thus may be considered beyond the scope of a technical corrections bill. Consequently, this statement discusses changes that might be made, as part of a technical corrections bill, without the need to reverse previously adopted policy positions. The purpose of the suggestions is to help accommodate the carryover-basis-at-death rule to the need to alleviate the liquidity problems it creates for estates and closely-held businesses as a result of sales forced to pay death taxes.

1. Allocation of basis to property sold to pay death taxes

One such approach would be to allow estates to allocate to the assets sold to pay death taxes part or all of the basis of other assets included in the gross estate. The allocation would be permitted only to reduce or eliminate gain, not to produce a loss. Giving an estate the right to marshal basis from one asset to another in this fashion would not reduce the income taxes ultimately payable with respect to the decedent's property, since the basis of the remaining assets would be reduced by the amount of the basis so allocated to the assets sold to pay death taxes.

Part II of this statement analyzes this approach, and suggests a legislative change to accomplish it. As explained in Part II, there are several alternative ways in which such a provision can be drafted. It might allow allocation of all the basis of such other property, or of only a portion thereof. It might be limited to sales of property made within a short period of time after death, or it might be limited to sales made to pay death taxes.

The legislative draft proposed in Part II takes the approach of limiting the permitted allocation to sales made to pay death taxes. Although it would be preferable to permit the entire basis of the retained property to be available for the election, the draft proposed in Part II, in order to illustrate the drafting technique that might be employed for a more limited provision, takes the approach of limiting the permitted allocation to the portion of basis resulting from the upward adjustment for Federal and State death taxes.

2. Proposal to apply section 303 to redemptions to pay income taxes caused by section 303 redemptions

The purpose of Section 303 is to help prevent the sales of stock in closely-held corporations that are forced by the need to raise cash for death taxes from causing these businesses to be sold to larger public companies, thus increasing economic concentration. Section 303 does this by protecting such redemptions from being taxed as dividends under Section 302. Before adoption of the Tax Reform Act of 1976, this meant that no income tax was generally payable at all on Section 303 redemptions, since the stock received a new basis at death equal to its fair market value.

The new carryover basis rule adopted by the Tax Reform Act of 1976 means that a capital gains tax will now usually result from such redemptions. But Section 303 was not changed accordingly to include within its scope the additional redemptions needed to pay such income taxes. These newly required forced redemptions are not protected from Section 302 treatment, and the result is that they will not only be taxed, but taxed at ordinary income rates.

Part III of this statement discusses this problem and proposes legislative amendments which would (a) include, within the protection of Section 303, those redemptions that are made to pay the income taxes on the redemptions now permitted by Section 303 and (b) permit the shareholder to reduce or eliminate his gain on Section 303 redemptions by allocating to such redemptions the basis in other shares held by him in the family corporation. The latter amendment is needed even if the first amendment suggested to Section 303 and the draft amendment submitted in Part II are adopted (unless the amendment discussed in Part II is adopted in a form that allows an allocation of all the basis rather than only a portion thereof), since the first amendment suggested to Section 303 does not (as explained in Part III) cover redemptions needed to pay income taxes on the redemptions made to pay income taxes, and because the second proposed amendment to Section 303 is not limited to a portion of the basis, as is the amendment submitted in Part II.

3. Fresh start basis for fixed preferred stock

Section 1023(h), added by the Tax Reform Act of 1976, provides a "fresh start" basis for property held at December 31, 1976. This is a transitional rule intended to "continue existing law with respect to appreciation in property accruing before January 1, 1977. . . ." Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 555 (1976).

For marketable stocks and bonds, the fresh start basis is their fair market value at December 31, 1976. However, for other assets, their appreciation is arbitrarily treated for purposes of this rule as if it had accrued ratably over the holding period before and the holding period after December 31, 1976.

This means, for example, that a $100 par fixed preferred stock received in exchange for common stock in a recapitalization will have a different "fresh start" basis if the company was a public one than if it was private.

If the preferred stock had a value of $100 both at December 31, 1976 and at death of the holder, the stock of the public company will have a "fresh start" basis of $100. Thus its sale at death will produce no gain.

However, if the stock had the same actual value but was of a private company, its "fresh start" basis will be less than $100. Assuming, for ease of illustration, that the decedent's basis in the preferred stock was zero, the "fresh start" basis of the private company's preferred stock would be that portion of the $100 date-of-death value that is equal to the portion of its holding period before December 31, 1976. Thus, if the stock is deemed held for 5 years before and 5 years after December 31, 1976, its "fresh start" basis will be only $50, and its sale at death under the new rules will produce a substantial taxable gain, even though its actual December 31, 1976 value was $100. Moreover, the longer the stock is held after December 31, 1976, the lower its "fresh start" basis will be under the present formula, even though its actual value does not decline.

Application of this "fresh start" averaging rule is arbitrary at best, even to property which has the potential for substantial appreciation after December 31, 1976, and is discriminatory against privately held property and closely-held family companies. It is not a method of arriving at the actual December 31, 1976 value which can be used under the new law only for publicly traded stocks and bonds) but only of making an arbitrary computation in lieu thereof. It produces a particularly unreasonable and harsh result when applied to assets, such as nonconvertible fixed preferred stock, which as a practical matter have little or no capacity for appreciation.

Part IV proposes a statutory amendment to help ameliorate this problem by giving nonconvertible fixed preferred stock that was outstanding on December 31, 1976 a "fresh start" basis equal to its value at the date of death of the decedent as determined for estate tax purposes. This will bring the treatment of fixed preferred stock that was issued by non-public companies into line with the treatment afforded such stock of public companies. It is a much fairer transition rule for such stock than the one presently provided.

4. Appropriate transitional rule for section 306 stock

When Section 306 was originally adopted in 1954, Congress intended that Section 306 would cease to apply to stock held by a decedent at death. The Senate Finance Committee Report in 1954 said that "Subparagraph (C) [of Section 306 (c) (1)] also would remove from the category of section 306 stock, stock owned by a decedent at death since such stock takes a new basis under section 1014." S. Rep. No. 1622, 83rd Cong., 2d Sess. 245 (1954). Moreover, Section 306 stock qualified for Section 303 treatment. This was also expressly intended. Indeed, Congress provided that if non-section 306 stock was held at death and later exchanged by the estate for Section 306 stock, redemption of the Section 306 stock would be entitled to capital gains treatment rather than dividend treatment. The Senate Finance Committee Report stated that Section 303(c) "applies notwithstanding the provisions of section 306." *Id.* at p. 239. Moreover, when Section 306 was adopted in 1954, it was expressly made inapplicable to stock received before adoption of the 1954 Code. See Section 306(h).

The adoption of the new carryover basis rule by the Tax Reform Act of 1976 left the status of Section 306 stock at death unclear. Moreover, no adequate transitional rule for Section 306 stock was provided. Sections 3(a)(1) and 3(a)(2) of the Technical Correcitons Bill of 1977 (H.R. 6715) propose to clarify the status of Section 306 stock (a) by eliminating Section 306 status for stock distributed before January 1, 1977 to the extent of the decedent's basis in the stock plus the "fresh start" adjustment in basis (but not to the extent of the increase in basis for death taxes), and (b) by expressly providing that Section 303 does not apply to Section 306 stock issued before the death of the decedent (and for this purpose the amendment in (a) would not apply), though also expressly providing that Section 303 could still apply to Section 306 stock issued after the death of the decedent.

These proposed amendments seem inappropriate. They provide a transitional status for Section 306 stock issued before January 1, 1977 which seems illogical in that (a) it is limited to the extent of the decedent's basis plus the "fresh start" adjustment in basis in the stock [2] and (b) it does not retain Section 303 status for such stock.

The appropriate transition rule for Section 306 stock would be to take the approach that was taken when Section 306 was originally adopted, namely, that the change in law regarding the Section 306 and Section 303 status of Section 306 stock should not apply to stock issued before the change. Thus, consistent with the approach that was taken in 1954, the transitional rule should be that Section 306 stock that was issued before January 1, 1977 should lose its Section 306 status upon the death of the holder, and should be eigibe for Section 303 treatment. Part V of this statement discusses proposed amendments to accomplish these changes.

PART II. PROPOSAL FOR ELECTION TO ALLOCATE BASIS TO PROPERTY SOLD TO PAY DEATH TAXES

One approach to reducing the liquidity problem imposed on estates and closely-held businesses by the new carryover-basis-at-death rule, without contravening the policy of that rule, would be to allow estates to allocate to the assets sold to pay death taxes part or all of the basis of other assets included in the gross estate. Such a provision would not be contrary to the policy of the carryover basis rule, because it would not change the amount of income tax ultimately payable. It would merely defer the impact of the tax.

Such an election should be limited so that the basis allocation could be made only from property received from the decedent to other property also received from the decedent. However, in other respects the election might be drafted in a number of different ways. To begin with, the amount of basis that might be allocated from the retained assets to the assets sold might be the entire basis (after all Section 1023 adjustments) of the retained assets, or it could be limited to only a portion of that basis. The portion might be the decedent's basis, or the "fresh start" increment, or the increment for death taxes, or any combination of these. Secondly, the amount of property sold which would be eligible for the election might include all property received from the decedent that is sold within a limited period (say, 18 months) after death, or it might be limited to amounts of property equal in value to the sum of the death taxes and administration ex-

[2] The proposed amendment also presents another problem. As presently drafted, it applies only if the basis of the stock includes a "fresh start" increment. The basis will not include such an increment if the value of the stock at death is not more than the decedent's cost basis. Thus, the amendment would mean if the stock is sold for more than the decedent's cost, both the decedent's basis and the "fresh start" increment could be recovered without tax, but if the stock is sold for an amount equal to or less than the decedent's basis, the entire proceeds of sale should be taxed as ordinary dividend income.

penses arising as a result of the death of the decedent, and the period of time involved could include the full period during which estate taxes are payable.

Attached at the end of this statement as an Exhibit to this Part II is a draft of a legislative amendment to create such an election. It would be preferable to permit the entire basis of the retained assets to be available for the election. However, in order to illustrate the drafting technique that might be employed if a more limited allocation were thought desirable, the draft takes the approach of limiting the basis available for the election to the increase in basis of the retained assets allowed by Sections 1023(c) and (e) for Federal and State death taxes.[3]

The draft also limits the amount of property eligible for such an increase in basis to an amount equal in value to the amount of death taxes and expenses of administration resulting from the death of the decedent. The election would apply for the period of time permitted for the payment of Federal estate taxes. The draft also provides that the election can be made by a taxpayer only to the extent that the taxpayer bears the actual burden of such death taxes and expenses of administration (a similar limitation exists in Section 303(b)(3), and this portion of the draft is modelled on that provision).

The manner in which the attached draft would operate can be illustrated as follows. Assume an estate owes estate taxes of $500,000 and sells for this purpose property having a value of $500,000 and a basis (after all Section 1023 adjustments) of $300,000. The estate has other assets with a basis (after Section 1023 adjustments) of $400,000, of which $70,000 represents the increase in basis permitted by Sections 1023 (c) and (e) for Federal and State death taxes. Under the draft provision, the estate can elect to allocate from the retained assets part or all of the $70,000 to the assets sold to pay death taxes, thereby reducing the $200,000 gain on the latter by the portion of the $70,000 so allocated. The portion of the $70,000 so allocated would be removed from the basis of the retained assets, thereby increasing the amount of gain on their later sale.

The draft election could be made only to reduce or eliminate gain, not to produce a loss. Moreover, the draft provides that the basis of property which in the hands of the decedent was a personal or household effect may be allocated only to other property which had the same character in the hands of the decedent. The draft also provides that the basis of capital assets and Section 1231 assets in the hands of the taxpayer could be allocated only to property which is a Section 1231 asset or a capital asset in the hands of the taxpayer. The election would apply for purposes of both the basic and the generation-skipping estate tax. (The portion of the draft which deals with the generation-skipping tax was modelled on Section 303(d), which contains a similar provision.)

PART III. PROPOSAL TO APPLY SECTION 303 TO REDEMPTIONS TO PAY INCOME TAXES CAUSED BY SECTION 303 REDEMPTIONS

Section 303 provides that where a shareholder of a closely held business redeems some of its stock in order to pay death taxes and funeral and administration expenses, the redemption, which might otherwise be treated under Section 302 as a dividend and taxed at ordinary income rates, shall be treated as a sale or exchange of the stock so redeemed. When the provision was adopted in 1950, its purpose was described by the House Committee on Ways and Means as follows:

"It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares

[3] We might note that Sections 1023(c) and (e) contain the following additional problems. The theory of these provisions is that the death taxes imposed on the appreciation in the property should be added to basis. But, although State death taxes are generally imposed on the same appreciation as Federal death taxes, the amount of the appreciation that may be taken into account for purposes of making the adjustment for state death taxes paid by heirs under Section 1023(e) is reduced by the adjustments for Federal death taxes and State death taxes paid by the estate under Section 1023(c). Section 8(c)(5) of the Technical Corrections Bill would add to this problem by computing the appreciation for purposes of the adjustment for State estate taxes paid by the estate as the appreciation reduced by the adjustment for Federal death taxes. Also, no basis adjustment is allowed under Section 1023 for foreign death taxes, even though they may be credited against the Federal estate tax (as may the State death taxes) and thus reduce the Section 1023(c) adjustment for Federal death taxes. To solve these problems, appreciation should be computed before death tax adjustments for purposes of all death tax basis adjustments, and an adjustment for foreign taxes payable on appreciation should also be allowed.

in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country.

"Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise." H. Rep. No. 2319, 81st Cong., 2d Sess., reprinted in 1950-2 Cum. Bull. 380, 427–428.

Before the changes made by the Tax Reform Act of 1976, a decedent's property received a new basis at death equal to its value for estate tax purposes. As a result, redemptions of stock treated under Section 303 as sales or exchanges generated little if any gain and thus little if any income tax. However, the Tax Reform Act of 1976 eliminated the step-up in basis to fair market value at death and substituted a carryover basis. As a result, stock which is redeemed to pay death taxes and administration expenses and which is treated as a sale or exchange under Section 303 will now usually generate taxable gain. Therefore, additional stock will not have to be redeemed, or other assets must be sold by the estate, to produce the funds with which to pay the Federal and State income and preference taxes attributable to such gain. The Tax Reform Act of 1976 did not take this factor into account, however, and Section 303 was not amended to provide sale or exchange treatment, rather than dividend treatment, for the additional redemptions needed to pay these capital gains taxes.

Frequently, the only or the primary asset available to the estate to pay these capital gain taxes will be shares in the family corporation Imposition of an ordinary income tax on the additional redemptions needed to pay the income and preference taxes on the shares redeemed to pay death taxes and administration expenses may therefore impose severe liquidity problems on such estates and family businesses, and will be likely to force the sale of such family businesses. If the entire business is sold, of course, the sale is treated as a sale or exchange and not as a dividend. Such tax-motivated sales would be contrary to the purpose for which Section 303 was adopted.

The problem can be illustrated by the following example. Assume a decedent's only material asset is $1,500,000 in value of shares of a closely held company, that the decedent's post-1976 holding period substantially exceeds his pre-1977 holding period, and that these shares therefore have a "fresh start basis" of $500,000. Assume further that the decedent, a widower, dies, leaving the shares to his sons, who are active in the business.

The Federal estate tax on the estate (assuming no prior taxable gifts and no significant deductions for expenses of administration) would be $509,000. Redemption of $509,000 of stock of the corporation (slightly over 1/3 of its stock) under Section 303 to pay this tax could generate a Federal capital gains tax liability of $89,000 (after taking into account the increase in basis of the shares for the Federal estate tax under Section 1023(c), and assuming a combined Federal capital gains and minimum tax rate of 39.875%). Any additional redemption made to pay this $89,000 income tax liability would itself be taxed as a dividend at ordinary income rates under Section 302. The amount of the redemption needed to provide $89,000 net after Federal income tax (assuming a 70% tax rate on ordinary income) would be $297,000, approximately 60% of the amount of the Federal estate tax levy of $509,000. This imposes a very substantial cash drain on the business—a total of $806,000 out of a business worth in total only $1,500,000 or 54% of the value of the business, and this in order to pay an estate tax of $509,000 or 34% of the value of the total business.

Moreover, the remaining stock in the business, worth $694,000, will have a basis of $554,000, so that a Federal capital gains and preference tax of $56,000 (assuming the rates described above) will be payable if and when this stock is later sold. Thus, the total Federal income tax payable if the estate follows the Section 303 route and tries to preserve the family business could be $353,000, consisting of $297,000 current liability and $56,000 deferred liability.

In contrast, if the estate sold all of the $1,500,000 stock of the family corporation to a large corporation, the total Federal capital gains and preference tax on the sale would be $264,000. This is $33,000 less than even the current $297,000 income tax immediately required to pay income taxes resulting from the redemptions to pay the Federal estate tax; and $89,000 less than the aggregate of this tax and the deferred tax liability of $56,000. Even if the company could raise the money to follow the Section 303 redemption route, it seems unlikely on these figures that the family would choose not to sell out to a larger corporation.[4]

When the effect of State estate and income, including preference, taxes are added, particularly in a State like New York where the estate taxes often exceed the Federal credit and where the income and preference taxes are high, the amounts of cash needed to preserve the family business will be substantially higher than those just given, and the incentive to sell out the entire business to a large company will be even greater.

Thus, the amendments made by the Tax Reform Act make it unlikely that the policy of Section 303, which is to preserve family businesses by avoiding the necessity of selling their stock to large corporations to obtain funds to pay estate taxes, will continue to be fulfilled.

It would seem desirable to correct this defect, in order to provide a more reasonable accommodation between Section 303 and the new carryover basis rules. Attached as Exhibit A to this Part III is a proposed amendment to Section 303 which would extend sale or exchange treatment to redemptions made to provide the funds to pay the Federal and State income and preference taxes on gains that are generated by redemptions permitted under present Section 303 to pay death taxes and administration expenses. The amendment would apply for purposes of both the regular and generation-skipping estate tax.

Under the proposed amendment, if the aggregate of the Federal and State income and preference taxes payable as a result of the redemptions made under Section 303 is, for example, $89,000 (as in the prior example), an additional redemption in the amount of $89,000 could be made under Section 303 and treated as a sale or exchange rather than as a dividend. Although the additional $89,000 redemption will itself create a liability for additional Federal and State income and preference taxes, and any redemption to provide funds to pay this additional liability will also generate a tax liability, and so on, the proposed amendment does not extend Section 303 treatment to redemptions made to pay these additional taxes. Thus, while the proposed amendment ameliorates, it does not completely solve, the problem.

A second amendment should also be made to help accommodate the new carryover basis rules to the purposes of Section 303. This is needed for two reasons: (1) because the first amendment, as mentioned above, does not completely solve the problem created by the new carryover basis rules; and (2) because the family corporation and the estate, even if they are able to raise the funds to pay death taxes, simply may not be able to raise the funds needed to pay the income and preference taxes imposed on the redemptions made to pay the death taxes. The provisions of the Code permitting delayed payment of estate taxes do not provide an answer to the problem, first because of the substantial interest expense[5] such delayed payment creates, and second because the delayed payment privilege applies only to Federal estate taxes and not to Federal (or State) income taxes. Because of these problems, it seems desirable to amend Section 303 to permit the estate to postpone the impact of such income taxes by being able to elect to allocate, to the stock redeemed under Section 303, basis in shares of the family corporation which are not redeemed. Exhibit B to this Part III is a draft of such a proposed amendment.

Under the proposed amendment, a shareholder redeeming stock in a family corporation under Section 303 to pay death taxes, administration expenses, or income taxes on such redemptions, and holding other shares in the same corporation, could elect to allocate basis from the other shares to the redeemed shares for the purpose of reducing or eliminating the gain resulting from the redemptions. The election could not be exercised in such a manner as to produce a loss. To the extent the election is exercised, tax on the gains from the redeemed shares will be deferred but not eliminated, until the other shares of the family corporation are sold, since the basis of these shares would be reduced by the

[4] The detailed computations for the example given are set forth at the end of this statement as an Appendix.

[5] It might also be noted that such interest, even if deductible, could be subject to the minimum tax on tax preferences as a result of the preference item for itemized deductions in excess of 60 percent of adjusted gross income.

amount allocated to the redeemed shares. The amendment would apply for purposes of both the basic and the generation-skipping tax. This second amendment should be made even if the amendment suggested in Part II of this statement is made, unless the amendment suggested in Part II is changed so that it applies to all and not to just a portion of the basis of the retained property.

PART IV. PROPOSAL TO CHANGE "FRESH START" FORMULA FOR NON-MARKETABLE FIXED PREFERRED STOCK

Section 1023(h), as added by the Tax Reform Act of 1976, was intended to "continue existing law with respect to appreciation in property accruing before January 1, 1977" [6] by allowing a step-up in basis at death to the value of the property at December 31, 1976.

For all property other than marketable bonds or securities, a formula was incorporated for this purpose based on date of death values. The formula was included to avoid the necessity of obtaining appraisals at December 31, 1976. The formula requires the appreciation at date of death to be allocated between the portion of the holding period of the property before and the portion after December 31, 1976.

The purpose of the formula is to arrive at an approximation of December 31, 1976 values. However, the formula does not achieve this result for nonconvertible fixed preferred stock, since the latter is not likely to appreciate. As a result, preferred stock having a cost basis less than its value and received in a distribution or recapitalization of a public company is treated under the statute very differently than such stock of a private company. Such fixed preferred stock of a public company receives a basis at death equal to its actual December 31, 1976 value; whereas, such fixed preferred stock of a private company will have a basis at death that is less than its December 31, 1976 value, and this disparity will increase the longer the holder lives.

For nonconvertible fixed preferred stock, the value at the date of death of the decedent is a fairer approximation of its December 31, 1976 value than the amount that is produced by the present "fresh start" formula. The Exhibit to this Part IV contains a proposed statutory amendment to provide a "fresh start" basis equal to the date of death value for nonconvertible fixed preferred stock that was outstanding on December 31, 1976. (The language in the draft defining "nonconvertible fixed preferred stock" is modeled on the provisions of Section 382(c), as amended by the Tax Reform Act of 1976.)

PART V. TRANSITIONAL RULE FOR SECTION 306 STOCK

Before the Tax Reform Act of 1976, Section 306 ceased to apply to stock held by a decedent at death, and Section 303 applied to redemptions of Section 306 stock. These results were in accordance with express Congressional intent at the time of the adoption of Section 306 in 1954. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 239, 245 (1954).

The Tax Reform Act of 1976, by the adoption of the new carryover-basis-at-death rule, left the status of Section 306 stock at death unclear. Sections 3(a)(1) and 3(a)(2) of the Technical Corrections Bill of 1977 (H.R. 6715) propose to clarify the status of Section 306 stock (a) by eliminating Section 306 status for stock distributed before January 1, 1977, but only to the extent of the decedent's basis in the stock plus the "fresh start" adjustment in basis (and not to the extent of the increase in basis for death taxes), and (b) by expressly providing that Section 303 does not apply to Section 306 stock issued before the death of the decedent (so that Section 302 would apply in full to such stock), though expressly providing that Section 303 could still apply to Section 306 stock issued after the death of the decedent.

It is submitted that these proposed amendments do not provide an appropriate transitional rule for Section 306 stock. The appropriate transitional rule would be one that follows the approach that was taken in 1954 when Section 306 was adopted. At that time, Section 306 was expressly made inapplicable to stock received before the adoption of the 1954 Code. This transitional rule is contained in Section 306(h).

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[6] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 at 555 (1976).

Consistent with this approach, it is submitted that the appropriate transitional rule to accommodate the prior law regarding Section 306 stock to the amendments made by the Tax Reform Act of 1976 would be to provide that Section 306 stock that was issued before January 1, 1977 should lose its Section 306 status upon the death of the holder, and should be eligible for Section 303 treatment. The Exhibit to this Part V contains a proposed amendment which would accomplish these results. The proposed amendment (whose language is modelled on Sections 306(h) and 1023(b)(1)) would add a new subsection (i) to Section 306 providing that Section 306 stock issued before January 1, 1977 would cease to be 306 stock at death. This would continue the treatment of prior law as to such stock, and as a result such stock would continue to qualify for Section 303 treatment.

AMENDMENT RELATING TO ALLOCATION OF BASIS TO PROPERTY SOLD TO PAY DEATH TAXES

(a) *In General.*—Subsection 1023(i) is redesignated as subsection 1023(j) and the following is added as subsection 1023(i):

"(i) *Election to allocate basis.*—

(1) *In General.*—In the case of carryover basis property which is sold or exchanged, within the period described in section 303(b)(1) after the death of the decedent, in a transaction in which gain would, but for this subsection, be recognized, the taxpayer may, under regulations prescribed by the Secretary, elect to allocate to such property, so as to reduce or eliminate such gain but not to produce a loss, any part or all of the increases in basis provided by subsections (c) and (e) for other carryover basis property acquired from or passing from the same decedent and held by the taxpayer. The basis of the property from which such allocation is made shall be reduced by the amount so allocated.

(2) *Limitations on election.*—The following limitations shall apply to the election provided by paragraph (1).

(A) The basis of property which in the hands of the decedent was a personal or household effect may not be allocated to property other than property which in the hands of the decedent was a personal or household effect.

(B) The basis of property which is a capital asset or property described in section 1231(b) in the hands of the taxpayer may not be allocated to property other than property which is a capital asset or property described in section 1231(b) in the hands of the taxpayer.

(C) The election provided by paragraph (1) shall apply to sales or exchanges of property only to the extent that the amount realized from such sales or exchanges does not exceed the sum of the amounts of taxes and expenses described in section 303(a).

(D) The election provided by paragraph (1) shall apply only to the extent that the interest of the taxpayer is reduced directly (or through a binding obligation to contribute) by any payment of an amount of taxes or expenses described in section 303(a).

(3) *Special rule for generation-skipping transfers.*—Under regulations prescribed by the Secretary, where property is subject to tax under section 2601 as a result of a generation-skipping transfer (within the meaning of section 2611(a)), which occurs at or after the death of the deemed transferor (within the meaning of section 2612)—

(A) the property shall be deemed to have been acquired from or to have passed from the deemed transferor;

(B) taxes of the kind referred to in section 303(a) which are imposed because of the generation-skipping transfer shall be treated as imposed because of the deemed transferor's death (and for this purpose the tax imposed by section 2601 shall be treated as an estate tax); and

(C) the period of distribution shall be measured from the date of the generation-skipping transfer."

(b) *Effective Date.*—The foregoing amendment shall apply in respect of decedents dying after December 31, 1976.

AMENDMENT RELATING TO DISTRIBUTIONS IN REDEMPTION TO PAY INCOME AND PREFERENCE TAXES ON SECTION 303 REDEMPTIONS

(a) *Amendment to Section 303(a).*—Section 303(a) (relating to distributions in redemption of stock to pay death taxes) is amended by striking out "and" in subsection (a)(1), by adding "and" at the end of subsection (a)(2), by deleting the part of subsection (a) that follows subsection (a)(2) and by inserting the following in lieu thereof:

"(3) the taxes (including any interest collected as a part of such taxes) imposed under this subtitle, and the taxes (including any interest collected as a part of such taxes) described in section 164(a)(3), payable by the shareholder on the amount of such distribution which does not exceed the sum of the amounts referred to in paragraphs (1) and (2),

shall be treated as a distribution in full payment in exchange for the stock so redeemed. For this purpose, the amount of the taxes referred to in paragraph (3) shall be the difference between the amount of taxes described in section 164(a)(3) plus the amount of taxes imposed under this subtitle actually payable by the shareholder, and the amount that would have been payable by the shareholder had the amount of the distribution referred to in paragraph (3) not taken place."

(b) *Amendment to Section 303(b).*—Section 303(b)(4) is amended by deleting the period at the end of subparagraph (B), by inserting in lieu thereof "—", and by adding at the end thereof the following: "plus the taxes referred to in paragraph (3) of subsection (a) attributable to the amount of the distribution equal to the lesser of the amounts referred to in subparagraphs (A) or (B)."

(c) *Effective date.*—The foregoing amendments shall apply in respect of decedents dying after December 31, 1976.

EXHIBIT TO PART I

AMENDMENT RELATING TO ALLOCATION OF BASIS TO SECTION 303 REDEMPTIONS

(a) *Amendment Regarding Election to Allocate Basis.*—Section 303 (relating to distributions in redemption of stock to pay death taxes) is amended by adding at the end thereof the following new subsection:

"(f) *Election as to Basis.*—If a distribution in redemption of stock that is treated under subsections (a)(1) and (a)(2) as an exchange would, but for this subsection (f), result in a gain to the shareholder, such shareholder may, under regulations prescribed by the Secretary, elect to allocate to such stock (so as to reduce or eliminate such gain) any part or all of the basis (but not in excess of such gain) of any other stock in such corporation (or in another corporation referred to in subparagraph 2(B) of subsection (b), or in subsection (c)) held by such shareholder. The basis of the stock from which such allocation is made shall be reduced by the amount so allocated."

(b) *Effective Date.*—The foregoing amendment shall apply in respect of decendents dying after December 31, 1976.

EXHIBIT B TO PART III

AMENDMENT RELATING TO FRESH START BASIS OF NON-CONVERTIBLE FIXED PREFERRED STOCK

(a) *Amendment to Section 1023(h)(2).*—

(1) Subsection 1023(h)(2)(B) is amended by substituting a comma for the period at the end thereof, and by adding the following at the end of said subsection: "except that in the case of non-convertible fixed preferred stock the increase under this subparagraph shall be the excess referred to in subparagraph (A)(ii)."

(2) Subsection 1023(h)(2)(E) is amended by adding at the end thereof the following new subparagraph:

"(iii) The term "non-convertible fixed preferred stock" means stock which at December 31, 1976 and all times thereafter until the death of the decedent—

(a) was fixed and preferred as to dividends and did not participate in corporate growth to any significant extent,

(b) had redemption and liquidation rights which did not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and

(c) was not convertible into another class of stock."

(b) *Effective date.*—The foregoing amendment shall apply in respect of decedents dying after December 31, 1976.

Exhibit to Part V

Amendment Relating to Transitional Rule for Section 306 Stock Outstanding on December 31, 1976

(a) *In General.*—Section 306 is amended by adding the following new subsection at the end thereof:

"(i) *Stock Received in Distributions and Reorganizations Before January 1, 1977.*—Section 306 stock which was received in a distribution or reorganization before January 1, 1977 and which is acquired from or passed from a decedent (within the meaning of section 1014(b)) shall, upon the death of such decedent, cease to be section 306 stock."

(b) *Effective date.*—The foregoing amendment shall apply in respect of decedents dying after December 31, 1976.

ANALYSIS OF EXAMPLE IN PT III—COMPARISON OF INCOME TAX CONSEQUENCES OF SEC. 303 REDEMPTION OF SALE TO LARGE CORPORATION

Line and item	Source	Amount
A. SEC. 303 REDEMPTION		
1. Taxable estate (fair market value of shares)	Assumption	$1,500,000
2. Estate tax	§§ 2001(c), 2010(a)	509,000
3. Value of shares redeemed	§ 303(2)(1)	509,000
4. Percent of shares redeemed	3/1	33.93
5. "Fresh start" basis of all shares	Assumption	500,000
6. Increase in basis of all shares for Federal estate taxes	§ 1023(c), (f); 2×(1−5)/1	339,000
7. Basis of all shares	5+6	839,000
8. Basis of redeemed shares	4×7	285,000
9. Capital gain on sale of redeemed shares	3−8	224,000
10. Estate's combined marginal capital gain and minimum tax rate (70 percent × 50 percent + 15 percent; 50 percent − (½×35 percent)).	Assumption—See §§ 1202, 1(e), 57(a)(9)(A), 56.	[1] 39.875
11. Estate's capital gain and minimum tax liability on sec. 303 redemption proceeds.	9×10	$89,000
12. Estate's marginal ordinary income tax rate	Assumption—See § 1(e)	70
13. Additional value of shares which must be redeemed to pay income tax.	11/(100 percent −12)	$297,000
14. Ordinary income tax on shares sold or redeemed to pay capital gains and minimum tax resulting from sec. 303.	12×13	208,000
15. Total current income tax liability on account of sec. 303 redemption	11+14	297,000
16. Basis or remaining shares	7−8	554,000
17. Fair market value of remaining shares	1−3−13	694,000
18. Deferred capital gain	17−16	140,000
19. Deferred capital gain and minimum tax on remaining shares	10×18	56,000
B. SALE TO LARGE CORPORATION		
20. Capital gain on sale of shares	1−7	661,000
21. Capital gain and minimum tax upon sale of shares	10×20	264,000

[1] This computation assumes that the redemption to pay the capital gains tax occurs in a taxable year following the sec. 303 redemption. If the redemption to pay the capital gains tax were made in the same year as the sec. 303 redemption, the amount of the minimum tax on the capital gains redemption might be reduced or eliminated because of the reduction of preference items by ½ the regular taxes payable for the taxable year.

White & Case,
Washington, October 31, 1977.

Re H.R. 6715, the "Technical Corrections Act of 1977."

Mr. Michael Stern,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Dear Mr. Stern: Enclosed are comments of White & Case on Section 2(o) of H.R. 6715. They are being submitted pursuant to the solicitation of Senator Byrd, Chairman of the Subcommittee on Taxation and Debt Management of the Finance Committee, because of our concern that certain changes made by the House bill do not go far enough in correcting inequities in the taxation of beneficiaries of foreign trusts.

These comments represent our observations, based on our experience as a firm with a substantial tax practice, of the inequities of the provisions of the present law with respect to foreign trusts created by nonresident aliens for nonresident alien beneficiaries. We have not been retained by any clients to submit these comments. We may have clients who would be benefited by the changes we are suggesting, but we know of only one specific instance. In that case we have had to advise a nonresident alien who is considering residence in the United States of the adverse consequences of present law on any distributions he might subsequently receive from a foreign trust which was set up by his nonresident relatives. While this client would benefit by the changes we are suggesting in the event he decides to become a resident of the United States, he has not retained us to make these comments, and the time required for the prepartion of these comments has not been charged to him or any other client.

However, we feel strongly about the unfairness of the present tax provisions applicable to foreign trusts set up in good faith by nonresident aliens and we urge that the enclosed documents be given most serious consideration.

Very truly yours,

RICHARD H. APPERT, *Partner.*

Enclosure.

COMMENTS OF WHITE AND CASE ON H.R. 6715, THE "TECHNICAL CORRECTIONS ACT OF 1977"

Section 2(o) of the House bill providing for the allowance of foreign tax credits for accumulation distributions does not go far enough in eliminating inequities with respect to accumulation distributions from foreign trusts. We would suggest that additional provisions be added to remedy the following inequities:

1. The elimination of the exact method throwback rule and the 6 percent per annum additional tax on accumulation distributions can create a tax liability where none should exist because the trust was created by a nonresident alien for the benefit of nonresident aliens. This can be shown by comparing the results under the law prior to the 1976 amendments with the law after the 1976 amendments. For example, assume a foreign trust created by a nonresdient alien, all of the beneficiaries of which are nonresident aliens, in which income and capital gains are accumulated. Assume further that at the termination of the trust the remainder is paid to a former nonresident who became a United States citizen or resident more than three years before the termination of the trust.

Under the prior law there would have been an accumulation distribution at the time amounts were paid out to the remainderman. However, by using the exact method throwback, no United States tax would be payable on ordinary income or capital gains accumulated during the period the remainderman was a nonresident alien. The measure of tax would have been the excess of tax which he would have paid had the amounts been distributed over the tax actually paid by the trust. Since his liability would be equivalent to the United States tax withheld at source on income from United States sources, there would be no additional tax due.

Under the present law the full amount of accumulated income and capital gains which have been accumulated will be taxed to the remainderman even though, had such amounts been paid out during the years in which they were accumulated, there would have been no tax because the income was from foreign sources or because if the income was from the United States sources the tax was fully covered by withholding at source. Moreover, such accumulation distribution will be subject to the 6 percent additional tax.

This problem is compounded in the case of capital gains which have been accumulated over the years. In the past, a beneficiary of these trusts who came to live in the United States suffered no undue hardship. The law as amended by the Tax Reform Act of 1976 creates a situation in which accumulated capital gains become subject to a confiscatory tax when the principal is distributed because of the denial of the Section 1202 deduction and the 6 percent additional tax. Such taxation of accumulated capital gains can easily result in

100 percent of the accumulation being paid as United States taxes. The purpose behind the 1976 Act changes was to simplify the taxation of accumulation trusts. See S. Rept. No. 94-938, p. 170. The inadvertent result has been to substantially increase the tax burden on nonresident aliens who immigrate to the United States. We suggest that the goal of simplifying the tax law does not warrant imposing such a heavy burden on taxpayers.

We recommend an amendment which would provide that the throwback amount not include any income accumulated in years in which the beneficiary was a nonresident alien. Alternatively, the throwback amount should not include any income accumulated in the year the beneficiary was a nonresident alien if such amounts would not have been included in the beneficiary's gross income for United States tax purposes if the amounts had been distributed to him from the trust. This result can be accomplished by the addition at the end of Section 661(a) of the following language:

"In the case of a foreign trust created by a nonresident alien individual, the term 'undistributed net income' for any taxable year does not include amounts for a taxable year for which there is not a United States beneficiary for any portion of such trust, other than amounts which would have been taxable to a nonresident alien beneficiary under § 871 had such amounts been distributed in such year."

2. The exception for the throwback rule which exempts distributions of income accumulated during minority does not apply to foreign trusts even though such foreign trusts were created by nonresident aliens and even though the beneficiaries were nonresident aliens during some or all of the period of accumulation.

We suggest that the exception applicable to amounts accumulated during minority should apply to foreign trusts created by nonresident aliens, at least to the extent that the minor beneficiaries were themselves nonresident aliens during the period of accumulation.

* * * * * * *

STATEMENT OF THE EVRA CORP.

Mr. Chairman and members of the committee, thank you for the opportunity to submit this statement on behalf of Evra Corporation, formerly named Hyman-Michaels Company, an Illinois corporation now liquidated, and its shareholders Everett and Ralph Michaels (collectively referred to as "Taxpayer"). We strongly urge the passage of Section 2(t)(12)(A) of H.R. 6715 (the Technical Corrections Bill of 1977 currently pending before your Committee) which amends Section 1101(g)(4) of the Tax Reform Act of 1976 ("TRA") to provide for a change of the effective date of TRA Section 1101(d) from "after December 31, 1975" to "after December 31, 1976."

The change in effective dates of TRA § 1101(d) affected by this section of H.R. 6715 was reported by the Committee on Ways and Means of the House of Representatives on October 12, 1977, and passed by the House of Representatives on October 17, 1977.

On July 8, 1976, the Taxpayer consummated a sale of substantially all its assets to Azcon Corporation, a Maine corporation. Negotiations for this sale began in February, 1976. Included in the assets sold was 100% of the stock of a domestic international sales corporation ("DISC"). Prior to consummation of the sale, Evra Corporation qualified for liquidation under § 337 of the Internal Revenue Code of 1954 ("Code"). Following the sale, Evra Corporation was liquidated.

Prior to the enactment of the TRA, § 995(c) off the Code did not provide for the recapture of accumulated DISC income upon disposition of the stock of a DISC in a transaction to which Code § 337 applied. In your report on the TRA, made on June 10, 1976, you specifically recognized this fact as follows:

"The committee amendment also includes two provisions to resolve technical problems in existing law. The first relates to recapture of accumulated DISC income upon disposition of stock of a DISC. Under present law if stock in a DISC is distributed, sold or exchanged in certain tax-free transactions (sec. 311, 336 or 337) there is no recapture because neither of the conditions for recapture are satisfied: No gain is recognized and the corporate existence of the DISC is not terminated. The committee's amendment specifically requires recapture under these circumstances. Conforming amendments with respect to the partnership provisions have also been made (sec. 751(c))."

§ 1101(d) of the TRA as finally enacted amended Code § 995(c) to provide for recapture of accumulated DISC income in such situations.

The House Bill (H.R. 10612), which became the TRA, contained certain provisions affecting other aspects of DISCs, but did not contain the recapture provisions of TRA § 1101(d). The recapture provisions of TRA § 1101(d) were first introduced in your committee on June 10, 1976. Your version of H.R. 10612 provided that most DISC provisions, including the recapture provisions of TRA § 1101(d), would apply to taxable years beginning after December 31, 1976. When the Senate passed its version of H.R. 10612 on August 6, 1976, the effective date for § 1101(d) of taxable years beginning after December 31, 1976 was retained.

When Taxpayer consummated its sale of assets in July of 1976, the law then in effect did not impose a recapture tax on the sale of 100% of the stock of a DISC where there was a § 337 liquidation of the parent. The only notice available to Taxpayer was the Senate proposal for a change in this provision to be effective for taxable years beginning after December 31, 1976.

As finally enacted on September 16, 1976, § 1101(g)(4) of the TRA provides that the recapture provisions (§ 1101(d)) are applicable "to sales, exchanges, or other distributions [of DISC stock] after December 31, 1975, in taxable years ending after such date." The Summary of the Conference Agreement prepared by the House Ways and Means Committee does not focus on the change in effective dates for the recapture provisions of § 1101(d). Apparently there was no discussion of the change of the effective date for § 1101(d) when the final bill was in Committee. The September 13, 1976 Statement of Managers of the Conference Committee indicated that the Senate provision for recapture of accumulated DISC income upon disposition of the DISC stock and a § 337 liquidation of the parent was included in the bill and, except with respect to a provision which is not material to the recapture provisions of TRA § 1101(d), was applicable to taxable years beginning after December 31, 1976. Notwithstanding the Committee Reports and the intent of the Senate, the 1976 TRA as finally passed makes the recapture provisions of § 1101(d) applicable to years after December 31, 1975. Examination of all material available provides no explanation for the change of the effective date.

It is understandable that Congress would view it desirable to amend Code § 995(c) to provide for recapture of accumulated DISC income in a § 337 liquidation situation. The Senate passed such a provision but intended for it to operate only prospectively. It is respectfully submitted that had there been great concern about the failure of Code § 995(c) to provide for such recapture: (1) Congress would not have waited four years to enact a recapture provision; (2) the House of Representatives would have included a provision for recapture in the DISC provision of its bill; and (3) the Senate bill would not have originally contained a prospective effective date for the recapture rules. Moreover, if such importance had been placed on this issue, the Conference Committee in all likelihood would have made a conscious decision as to the earlier effective date and would have so noted it in its report instead of apparently inadvertently making the effective date retroactive.

To reiterate, when the sale of all of the assets of Taxpayer, including the 100% stock interest in the DISC was being negotiated and at the time of closing, there were no adverse tax consequences resulting under the Internal Revenue Code and the DISC recapture provisions of the TRA had not yet been enacted. The Taxpayer was aware that the House version of the DISC provisions of H.R. 10612 did not deal with the question of recapture of accumulated DISC income and that the proposed provisions for recapture of DISC income contained in the Senate bill had an effective date for tax years beginning after December 31, 1976. Based on this knowledge, Taxpayer proceeded to close the sale with no reason to anticipate that final legislation would provide for recapture of accumulated and undistributed DISC income retroactive to January 1, 1976. Clearly, had such retroactivity seemed likely, Taxpayer would have negotiated a different sales price for the transaction so as to take into consideration the new DISC provision. Taxpayer negotiated and consummated the sale in reliance on (i) then existing law and (ii) knowledge that the proposed changes, which were contained only in the Senate bill, were to apply to taxable years beginning after December 31, 1976, and thus would not directly affect the transaction in question. It is respectfully submitted that under these circumstances it was inequitable for Congress to retroactively change the effective date of the proposed law upon which date the Taxpayer had relied.

It might be suggested that § 2(t)(12)(A) of H.R. 6715 is "special interest legislation." This is not so. It seeks only to eliminate the inequity caused by the retroactive application of § 1101(d) after all indications entitled taxpayers to assume that if enacted the effective date would be prospective and therefore have no effect on pre-1977 transactions. This legislation (§ 2(t)(12)(A) to remedy an inequity which apparently was inadvertently caused by previous legislation (TRA § 1101(g)(4)) cannot be considered "special interest legislation." Taxpayers must be able to rely on existing law to conduct their affairs and should not be forced into inaction out of the fear that existing law will be changed retroactively.

The result of the retroactive effective dates of this legislation has been to increase the Taxpayer's tax liability by more than $500,000. Clearly, this is a serious matter to the Taxpayer. To our knowledge, this situation is not a common one; therefore, it is unlikely that the granting of the relief sought will have a serious adverse effect on the revenues of the United States. In our instance, the only effect on these revenues would be a refund of taxes paid for the calendar year 1976. Taxable years subsequent to 1976 would not be affected. Granting the relief sought would eliminate a serious inequity to Taxpayer which could not be anticipated at the time the transaction in question was completed.

Therefore, it is respectfully requested that this Committee pass Section 2(t)(12)(A) of H.R. 6715, the Technical Corrections Bill of 1977, which amends § 1101(g)(4) of the TRA so that the effective date of § 1101(d) of the TRA will be for years ending after December 31, 1976. This would restore the effective date of this provision to that originally proposed by this Committee and originally passed by the Senate, there being no indication that this change in date in the final bill was a conscious and deliberate act of the Conference Committee and the Congress.

Respectfully submitted on behalf of Evra Corporation and its Shareholders.

SIDNEY J. HESS, Jr.
DONALD S. LOWITZ.
DAVID W. ALLEN.
AARON, AARON, SCHIMBERG & HESS.

STATEMENT OF MARTIN L. COYNE, SENIOR VICE PRESIDENT, J. ARON & COMPANY, INC.

Chairman Long members of the committee, my name is Martin L. Coyne and I am Senior Vice President of J. Aron & Company, Inc. J. Aron is a dealer in several commodities including precious metals and, through its wholly-owned subsidiary, also acts as a futures commission merchant. My primary role at the firm consists of oversight and supervision of all activities on futures exchanges.

While our firm, as a dealer in commodities, does not effect transactions in commodity futures which would result in capital gains or losses, we are vitally concerned with the change in the tax laws proposed to be effected by Section 2(u) of H.R. 6715. That section would effectively increase to twelve months the holding period required for capital gain and loss treatment for all non-agricultural commodity futures; the six-month holding period presently required for capital gains treatment would remain unchanged with respect to futures in agricultural commodities.

I believe that there is no justification for differing tax treatment of gains or losses realized by the sale of commodity futures in different commodities which are held for an identical period of time. Moreover, in my view, the direct result of the creation of such a difference would be the weakening of the efficiency and reliability of the futures exchanges which trade non-agricultural commodities.

I understand that the major basis for treating transactions in agricultural commodities differently from other commodities is the thought that agricultural commodities are subject to seasonal fluctuations which are not relevant to non-agricultural commodities. This hypothesis does not hold up under examination because long-term capital gains treatment depends solely upon the maturity of the distant contracts traded and the fact that a distant contract may be in the next crop year has no effect on tax treatment. Until the recent addition of more distant contracts on Commodity Exchange, Inc., the most distant available maturities on all domestic exchanges did not reflect any consistent pattern of shorter maturities for agricultural commodities and longer maturities for non-agricultural commodities. In agricultural, as well as non-agricultural commodities, futures exchanges trade commodities which are twelve or more months distant.

The fact that distant months are available for trading on commodities exchange does not detract from the importance of insuring substantial volume in the more nearby months. My firm regularly uses the facilities of domestic futures exchanges to hedge its positions in physical metals and such hedges are customarily placed in positions less than 12 months forward. As a result, it is of extreme importance that investors not be discouraged from engaging in transactions in those months.

If members of the public are deprived of realistic opportunities to obtain equitable tax treatment in precious metals futures markets, I fear that public participation in those markets will decline. The decline in volume on the exchanges which trade precious metals will have an effect on the liquidity of those markets and will consequently make our hedging activities, and those of our competitors, less reliable. Our ability at the present time to offer a two-way market with an extremely small spread between buy and sell prices is directly related to our efficient use of futures markets. If our ability to adequately use those futures markets were curtailed, the prices quoted to our customers would undoubtedly be affected.

Under the title of a Technical Corrections Act the House of Representatives has, without the benefit of the views of our industry, passed a bill which would have a very deleterious impact. I am grateful for this opportunity to express my views to this Committee on this matter of extreme importance to the precious metals industry.

MILLER & CHEVALIER,
Washington, D.C., October 26, 1977.

Hon. HARRY F. BYRD, Jr.
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Pursuant to the Subcommitee's press release of October 20, 1977, the following comments are submitted to encouraged the Subcommittee to make it clear that section 3(i) of H.R. 6715 (the "Technical Corrections Act of 1977") does not apply to transfers of stock if the transferor cannot vote the shares transferred.

Section 2009(a) of the Tax Reform Act of 1976 was enacted to provide that transferred stock would be included in the transferor's gross estate if he retained voting rights therein. Section 3(i) of H.R. 6715 would limit this rule to cases in which the transferor and his relatives hold at least 20 percent of the voting power in the corporation. This is a sensible provision, and it should receive the approval of the Subcommittee, the full Committee, and the Senate.

As passed by the House of Representatives, however, section 3(i) leaves some doubt as to its effect, because it introduces the undefined concept of the right to vote stock "indirectly." A possible—albeit strained—interpretation is that if a holder of 70 out of 100 shares issued by a corporation transfers 10 shares, including the voting rights therein, he is nevertheless deemed to have retained the right to vote the transferred 10 shares "indirectly," because his control over the corporation through his 60 shares is as effective as it was when he held 70 shares. Such a result has nothing to commend it, and it is explicitly repudiated in the last paragraph of the Ways and Means Committee's explanation (H.R. Rep. No. 95-700, p. 77).

The best response would be for the Subcommittee to preclude this result by drafting a suitably restrictive statutory definition of "indirect" voting rights. Since this might be difficult, the Finance Committee should consider making its intentions clear in its report to the Senate. The explanation of the Ways and Means Committee (p. 76) appears to be concerned more with indirect transfer than with indirect voting rights, and this failure to address the precise statutory language creates the specter that the term "indirectly" may be broader than it seems. The Finance Committee can correct this short-coming by citing appropriate examples of "indirect" voting power—such as voting trusts, irrevocable proxies, or whatever might be intended.

At the minimum, however, the Finance Committee report should reaffirm the disclaimer contained in the last paragraph of the Ways and Means Committee's explanation (p. 77).

As passed by the House, section 3(i) of H.R. 6715 would be applicable to transfers of stock made after June 22, 1976. This appears appropriate, because that was the effective date of the original provision in section 2009(a) of the 1976 Act. The Ways and Means Committee report (p. 77) erroneously indicates that section 3(i) is to be effective with respect to decedents dying after December 31, 1976. The Finance Committee report should correct this discrepancy and follow the language of the bill.

Respectfully,

JOHN M. BIXLER.

SUTHERLAND, ASBILL & BRENNAN,
Washington, D.C., October 28, 1977.

Hon. HARRY F. BYRD, Jr.
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Your Subcommittee on Taxation and Debt Management held hearings on October 26–28, 1977 with respect to H.R. 6715 ("The Technical Corrections Act of 1977") and certain other bills (S. 1954, S. 2227, S. 2228) relating to the so-called "carryover basis" provisions of the Tax Reform Act of 1976. We respectfully request that this letter, which is submitted on behalf of the Massachusetts Mutual Life Insurance Company, be included in the printed record of the Subcommittee's hearings.

For the reasons set forth in this letter, Massachusetts Mutual supports legislation, as described below, and as recommended by the Treasury Department in its October 27, 1977 testimony before the Subcommittee, to alleviate certain adverse and unintended effects of the carryover basis rules upon corporate buyout arrangements.

SUMMARY

Prior to passage of the Tax Reform Act of 1976, the tax basis of property acquired from a decedent was generally equal to the fair market value of the property on the date of the decedent's death. In the 1976 Act, Congress modified this long-standing rule by the addition of sec. 1023 to the Internal Revenue Code. In general, sec. 1023 provides that the basis of property acquired from a decedent will be equal to the decedent's basis in the property. As a result of this change in the law, the potential capital gain resulting from utilization of a stock redemption plan will generally be greater than the potential capital gain under a shareholder cross-purchase plan. In contrast, under prior law, the tax consequences of the two types of plans were, in this respect, identical.

Naturally, a strong interest is being evidenced in eliminating this new tax disadvantage by converting existing stock redemption plans to cross-purchase plans. It is quite typical that small businesses, to whose continued existence these plans for transfer of the stock of a deceased shareholder are most important, fund corporate stock redemption plans through life insurance on the shareholders, owned and paid for by the corporation. The corporation receives no tax deduction for premiums paid but anticipates that the policy proceeds will be exempt from income tax under sec. 101(a)(1) of the Code.

It is in the effort to convert stock redemption plans funded by life insurance to cross-purchase plans that the parties meet a frequently insurmountable (and unintended) impediment. The proceeds of a life insurance policy purchased by a shareholder from the corporation upon such a conversion are not protected by any of the exemptions in sec. 101(a)(2) of the Code from the "transfer for value" rule, described below. Yet, refunding through new insurance may be either impossible or require such a higher premium cost that shareholders cannot avoid some substantial tax disadvantage vis-a-vis those who initially adopted a cross-purchase plan.

To alleviate this harsh effect, Massachusetts Mutual supports the Treasury recommendation that the "transfer for value" rules be amended to exclude transfers of life insurance policies by a corporation to a shareholder if the insured is a co-shareholder of that corporation. Such an amendment, although necessary as a matter of equity, presents no potential for tax avoidance or abuse. This is because, under existing law, the failure of the corporation to receive fair market value for transferred policies will be treated as a distribution to the shareholders and taxed as a dividend to the extent provided in sec. 316 of the Code.

DESCRIPTION OF THE PROBLEM

Use of Stock Purchase Plans. Frequently, shareholders of closely held corporations desire a mechanism whereby, upon the death of one or more of the corporation's shareholders, the business of the corporation may be continued in an orderly fashion and without the risk of shares of stock passing to individuals who neither have any experience with the business nor any desire to see it continued. Such mechanisms usually take the form of stock redemption plans or shareholder cross-purchases plans. In either case, many plans are funded by policies of ordinary life insurance upon the lives of the shareholders.

Where a stock redemption plan is used, the corporation owns a policy of life insurance upon the life of each shareholder. Upon the death of a shareholder, the stock held by such shareholder is redeemed by the corporation with the proceeds of the policy of insurance on the life of the deceased shareholder. In the case of a shareholder cross-purchase plan, the shareholders themselves each own policies of insurance upon the lives of their co-shareholders. Upon the death of a shareholder, the stock held by such shareholder is purchased from his estate by the surviving shareholder or shareholders.

There are a variety of business or non-tax factors which may prompt the selection of one form of plan over another in a particular case. A principal consideration may involve whether the governing State law imposes restrictions on the amount which may be distributed by a corporation in redemption of its stock. For example, some States, to protect creditors, limit the amount which can be distributed in redemption of stock to an amount equal to the corporation's earned surplus. In some situations, this type of restriction may make a cross-purchase plan more attractive than a stock redemption plan. There are, however, other factors which may make a stock redemption plan more desirable. For example, in some instances, a cross-purchase plan may involve a greater degree of complexity. One such complicating factor is that some provision must be made to have the surviving shareholders purchase the policies of insurance on the survivors owned by the decedent. Additionally, in a cross-purchase plan, some inequity in the insurance burden assumed by the shareholders may result if the shareholders are of different ages, varying health, or hold different amounts of stock. In contrast, use of a stock redemption plan will facilitate equalization of the burden of premiums among shareholders of unequal age or health. Thus, while Federal tax considerations come into play in the selection of one type of plan over another, business factors such as those outlined above play an important, and often controlling, role in the selection process.

Impact of the Tax Reform Act of 1976. As pointed out previously, the operation of new sec. 1023 of the Code results in the potential capital gain resulting from utilization of a stock redemption plan generally being greater than the potential capital gain under a shareholder cross-purchase plan. In contrast, under prior law, the tax consequences of the two types of plans were, in this respect, identical.

The unequal application of the new carryover basis rule may be illustrated by reference to a simple example involving a corporation with two shareholders each of whom owns 50 percent of the corporation's outstanding stock and each of whom has a zero basis in his stock. It should be assumed, for simplicity, that the corporation has a net worth at all times of $100,000. Additionally, it should be assumed that, as is frequently the case, both the stock redemption plan and the cross-purchase plan in the example are funded by one or more policies of life insurance. If a stock redemption plan is utilized, the corporation, upon the death of the first shareholder, will receive $50,000 in life insurance proceeds which will be distributed to the decedent's estate in redemption of the decedent's stock. The surviving shareholder will thereafter own stock representing a 100 percent interest in a $100,000 corporation and will have a zero tax basis in his stock. When the surviving shareholder subsequently dies, his stock will have a carryover basis under sec. 1023 of zero and a $100,000 potential capital gain. Under prior law, of course, the stock would have a stepped up basis of $100,000 and a zero potential capital gain.

If, in the same example, the parties utilize a cross-purchase plan, the tax results would be quite different. Under a cross-purchase plan, the $50,000 in life insurance proceeds would be paid to the surviving shareholder and used by him to purchase the shares of stock owned by the deceased shareholder prior to his death. The surviving shareholder would, thus, as under a stock redemption plan, own stock representing a 100 percent interest in a $100,000 corporation. However, unlike the stock redemption plan, the surviving shareholder would have a $50,000 tax basis in his stock (representing the amount paid by him to the decedent shareholder's estate). When the surviving shareholder subsequently dies, his stock, under sec. 1023, will have a carryover basis of $50,000 and a potential capital gain of $50,000. Under prior law, the stock would have had a stepped-up basis and no potential capital gain. Thus, as a result of the new carryover basis rule in 1976, the use of a stock redemption plan produces substantially less favorable tax consequences than existed under prior law.

Impact of "Transfer for Value" Rule. Upon learning of the new adverse effect of the new carryover basis rules, shareholders of closely-held corporations began to express an interest in converting existing stock redemption plans into cross-purchase plans. Interested taxpayers soon discovered that the desired conversion by a transfer of corporate-owned life insurance policies to the shareholders would produce adverse tax consequences under the so-called "transfer for value" rule contained in sec. 101(a)(2) of the Code.

As a general rule, the proceeds of life insurance policies are excluded from gross income under sec. 101(a)(1) of the Code. An exception to this rule is contained in sec. 101(a)(2) of the Code. That exception provides a reduction in the proceeds otherwise excludable from income if the policy is transferred for a valuable consideration. While this "transfer for value" rule does not apply to certain enumerated transfers, it does apply to transfers by corporations to co-shareholders of the insured. Consequently, the "transfer for value" rules stand as a bar to the effective conversion of stock redemption plans to cross-purchase plans. Thus, shareholders who wish to convert to a cross-purchase plan in view of the unanticipated adverse tax consequences of the new carryover basis rules are confronted with a second adverse tax consequence under the "transfer for value" rule.

PROPOSED LEGISLATIVE SOLUTION

Because of the impact of the "transfer for value" rule, as described above, some have proposed that the conversion be accomplished by permitting the existing corporate-owned policies to lapse and having the shareholders thereafter purchase new policies of insurance upon the lives of their co-shareholders. Insurers generally, including Massachusetts Mutual, which sell policies of life insurance used to fund such plans, do not condone the lapsing of existing policies for the purpose of purchasing new policies. Such a procedure could often be disadvantageous to shareholders of closely-held corporations. In some instances, with the passage of time, one or more of the shareholders may no longer be insurable, or be insurable only at a much higher premium than that currently paid for preexisting policies.

Massachusetts Mutual respectfully submits that this problem can and should be resolved, as the Treasury has proposed, by amending sec. 101(a)(2)(B) of the Code by adding, to the existing exemptions to the so-called "transfer for value" rules, a transfer by a corporation to a co-shareholder of the insured. Such an amendment would permit the conversion of existing stock redemption plans to cross-purchase plans by the transfer of the life insurance policies held by the corporation to its shareholders without the loss of the exclusion otherwise available under sec. 101. Such an amendment would not open any avenue for tax abuse. This is because a transfer of a policy by a corporation to one of its shareholders will generally be taxed as a dividend unless the transfer is for fair market value. However, if the transfer is for value, it will almost always constitute a "transfer for value" within the meaning of sec. 101(a)(2), with the result that the portion of policy death proceeds otherwise excludable from income will necessarily be reduced. Thus, an amendment to sec. 101(a)(2) is clearly needed if shareholders of closely-held corporations are to be given the opportunity, now available for new plans, to select a particular plan with full knowledge of the new and heretofore unanticipated tax consequences.

For these reasons, existing law should be amended by adding to the exemptions from the "transfer for value" rules a transfer, for a valuable consideration, of a life insurance policy by a corporation to a co-shareholder of the insured.

Respectfully submitted.

DONALD V. MOOREHEAD.

AMERICAN HOTEL & MOTEL ASSOCIATION,
Washington, D.C., October 28, 1977.

Re section 2(q) of H.R. 6715: Real Estate Exception of Limitation on Partnership Losses in the Case of Non-Recourse Loans.

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: We wish to comment on Section 2(q) of the Technical Corrections Bill of 1977. The American Hotel & Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands, having a membership in excess of 6,500 hotels and motels containing in excess of 850,000 rentable rooms. The American Hotel & Motel Association maintains offices at 888 Seventh Avenue, New York City, and at 777—14th Street, NW., Washington, D.C.

We believe that Section 704(d) of the Internal Revenue Code of 1954 as Amended by Section 213(e) of the Tax Reform Act of 1976 could have an adverse effect on the hotel-motel industry—an effect, we believe, not intended by Congress.

In an effort to limit tax shelters, the bill limited partners and partnerships from deducting losses in excess of the amount of money or property that the partner had contributed or was required to contribute to the partnership. There were specific exceptions in Section 704(d) to the general at-risk limitations and one of the exceptions was "real estate." The exception for real estate provides ". . . nor shall it (provision limiting partner basis to amount to which he is at-risk) apply to any partnership the principle activity of which is investing in real property . . .".

A problem arises because the language that presently exists in Section 704(d) and that which is proposed to substitute for it (Section 2(q) of H.R. 6715) are both ambiguous and do not clarify the law.

If a partnership owns a hotel or motel, the hotel-motel rents both room space (real estate) and furnishings (personal property), and gives substantial services to its guests.

Section 2(q) of H.R. 6715 attempts to solve the problem of the definition "principle activity" but creates problems of its own with its "rental type income" and "substantially all" language. A hotel would still not be sure if its activities made it exempt under the real-estate exception to the law.

The purpose of the exception to the general at-risk limitation for real estate was to exclude non-recourse debts with respect to real estate. We think that the intention of Congress would be fulfilled if the exception to the general at-risk limitations covered "non-recourse loans secured by real estate". This would apply to all partnerships regardless of the nature of their activities, but only with respect to their non-recourse loans secured by real property.

We also request that in the Committee Report it be made clear that the rental of furniture, fixtures and other tangible personalty normally associated with the rental of rooms in hotels and motels be specifically excluded from Code Section 465(c)(1)(C), and that a partnership, the principal activity of which involves the ownership of hotels and motels, be treated as within the real property exception to Code Section 704(d).

We are not the only industry affected by Section 704(d) of the law but we know that its effect on us would be extremely serious. We do hope that the bill can be corrected and the law restored to the effect originally intended by the Congress.

Sincerely,

ALBERT L. MCDERMOTT,
Washington Representative.

STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION

I am Albert L. McDermott, Washington Representative of the American Hotel & Motel Association, which is a federation of hotel and motel associations located in the fifty states, the Districte of Columbia, Puerto Rico and the Virgin Islands, having a membership in excess of 6,500 hotels and motels containing in excess of 850,000 rentable rooms. The American Hotel & Motel Association maintains offices at 888 Seventh Avenue, New York City, and at 777 - 14th Street, N.W., Washington, D.C.

Last year, Congress passed the Tax Reform Act of 1976. Section 602 of that bill and new Section 274(h) of the Code limits the amount of tax deductions that can be taken by an individual or corporation on a business convention overseas.

We recognize that the business travel section of the tax law previous to the Tax Reform Act was fraught with administrative difficulties, and too susceptible to some abuse and confusion. We could understand why more exact language and a more objective law was called for; but, we feel that the law as passed in the '76 Reform Act was far more severe than necessary.

The law should have been focused upon the vacation disguised as a business trip and not on all legitimate conventions that take place overseas. The law has had a serious economic impact on many U.S. hotel corporations who have properties outside the United States.

The law has so frightened convention planners that many conventions are being cancelled in Mexico, Canada, the Caribbean and Bermuda, to name some of the areas. These countries rely heavily on tourism and trade with us; and they contain many resort properties that are American owned or managed, that entertain American tourists who arrive on American airlines.

The oft-discussed retaliatory potential of this law still exists. Last year, for example, 429,000 Canadians visited the United States expressly to attend conventions, conferences and seminars. There is a real possibility that Section 602 will hinder this free flow of tourist trade between us and our neighboring countries. Even the Helsinki Agreement, to which the United States is a party, states that countries should ". . . encourage increased tourism on both an individual and group basis" and ". . . facilitate the convening of meetings as well as travel by delegations, groups and individuals. . . ."

The reporting requirements of the new law are onerous and extremely difficult in practice. The per diem limitation is confusing since the government changes it contsantly and also provides for special appeals by a civil servant that would not be available to a private citizen. In addition, many government officials are not even bound by per diem requirements; rather, they are just reimbursed for their actual travel expenses. Government employees may be given special rates by hotels and motels, they may often eat at government installations, and can often stay in smaller, less expensive hotels that would be difficult for a private citizen attending a convention to do so.

These are just some of the problems of the new law and although we are doing all we can to understand it, and comply with it, we are finding it very difficult. We think that the law should be completely repealed and a new law with adequate reporting requirements and no limitation on travel be drawn up.

If such a repeal of the law is not practical, we would be in favor of many other refinements which would make the present law workable. For example, we would favor the so-called North American exemption (this would exempt Canada, Mexico, the Caribbean, and Bermuda) which would insure that our neighboring countries not retaliate against us and curtail their tourist and convention business in this country; and, we would favor a repeal of the requirement that subsistence expenses not exceed the dollar per diem rate for United States civil servants—civil servants' per diem rates, as I have mentioned, are not the best indicias of travel costs.

Pleas for relief from newly passed tax laws are probably common, but in our case the law has gone beyond the problem of tax subsidized vacation travel and into the hindering of business and the hurting of foreign realtions with close and friendly countries. We ask that you reconsider the law you have passed and review the impact of Section 602.

CORCORAN, YOUNGMAN & ROWE,
Washington, D.C., October 31, 1977.

Re H.R. 6715, The Technical Corrections Act of 1977.

Senator HARRY F. BYRD, Jr.,
Chairman, Senate Finance Subcommittee on Taxation and Debt Management, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Section 2(b)(3) of H.R. 6715, which provides certain amendments to the changes made in section 57(b)(2) of the Internal Revenue Code by the Tax Reform Act of 1976, makes clear that the minimum tax applies to amounts transferred to so-called charitable lead trusts after January 1, 1976. As you are aware, a charitable lead trust is a trust where a charitable organization receives an annual unitrust or annuity trust amount for a period of years and then noncharitable beneficiaries become entitled to the trust's income and principal.

The minimum tax becomes applicable to these trusts because under proposed section 57(b)(2)(c)(iv) of H.R. 6715 deductions allowed in any taxable year under section 642(c) for amounts paid to charity by such trusts shall not be treated as deductions allowable in arriving at adjusted gross income, but rather as itemized deductions. Pre-January 1, 1976 charitable lead trusts will not be subject to the minimum tax if the charitable deduction exceeds 60 percent of the trust's income. Charitable remainder trusts, however, will not be subject to the minimum tax, whenever created.

The reason for limiting the exclusion to charitable lead trusts created before January 1, 1976 is not apparent. The restrictions on the income tax deductibility of contributions to such trusts contained in section 170(f)(2) effectively limit their potential for abuse and the possibility that they will be used to shelter funds from the minimum tax. Under that section, a grantor must remain taxable on the trust's income in order to obtain an income tax deduction for the value of the charitable interest. Thus the minimum tax would be applicable to him directly if the charitable interest could produce excess itemized deductions. If the grantor does not remain taxable on the income, he receives no income tax deduction for the charitable interest. Under these circumstances, the only real effect of the application of the minimum tax to charitable lead trusts is to deprive charities of funds.

This inequity with reference to charitable lead trusts can be remedied by according such trusts the same treatment as charitable remainder trusts received in H.R. 6715 as passed by the House, i.e., exclusion of the charitable deduction from the minimum tax preference attributable to excess itemized deductions regardless of when the trust was created. But in any event, charitable lead trusts created under wills or receivable trusts which are used as will substitutes clearly should not be subjected to the minimum tax as a result of their charitable deductions, for the charitable interest would not come into effect until after the death of the grantor. Therefore, there is obviously no potential for individual avoidance of the minimum tax at that time.

An exclusion of charitable lead trusts created under wills and/or revocable trusts which are used as will substitutes is certainly in keeping with Donald C. Lubick's testimony of October 26, 1977 before your Subcommittee when he declared that:

> The only charitable trusts that should be subject to inclusion in the minimum tax preference base are those where the grantor or a noncharitable beneficiary can use the trust as a device to avoid the limitation on excess itemized deductions.

I would appreciate your incorporating this letter into the hearings in such manner that it may be entitled to further consideration by the Committee.

Sincerely,

DONALD J. CRONIN,
Attorney-at-law.

WRITTEN COMMENTS OF THOMAS P. SWEENEY

SUMMARY

The comments set forth herein are respectfully submitted by Thomas P. Sweeney, a partner in the law firm of Richards, Layton & Finger, 4072 DuPont Building, Wilmington, Delaware 19899, as his individual comments pertaining to the particular provisions of the Tax Reform Act of 1976 (P.L. 94-455) set forth below and with respect to S. 1954, S. 2227, and S. 2228 in order to alleviate great inequities and burdens created by the Tax Reform Act of 1976.

SPECIFIC COMMENTS

I. Separate consideration of H.R. 6715 from S. 1954, S. 2227, and S. 2228

Because of the need to eliminate confusion with respect to numerous drafting errors and ambigious language contained in the final version of the Tax Reform

Act of 1976 (P.L. 94–455), it is extremely important to enact promptly H.R. 6715 (The Technical Corrections Act of 1977).

The grave need to repeal or delay the Carryover Basis Rules is a matter of substance and policy that is entitled to consideration separate from an Act intended to make explicit what Congress had thought it had made explicit in the Tax Reform Act of 1976 (P.L. 94–455). Consequently, the policy debates and disagreements which might surround repeal or delay of the Carryover Basis Rules should not give rise to delay in Enactment of a Bill (H.R. 6715) which is intended to merely clarify and make technically correct the Tax Reform Act of 1976 (P.L. 94–455). To delay or defer the enactment of H.R. 6715 would be extremely unfair to taxpayers since a number of the provisions of P.L. 94–455 corrected therein have effective dates which preceded the actual enactment of P.L. 94–455 and thus have created uncertainty as to what should have been reported on prior years' tax returns or in tax returns due to be filed for calendar year 1977.

II. Carryover basis provisions

The Carryover Basis provisions contained in Section 1023 of the Internal Revenue Code of 1954, as added by the Tax Reform Act of 1976, are an undue burden on the citizens of the United States and seem to conflict entirely with the congressional desire to retain and enhance capital formation. Obviously, the private sector cannot continue to develop capital if that capital is constantly going to be confiscated in the form of taxation, particularly when a substantial portion of the capital, in terms of value, is attributable to inflation factors rather than real increases in capital.

The complexities of the provisions of Section 1023 and the failure to consider carefully their interplay with other provisions of the Internal Revenue Code have caused, and are causing, grave problems in the case of decedents dying on and after January 1, 1977.

For example, the carryover basis provisions constitute an unbearable burden on the small estate in Delaware where the probate property is an amount less than $7,500 and the estate can be administered by affidavit rather than by full probate administration. In such situations the actual taxable estate could be several million dollars or several hundred thousands dollars. Jointly-held property, real property, and life insurance proceeds are not subject to probate in Delaware. Under these circumstances, where the estate is administered without counsel, the surviving joint tenant, or tenant by the entirety, and the recipient of the insurance proceeds, etc., has no idea as to the application of the Carryover Basis provisions, the reporting requirements, the tracing requirements, the Fresh-Start Rule, the minimum fair market value of $60,000, and the Ten-Thousand Dollar Rule as to household and personal effects. It is not uncommon with inflation and increased life insurance for the estate of the modest factory worker to reach a size of $100,000 to $300,000 and, where this is the situation, the Carryover Basis Rules creates utter havoc and places an unadministrable burden not only upon the potential taxpayer, but also upon the Internal Revenue Service itself.

For the foregoing reasons, as well as the reason that eventually the Carryover Basis Rules will substantially deplete within the private sector a large portion of the private capital which is currently being used to create jobs for people and in order to achieve simplification and equity, the Carryover Basis Rules should be repealed immediately.

In our office, much to our consternation, we have had to turn down the representation of four individual executors simply because the estates were not large enough (from a probate point of view) to justify the payment of a legal fee under the Rules of the Court of Chancery of a sufficient amount to cover the time that it would take to make certain that the executor complied with the Carryover Basis Rules in ascertaining the decedent's basis in all assets; determining what assets to which the $10,000 exclusion, with respect to household effects, would apply; to determine what assets to which the $60,000 minimum fair market value would apply; and to make certain that the executor would comply with the reporting requirements to the Internal Revenue Service and to the beneficiaries. In each case, the bulk of the estate was jointly held, there were few or no records as to the actual cost, there were few or no marketable securities involved, and thus the Fresh Start Formula which would apply required application of that complicated formula to determine the carryover basis of assets which were not marketable securities and to see how the application of the minimum $60,000 exclusion and the $10,000 personal property exclusion would be applied. Further, in each case it appeared that probably no Federal Estate Tax Return would be required to be filed under the new filing requirements because of the unified credits, but, possibly, such a return may be required depending upon the ultimate valuation of real estate (jointly held) and other jointly-held property.

From the foregoing it is our hope that Congress can see the albatross which it has hung around the neck of the so-called "surviving spouse executor," particularly in small estates with respect to the Carryover Basis Rules.

S. 1954, which would repeal the carryover basis rules enacted in the Tax Reform Act of 1976, would provide the result necessary to provide equity for all taxpayers (small or large) and eliminate in their entirety the problems enumerated above.

However, because of the lack of time and the cumbersome legislative process which was undertaken in passing the Carryover Basis Rules as part of the Tax Reform Act of 1976, the very least that should be done is to defer the effective date of the Carryover Basis Rules as suggested in S. 2227 in order that Congress may have the proper time to consider the devastating effect of the Carryover Basis Rules on *all* taxpayers.

The changes suggested by S. 2228 do nothing more than push the problems off on those taxpayers already bearing the greatest tax burden and fail to take into account that in setting the Estate Tax Rates Congress did consider the fact that assets would receive a stepped-up basis on death (under the pre-Carryover Basis Rules) and set high estate tax rates accordingly. The mistakes of the legislative rush in enacting the Estate and Gift Tax Reform Provisions of the Tax Reform Act of 1976 should have been lesson enough to show that repeal or at least deferral of effective date is what is needed.

Respectfully submitted.

THOMAS P. SWEENEY.

STATEMENT OF THE SUPERIOR OIL COMPANY

The Superior Oil Company files this statement in support of a provision modifying Section 956 of the Internal Revenue Code.

Section 956 of the Code now provides that if a United States corporation owns more than 50 percent of the stock of a foreign corporation and the foreign corporation makes certain investments in United States property, the amount so invested is to be treated as a dividend to the U.S. corporation.

The Superior Oil Company ("Superior") is a U.S. corporation which owns about 53 percent of the stock of Canadian Superior Oil, Ltd. ("Canadian Superior"), a Canadian corporation that is engaged in the exploration for oil and gas in Canada and throughout the world. Canadian Superior's remaining stock is publicly held, and a majority of Canadian Superior's directors are Canadian residents. Canadian Superior has explored for oil and gas off the Outer Continental Shelf of the United States, as well as elsewhere throughout the world.

Since 1964, Canadian Superior has advanced substantial funds to Canadian Superior's wholly-owned U.S. subsidiary for use in the acquisition, exploration, and development of interests in Federal oil and gas leases on the Outer Continental Shelf in the Gulf of Mexico, more than 12 miles beyond the coastline of the United States. The U.S. subsidiary as organized because Federal leasing regulations require that such leases be held by a U.S. corporation.

The amounts paid for these leases have been paid into the United States Treasury. Any oil or gas discovered on these leasehold interests is sold by Canadian Superior to unrelated U.S. companies.

Superior has derived no tax or other benefit from the expenditures made by Canadian Superior. Indeed, since Canadian Superior and its U.S. subsidiary do not have U.S. income from other sources, the usual tax deductions for the oil and gas exploration and development expenditures by Canadian Superior's U.S. subsidiary in excess of its income therefrom have produced no tax benefit. Superior could not properly prevent Canadian Superior, with 47 percent of its stock publicly held, from using Canadian Superior's own funds to acquire oil and gas leases on the Outer Continental Shelf or elsewhere in the world if Canadian Superior considered it desirable to do so.

Superior believes that it was not the intent of Section 956 to cause the expenditures made by Canadian Superior on the Outer Continental Shelf in the ordinary course of its business of exploring for oil and gas to be taxable as dividends to Superior. If Canadian Superior's expenditures in past years were taxable to Superior when made, then under Section 959 of the present law dividends in corresponding amounts paid by Canadian Superior to Superior in future years would be tax-free. The uncertainty of the status of the past expenditures also produces uncertainty as to the tax status of future distributions.

The Tax Reform Act of 1969 added Section 638 to the Internal Revenue Code to provide that for certain purposes the Outer Continental Shelf, even though outside the 12-mile limit, should be treated as being within the United States. It does not appear that Congress contemplated the effect this amendment might have in broadening the scope of Section 956 when the amendment was enacted in 1969. Accordingly, Superior requests the adoption of legislation which provides that investments in property situated on or used exclusively in connection with the Outer Continental Shelf made by foreign corporations subsequent to the Tax Reform Act of 1969 will not be treated as dividends to their U.S. shareholders.

Superior believes that this provision is fair and reasonable and respectfully urges its enactment.

Statement of Thomas J. Reese, Legislative Director

Mr. Chairman and members of the committee, My name is Thomas J. Reese and I am Legislative Director of Taxation with Representation, a public interest taxpayers' lobby with over 15,000 members.

I want to urge the committee not to change the effective dates of any additional part of the Tax Reform Act before these matters are taken up in connection with the Administration's tax reform proposals. Changing anything now will only cause additional confusion and uncertainty.

Carryover Basis.—Under prior law, the cost or other basis of property acquired from a decedent generally was "stepped-up" to its fair market value at the date of death. The Tax Reform Act of 1976 provided that the basis of property passing from a decedent who dies after December 31, 1976, is to be the same as the decedent's basis immediately before his death (with certain adjustments). The basis of appreciated property is increased by federal and state death taxes attributable to the appreciation in that property. In addition, the aggregate basis of all carryover basis property may be increased to a minimum of $60,000. A $10,000 exemption is provided for household and personal effects of the decedent. Generous transition rules were provided.

Taxation with Representation did not support the carryover basis provision in the reform bill. Rather we always supported a stronger proposal calling for taxation of capital gains at death. Because of the opposition of those who opposed taxing gains at death, you adopted the carryover basis provision, essentially as a compromise, rather than the simpler, more equitable, and more efficient proposal to tax gains at death. But since you did adopt the carryover basis provision, we think that it should remain the law until the administration's forthcoming tax proposals can be considered.

According to a study by Professor James D. Smith of Pennsylvania State University, which is attached to my testimony, only 7% of the population had a net worth of over $60,000 in 1972. He estimated that only the estates of the richest 5% of the population were taxed under the old law. Under the new law, an estate does not become taxable unless far larger amounts are involved; up to half a million dollars can now pass estate-tax-free in some circumstances. I would guess then that less than 2% or 3% of the populaton will be affected under the new law by the carryover basis provision.

Attached to my testimony you will find a copy of Professor Smith's article. In adidtion, I have attached a copy of a news story from Tax Notes, October 17, 1977, which describes the hearings before the Ways and Means Committee on carryover basis. I ask that both of these articles be printed as part of the record. I hope you will find the Tax Notes story interesting, especially my comments on carryover basis which are quoted.

Thank you, Mr. Chairman.

Attachments: "Congressional Testimony Carryover Basis Hearings." Tax Notes, October 17, 1977, page 11. James D. Smith, "The Impact of the Estate Tax: Only the Wealthy Feel Its Bite," Tax Notes, April 26, 1976, pages 18–22.

Congressional Testimony

CARRYOVER BASIS HEARINGS

The House Ways and Means Committee October 6 heard strong criticism of a new system of dealing with the appreciation of assets held until death—a system that President Carter is expected to propose scrapping in favor of a much tougher one that would increase tax collections on those assets by about $17 billion a year. Tax experts gathered at the Ways and Means hearings to allege severe administrative problems with the current system of "carryover basis." But a tax reform lobbyist angered the tax experts when he asserted that their real objective was to lower their clients' taxes.

Carryover basis requires that the cost of an asset when acquired by a decedent, be carried over by the heir and used in the heir's computation of gain or loss when the asset is sold. This contrasts with the practice prior to enactment of the Tax Reform Act of 1976 under which heirs could assume that the cost of an asset received from a decedent was the value at the time of death. This had the effect of substantially reducing or eliminating any tax on the capital gains realized when the heirs sold the asset.

Tax practitioners critical

Witnesses from several organizations, including the Tax Section of the American Bar Association, the American Bankers Association, the American Institute of Certified Public Accountants, the American College of Probate Counsel and the New York Bar Association, supported repeal of the carryover basis provision. Thomas J. Reese, legislative director of Taxation with Representation, which describes itself as a public interest taxpayers' lobby, was one of the few witnesses to defend carryover basis, though he said he preferred an actual income tax on gains at the time of death. The same position on carryover basis and in favor of a tax on gains at death was advocated by Sheldon S. Cohen, former Commissioner of Internal Revenue and now the principal partner in the Washington law firm of Cohen & Uretz.

Such a proposal is expected to be proposed by President Carter along with an end to preferential treatment for lifetime gains as well. The tax on gains at death would raise an estimated $1.7 billion a year when fully effective and the lifetime gains proposal would raise another $4.5 billion annually.

Ways and Means member Charles A. Vanik, D-Ohio, asked Reese to respond to the objections to carryover basis raised by the other witnesses. Following are excerpts from his answers:

The first point to remember is a person has to have over 60 or 70 thousand dollars worth of capital before the carryover provision will affect him.

The povision in the law says that the total assets of the estate can be stepped up to $60,000, plus there is a $10,000 exemption for personal property and household goods.

My second point is that this committee cannot deal in the tax code with stupidity. If people do not keep records there is not much that this committee can do about it. These people are already hiring highly sophisticated tax lawyers to avoid paying any taxes.

I agree the carryover basis provisions are not simple, but we have had the carryover basis problem with gifts for many years. People had to figure out what their basis was if they were going to give away their assets. We have the same problem now with transfers at death.

Also, if the property came from another decedent, the tax return that was filed with the estate tax will give the basis at the time of the death of the parent, or whoever left the property to the decedent. Thus, you have that basis recorded on the old estate tax return.

Goal is tax reduction

Now I do not want to minimize entirely the amount of problems with carryover basis, but I think the bottom line for the people testifying here today is that they want to reduce the taxes of their clients to the lowest possible amount.

If you enacted into the law a 10 percent credit for appreciation on property of an estate, I think that these people could figure out quickly how to calculate the appreciation in an estate in order to take advantage of that 10 percent credit.

It is only when we have a problem of taxing and paying taxes that all of these terribly complex problems arise. I don't think that these people would be concerned about the complexity of setting up generation-skipping trusts.

We are talking about people that are paying thousands of dollars to their tax lawyers in order to figure out how not to pay estate taxes. We feel these people ought to be paying estate taxes. Because of the tremendous amount of lobbying on this issue, we did not get a simple solution, namely, the taxing of capital gains at death.

We think that taxing capital gains at death is proper and could be very simple with a large exemption. I don't care what the exemption is, it could be $60,000 worth of capital gains, $100,000 worth of capital gain. Maybe this committee will have to go to a million dollars worth of capital gain in order to exempt the so-called small business and small farmer, but somewhere along the line we have to tax capital gains at least once in a person's lifetime.

James C. Corman, D-Calif., a member of the Ways and Means Committee noted wryly that people always complain about tax-raising provisions but never complain about tax incentives. "We have the wrong people drafting the wrong pieces of the tax code," he said. "Whoever drafts tax incentives is very, very good. I have never seen them draft one so complicated you could not live with it. But every time we try to impose taxes, they run in the other team and write it so complex you can't live with it."

The Impact of the Estate Tax: Only the Wealthy Feel its Bite

(By James D. Smith)

The federal estate tax produces relatively little revenue, $3 billion a year, compared to $103 billion from the personal income tax and $36 billion from the corporate income tax. It was never intended to be a leading source of public funds. Its purposes have been and should continue to be to act as (1) an impediment to the accumulation of such great economic power in the hands of the few as to undermine the political efficacy of the many, and (2) a mechanism to even out to some degree the life chances of children who had the foresight to choose rich parents and those who lacked such prescience. Thus, the estate tax is one of a class of instruments intended to make the market and political systems fairer and, perhaps, more efficient games. Given its peculiar functions, it is important to insure that it provides horizontal and vertical equity, i.e., that equals are treated equally and nonequals unequally.

Unfortunately, the estate tax is not the best suited type of death tax for achieving its intended ends. Many of the problems (including that of liquidity) associated with the estate tax would be less troublesome if we had an inheritance tax. Under the present system of levying a tax against the value of the entire estate, the potential inheritance of a poor heir and a rich one are dminished by the same proportion. There is little point in worrying about equity among the dead and of any power that they may exercise. If a goal of the estate tax is to disperse economic power, it would be well to tax inheritances on the basis of the combined prior wealth and inheritance of the *legatees*. Such a system could permit the transfer of rather sizeable amounts of wealth, without any tax, to persons of modest means and could tax quite heavily wealth flowing to the already affluent.

THE DISTRIBUTION OF WEALTH IN THE UNITED STATES

In most uses of wealth distribution data, we are interested in economic units such as the family, because study of those units gives us a better view of one's economic status than does the study of the wealth an individual holds in his own name. This is particularly true of the very young and very old. However, for purposes of formulating estate tax policies, the indvidual is the natural tax unit, because it is the individual's death that triggers the tax.

For practical purposes, a quarter of all U.S. citizens owned nothing in 1972. Many of these unpropertied persons were, of course, children, but also included are the old, and young adults living in poverty. About 55 percent of all individuals had a net worth of less than $5,000, and I am not talking simply about financial assets, but also about houses, automobiles and personal effects in the manner in which the IRS views these things. Only about 7 percent of the population had a net worth of $60,000 or more in 1972. Nobody below this 7 percent of the population has his estate taxed if he dies, and for practical purposes, one is probably safe in saying that only the estates of the richest 5 percent of the population are taxed at all under the present estate tax system.

The Assets Held by the Rich

For some perspective about the types of assets hed by the rich (those with a net worth of $60,000 or more), let us examine that group more closely. It is apparent that a substantial share of the total value of several types of assets are held by his group of wealth-holders. Taking into account the normal statistical errors attendant on data such as these, citizens with a net worth of $60,000 or more in both 1969 and 1972 held practically all the value of personally held state and local bonds, federal bonds (other than savings bonds), notes and mortgages, and foreign and corporate bonds.

The most popular asset of the affluent is corporate stock, followed by real estate. Surprisingly, the rich as a group hold a high proportion (13 percent of their portfolio in cash (demand and time deposits). If various types of bonds and notes and mortgages are added to cash holdings, it turns out that 25 percent of the wealth of the rich is in a highly liquid form. Although some of the corporate stock held by the rich is issued by closely held corporations, the overwhelming share represents traded securities, which are highly liquid. The general conclusion suggested by these data is that the rich, as a group, maintain very liquid portfolios.

Wealth Concentration Constant Over Time

Looking at the distribution of wealth over a period of years, one is struck by the constancy of its concentration. Because a dollar value, such as $60,000, implies different levels of real wealth in different years as price levels change, secular movement in wealth concentration is best looked at by taking some fixed percent of the population arrayed by wealth level. In Table 1 the share of the nation's personally owned wealth held by the richest 1.0 percent and 0.5 percent of persons is displayed. It can be seen from Table 1 that the share of U.S. wealth held by the richest half of 1 percent of the population has been measured repeatedly at between 22 and 24 percent of the total, over a period of nearly two decades.

If we go back further, there is evidence that at times there have been trends toward less concentration. My colleague, Robert J. Lampman, of the University of Wisconsin, has provided us with estimates for selected years from 1922 through 1956. When his estimates are added to our own, a picture of the historical trend emerges. Wealth in the United States has become less concentrated in the last half century. But the diminution, is not great, and it all occurred in periods when the market system was functioning with difficulty or was in administrative abeyance, specifically during the Great Depression and World War II.

Because wealth in the U.S. continues to be so highly concentrated, as shown in Table 1, the burden of the estate tax is similarly concentrated. And because the estate tax burden falls predominantly on the most wealthy, any move to cut estate taxes will necessarily confer its greatest benefits on those whose wealth is substantial.

THE LIQUIDITY ISSUE

The President and others have stated that the estates of some decedents may suffer a hardship in paying their estate taxes because of lack of liquidity. The issue is felt to be particularly important in the case of family farms and small businesses. There is little question that converting assets to a liquid form to pay taxes may pose a financial burden on some estates. But from a policy point of view, there are a number of questions that must be answered before one can be comfortable in recommending legislation to alleviate the alleged liquidity problem:

How extensive is the liquidity problem?

In addition to farms and businesses, are there other nonliquid assets, such as personal effects, jewelry, art, household durables and the like, which also pose a liquidity problem?

Is a lack of liquidity in estates an inadvertent condition of the decedent's prior economic life or is it in part due to prior inter-vivos transfers of liquid assets to the legatees who may use them to pay estate taxes?

Is the estate the correct unit of analysis for deciding whether a liquidity problem exists? Or is the liquidity of the legatee also a relevant consideration?

TABLE 1.—SHARES OF RICHEST 0.5 PERCENT AND 1 PERCENT OF PERSONS IN NATIONAL WEALTH, 1953, 1958, 1962, 1965, 1969 AND 1972

[Dollar amounts in billions]

Asset	1953					1958					1962				
	Value held by richest			Share held by richest		Value held by :ichest			Share held by richest		Value held by richest			Share held by richest	
	100%	0.5%	1%	0.5%	1%	100%	0.5%	1%	0.5%	1%	100%	0.5%	1%	0.5%	1%
Real estate	$439.0	$45.0	$68.0	10.3	15.5	$621.5	$62.5	$93.9	10.1	15.1	$770.0	$79.6	$117.8	10.3	15.3
Corporate stock	151.1	116.6	130.8	77.0	86.3	264.1	175.9	199.2	66.6	75.4	426.4	227.3	264.4	53.3	62.0
Bonds	72.8	33.0	38.3	45.3	52.6	87.0	31.3	36.0	36.0	41.4	94.5	33.2	38.4	35.1	40.6
Cash	160.1	20.9	28.8	13.1	18.0	216.0	22.5	32.8	10.4	15.2	278.3	28.9	42.5	10.4	15.3
Debt instruments	34.0	8.2	10.9	24.1	32.1	43.7	12.5	16.3	28.6	37.3	51.5	16.5	21.8	32.0	42.3
Life insurance (cash surrender value)	64.5	6.6	9.1	10.2	14.1	79.9	7.5	11.3	9.4	14.1	93.8	7.1	10.7	7.6	11.4
Trusts	20.5	17.5	18.8	84.5	91.7	30.3	25.8	27.9	85.1	92.1	46.1	NA	NA		
Miscellaneous	222.8	12.5	19.8	5.5	8.9	312.9	19.8	24.9	6.3	7.9	379.4	39.8	52.7	10.5	13.9
Total assets	1,144.7	242.8	305.7	21.2	26.7	1,625.1	332.0	414.4	20.4	25.5	2,093.9	432.4	548.3	20.7	26.2
Liabilities	140.0	21.3	29.0	15.2	20.7	227.4	29.2	38.3	12.9	16.8	314.0	47.8	61.0	15.2	19.4
Net worth	1,004.7	221.5	276.7	22.0	27.5	1,396.7	302.8	376.1	21.7	26.9	1,779.9	384.6	487.3	21.6	27.4
Number of persons (millions)		.80	1.60				0.87	1.74				.93	1.87		

Asset	1965					1969					1972				
	Value held by richest			Share held by richest		Value held by richest			Share held by richest		Value held by richest			Share held by richest	
	100%	0.5%	1%	0.5%	1%	100%	0.5%	1%	0.5%	1%	100%	0.5%	1%	0.5%	1%
Real estate	$917.7	$94.4	$135.8	10.3	14.8	$1,188.8	$117.0	$170.7	9.8	14.4	$1,492.6	$150.9	$225.0	10.1	15.1
Corporate stock	596.6	317.2	364.9	53.2	61.2	832.1	366.3	423.3	44.0	50.8	870.9	429.3	491.7	49.3	56.5
Bonds	103.6	57.5	63.2	55.5	61.0	133.9	63.7	71.5	47.6	53.4	158.0	82.5	94.8	52.2	60.0
Cash	366.0	43.7	62.7	11.9	17.1	496.9	48.1	71.2	9.7	14.3	748.8	63.6	101.2	8.5	13.5
Debt instruments	53.3	19.8	25.4	37.1	47.7	72.4	21.9	29.6	30.2	40.9	77.5	30.3	40.8	39.1	52.7
Life insurance (cash surrender value)	107.2	6.5	10.9	6.1	10.2	127.2	8.4	13.8	6.6	10.8	143.0	6.2	10.0	4.3	7.0
Trusts	57.5	49.0	52.7	85.2	91.7	69.9	60.0	64.5	85.8	92.3	99.4	80.3	89.4	80.8	89.9
Miscellaneous	456.6	36.3	49.1	8.0	10.8	632.8	47.0	68.7	7.4	10.9	853.6	59.5	83.3	6.8	9.8
Total assets	2,601.0	575.4	712.7	22.1	27.4	3,484.1	672.4	848.8	19.3	24.4	4,344.4	822.4	1,046.9	18.9	24.1
Liabilities	413.3	57.0	73.1	13.8	17.7	557.5	75.8	100.5	13.6	18.0	808.5	100.7	131.0	12.5	16.2
Net worth	2,187.7	518.4	639.6	23.7	29.2	2,926.6	596.7	748.1	20.4	25.6	3,535.9	721.7	915.9	20.4	25.9
Number of persons (millions)		.97	1.94				1.01	2.03				1.04	2.09		

To answer these questions, we computed for each estate a ratio of (a) federal estate taxes plus administration costs, to (b) liquid assets minus debts. We regard this ratio as a conservative index of the etate's ability to pay estate taxes without forced liquidation of less marketable assets.

Liquidity Problem Not Extensive

It is clear from a study of the figures that the liquidity problem is less extensive than one might expect. Nearly three-quarters of the estate tax returns filed in 1973 had a ratio of taxes and costs to liquid assets minus debts of less than .25, and 91 percent paid taxes of no more than 75 percent of their liquid assets, after prior payment of all debts. Only about 6 percent of the estates filing returns in 1973 had taxes and costs equal to or greater than their liquid assets once all debts had been paid.

The Ford Administration's assertion that estates which include unincorporated businesses or farms are substantially less liquid than others is not entirely without merit, however. About 16 percent of the estates in 1973 that contained business or farm assets had a ratio of taxes plus costs equal to .75 or more of their liquid assets once debts had been subtracted, compared to only 4 percent for estates without business and farm assets.

The estate tax base includes within it certain lifetime transfers which, though not the property of the estate, are included for purposes of tax computation if they were made in contemplation of death or were for less than fair market value. These transfers add to the estate's taxes, but have not been included as part of liquid assets in our ratio. When the returns are tabulated after excluding those with lifetime transfers, there is a further diminution of the proportion of estates iwth a high ratio of taxes to liquid assets.

Another factor to be kept in mind when evaluating an estate's liquidity is that inter-vivos transfers may well have been made to potential heirs by the decedent. In there is a tendency, for estate planning purposes, to transfer liquid assets to those who will be named as heirs, the liquidity problem will be even less a matter of concern for public policy.

Finally, with all due respect to the Administration's proposal, I suggested that it is not the liquidity of the estate that should be the controlling issue. The real burden, indeed the only meaningful burden, of a death tax is that which falls upon the living. A death tax levied against a very nonliquid estate is not a liquidity problem to an heir who is himself in a liquid position, or who is rich enough so that access to the capital market is relatively easy.

Evaluating the Liquidity of Surviving Spouses

We can provide a limited amount of insight into the liquidity and wealth position of the heirs by looking at the one class of human heirs, spouses, who are identified on the Form 706. Married men, on the average left (or the courts distributed) 65 percent of their estates to their surviving spouses. Married women left about 50 percent to their spouses. We can, by making a not-too-heroic assumption that husbands and wives share roughly equally in the ownership of assets, ask the question: What is the liquidity burden on the spouse of a tax levied against the estate of the decedent spouse? To simulate this situation, we altered our computer file in the following way:

The surviving spouse of each decedent was assumed to have assets equal to the decedent's estate. In other words, if the decedent was shown to have an estate with an economic value of $1 million, the surviving spouse was assumed to have assets equal to $1 million. This may understate the survivor's wealth and liquidity, because debt associated with the cost of the last illness (which reduces the value of the decedent's estate) should not be subtracted from the survivor's assets.

The surviving spouse was assigned a tax rate proportionate to the share of the decedent's estate he or she received. Thus, if the surviving spouse got 80 percent of the decedent's assets, the survivor also was assumed to have borne 80 percent of the tax.

The ratio of tax burden to liquid assets of the surviving spouse was calculated.

When these things are done, the liquidity problem, at least for transfers at death among spouses, nearly disappears.

Table 2 summarizes a portion of these findings. The table shows the percentage of returns in each asset class on which taxes were equal to or greater than the liquid assets available to the surviving spouse. (The liquid assets included those in the decedent's estate.) These results are shown for estates which consist of some farm and non-corporate business assets, the least liquid type of assets. Results are shown for all estates. In addition, the table shows the percentages of estates in each asset class that paid no taxes.

Conclusions Regarding Liquidity

Thus, whether one looks at the figures relating to the ratio of taxes and other costs to liquid estate assets, or at figures relating to the liquid wealth of surviving spouses, the point is the same: the liquidity problem is less than one might expect, even when attention is concentrated on estates containing farms or closely held business assets. On average, almost 93 percent of farm and business estates encounter no liquidity problem. Even where the liquidity problem is worst—in estates in the $200 thousand to $1 million range—about 90 percent of all estates escape difficulties. Solutions to whatever liquidity problems may exist should take these facts into account.

TABLE 2.—LIQUIDITY BURDEN ON SURVIVING SPOUSES, 1972

Economic value of estate (includes cash value of life insurance; excludes life transfers) thousands of dollars	Percentage of returns where taxes were equal or more than liquid assets: Some farm and noncorporate business assets	Percentage of returns where taxes were equal or more than liquid assets: All returns	Percentage of returns showing no estate tax liability: Some farm and noncorporate business assets	Percentage of returns showing no estate tax liability: All returns
Negative value	2.4	1.5	97.6	98.5
Less than $60	0.7	.2	99.3	99.8
$60 to $80	4.0	1.4	76.8	83.5
$80 to $100	4.7	1.6	74.5	80.5
$100 to $150	6.9	2.6	47.5	51.9
$150 to $200	7.9	5.7	1.0	1.4
$200 to $300	10.8	4.6	1.4	1.2
$300 to $500	10.3	5.4	.5	1.0
$500 to $1,000	10.0	4.4	.4	.5
Over $1,000	6.3	3.3	1.0	1.2
Average	7.4	2.9	38.8	48.3

THE NORTHERN TRUST CO.,
Chicago, Ill., October 25, 1977.

Re Carryover Basis Provisions of The Tax Reform Act of 1976.

Hon. RUSSELL B. LONG,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: We have been advised that hearings on the carryover basis provisions of The Tax Reform Act of 1976 have been scheduled by a Subcommittee of the Senate Finance Committee this week. On Thursday, October 6, 1977, the Ways and Means Committee of the House of Representatives held hearings on the same subject. Raymond E. George, Jr., Senior Vice President in our Trust Department, testified at those hearings. A copy of this prepared statement as filed in support of his testimony is enclosed.

As you will see from Mr. George's statement, one of the major administrative difficulties which any executor will encounter under the present provisions is the determination of the basis of the decedent's assets. Our actual experience to date shows that it takes an average of more than three quarters of an hour to determine the basis of an asset and that the consequent increase of administrative costs will approximate 20 percent for this function alone. Additional costs will be involved in connection with the complex computations involved in adjusting the carryover basis pursuant to the statutory rules.

In our opinion, it is unreasonable to impose such a cost burden upon the general public. It should be noted that the carryover basis provisions are applicable to estates of all decedents who own assets with a basis in excess of $60,000, not just to the estates of those required to file Federal estate tax returns.

If a professional fiduciary has the problems indicated in Mr. George's statement, it is reasonable to ask how individuals, not skilled in such matters, can possibly cope with the problems presented by the carryover basis provisions.

It is our recommendation that the carryover basis provisions of the Code be repealed. We believe that only in this way can this unwarranted burden be lifted from the general public.

With current newspaper articles indicating President Carter's intention of reducing taxes in the neighborhood of $16 to $20 billion, it would seem unnecessary to provide a replacement for the speculative revenues which would be generated at some far distant future date by the carryover basis provisions. If, however, such replacement is deemed essential, we would recommend that the method adopted be one which would not require establishment of the decedent's basis in assets. While some argue that taxpayers should and do keep adequate records, the clear truth of the matter, as demonstrated by our actual experience, is that they do not. We would specifically abjure taxation of gains at death, not only because of the necessity of establishing the decedent's basis but also because of the liquidity problems which it would impose, particularly on estates comprised of closely held businesses, farms and other illiquid types of assets. Perhaps a modest upward adjustment of the unified tax rates would provide both the required revenue and the much to be desired simplicity in administration.

We respectfully request your support of measures which will eliminate the impossible burden which the carryover basis provisions would impose on the general public, whether they take the form of outright repeal or a postponement of the effective date to give Congress the time to study the matter in depth. We believe it is essential that action in this regard be taken before Congress adjourns this Fall.

Very truly yours,

J. GORDON HENRY.

Enclosure.

STATEMENT OF RAYMOND E. GEORGE, JR., SENIOR VICE PRESIDENT OF THE NORTHERN TRUST CO., CHICAGO, ILL.

The Northern Trust Company is among the three largest trust companies in the nation in terms of assets under management in accounts established by individuals. I have responsibility for the administration of probate estates and personal trusts which involves over 7,000 accounts. I come before you today in an effort to describe to you the extreme administrative difficulties which have been created by the carryover basis provisions for executors of estates both large and small.

We are certain that you have heard from many sources the great difficulties which fiduciaries all across the country are having in administering the carryover basis provisions under the 1976 Tax Reform Act. We believe our experience at The Northern Trust Company demonstrates that these provisions of the Act are incapable of efficient administration at an acceptable economic cost.

You should be aware that the executor's job of developing cost basis information in an estate is a difficult and time consuming process even in the best of circumstances. Even if the decedent had the resources to hire an accountant to maintain his cost basis records or the skills to do it accurately himself, at the very least the executor has the fiduciary duty to verify that capital changes have been properly reflected and adjustments to basis accurately made. As an example of how complicated this process can be, annual dividends of certain widely held utilities are partially nontaxable, and each such payment requires an adjustment to basis. Another illustration is Georgia Pacific Corporation whose common stock has had over 30 capital changes affecting its basis in the past 10 years. Many of these issues are favorites of elderly people and have been held by them for many years. Thus, a seemingly simple taks of verification of historical data can become an expensive and time consuming effort.

It has been our experience to date, that the ideal situation of complete and accurate records as to cost basis is a rare occurrence. On the contrary, in the majority of cases, we have found decedents' records to be woefully inadequate and in some situations nonexistent. For example, we are currently administering an estate worth approximately $380,000 consisting of 56 issues of stock. The decedent's records were voluminous, unorganized and filled three large cartons. As executor, we were first required to sort through this material and organize it. Then we had to analyze relevant documents, balance the decedent's holdings at death to his records and then calculate the bases. Even then, cost basis records were incomplete and we had to search Probate Court files to locate and trace assets received from the mother's and father's estates. All of this work required approximately 80 manhours of experienced staff employees. The projected cost to the estate for this extraordinary work would be $30 per hour for a total of $2,400. This would be in addition to the typical executor's fee of $10,000 in an estate of this size.

In cases where records are nonexistent, the process of establishing the decedent's basis can be equally as frustrating and time consuming. Section 1023(g)(3) of the Code suggests that you use fair market values as of the decedent's dates of acquisition. This apparently presumes that if you have no records to establish dates of acquisition, you use the dates which appear on the stock certificate. In some cases this might work, but not always. We have an estate where all of the stock certificates were dated in April, 1970 and we have no record older than 3 years. We have determined that anyone from whom the decedent might have inherited property predeceased him by many years. It seems unlikely that he acquired these stocks all at one time and consequently, as executor, we have had to write the transfer agent for each of 45 issues the decedent owned to request a transcript of activities. We are aware that in several cases, the transfer agents have changed and anticipate that we will have considerable difficulty tracking back to previous record keepers. Assuming transfer agent charges average $10 per issue and we are required to spend a minimal 2 hours per issue, at $30 per hour, the additional cost to the estate in this case could easily exceed $3,150.

Attached to this statement are Appendix A which sets forth other examples of the carryover basis problems under the 1976 Act and Appendix B which gives a sampling of time executors have had to spend merely to establish cost basis data. As you will see from Appendix B, even in modest size estates in the $100,000 to $400,000 bracket it is not uncommon for the executor to have to spend over one hour per issue to complete this task and in one $60,000 estate almost 3 hours per issue was required.

To illustrate these difficulties further, consider the case of an individual, who during the 25 year period before his death, owned three homes at different times, one in New York, one in Connecticut and one in Florida, each of the latter two being acquired in part by the reinvestment of the proceeds of the previously owned residence. Consider, also, that the decedent may have various expenditures with respect to each home. At his death, his executor must determine the original basis of the first home, then roll over that basis, with adjustments, into the next residence and repeat the same adjustment procedure as to the third. In each instance he must identify expenditures made in connection with each residence and assign them to one of three categories: maintenance and repair, ordinary improvements or "substantial improvements". Those assigned to the first category are ignored for purposes of basis, those assigned to ordinary improvements are added to basis, and those in the "substantial improvements" category (Sec. 1023(h)(2)(D)) must be identified as a separate asset for Sec. 1023 adjustment treatment. This enormously difficult task must be done at least on a tentative basis before sale by the executor or distribution to the heirs or other distributees. If the last residence is held in joint tenancy with right of survivorship, the executor must provide basis information almost immediately to the survivor.

Even when the cost information of a decedent's assets has been obtained, the fiduciary is faced with additional administrative burdens. In most estates, sales are required at the outset of administration to raise money for death taxes and expenses. Gains or losses realized on the sales are reportable on a fiduciary income tax return which is often filed prior to the due dates prescribed for the Federal estate tax return and any state death tax returns. In these cases, as well as the situations where Federal estate or State death tax returns are revived upon audit, the final adjustments to basis authorized by § 1023 cannot be made, and the executor is required to file both a tentative return based upon the executor's best estimate and an amended return based upon the adjustment figures as finally developed.

Another type of administrative problem caused by the adoption of carryover basis rules, with their many exceptions and adjustments is the imposition on executors and administrators of a number of judgment decisions, as well as mathematical determinations.

Stamp and coin collections, jewelry and clothing present particular difficulties in tracing original costs and current values. Even when the executor or administrator has established cost figures, the determination of current values must of necessity be approximations based on the opinions of appraisers and are subject to question and revaluation by an IRS agent on audit. The language of the Code is not clear whether an asset worth more than $10,000 can be selected for a kind of "proportionate" exemption. Neither is it clear what the effect is if the executor reports an item of jewelry at, say $9,000, and the agent on audit finds it worth $13,000. Moreover, the selection of personal and household effects for the purpose of the $10,000 exception must be made before the time the estate tax return is filed.

The proper funding of marital deduction and residuary trusts creates considerable uncertainty for a fiduciary in selecting assets to satisfy such bequests where the testator or grantor has died since January 1, 1977. No guidance has been given by the IRS on the subject and professional corporate fiduciaries and their attorneys are far from unanimous as to the course to be followed. In drafting new wills attorneys are unclear as to whether specific directions should be given to the legal representative in regard to funding marital formula bequests or whether the choice of assets may, or must, be left to the executor's discretion and if the latter, what liability the representative may incur if he makes a non pro rata allocation of high and low basis assets or if he violates state rules on fiduciary impartiality. In view of the current decisions holding the legal representative to be a virtual guarantor of success in the outcome of his tax decisions, the responsibilities of the representative are indeed frightening.

Carryover basis rules are capable of producing capricious results never intended by the Congress. It is possible that when an heir inherits property subject to a liability that exceeds the carryover basis from the decedent, the heir may suddenly discover he has a potential income tax liability greater than the net worth of the property inherited. For example, assume A purchases property for $10,000 in 1974. The property appreciates in value to $100,000 by 1990 when A mortgages the property for $80,000. He died in 1992 when the property has a value of $100,000 and the mortgage is still outstanding in the amount of $75,000. Assuming the computation of the "fresh-start" adjustment results in a basis for gain of $20,000 and assuming also that the property is sold in 1992 by the heirs for $100,000, they will realize taxable income of $80,000 which at a 35% capital gain rate will generate a tax liability of $28,000. After paying the mortgage of $75,000 they will have only $25,000 left but have a tax liability for $28,000.

Probate Court records for the Greater Chicago area indicate that 1560 estates were opened in 1976 that had a value in excess of $100,000. See Appendix C. In 1156 or approximately three-fourths of those estates, individual executors were responsible for the administration. While a professional fiduciary can be expected to develop the cost information and make the many difficult calculations and adjustments required by the new act (though at an increased cost to the beneficiaries), it is unlikely that the individual executor will be able to cope with these multiple problems by himself. The result will be either increased administrative expense to the estate where outside professional aid is sought or massive noncompliance where the uninformed or overwhelmed individual executor fails to satisfy the new requirements. In this regard, proper enforcement of the income tax laws becomes impossible and increased income tax revenues, which were designed to offset revenue lost from the increased estate tax exemption, will not be forthcoming.

In conclusion, we feel that the difficulties caused by carryover basis provisions of the 1976 Tax Reform Act, including the excessive expenses involved in establishing a decedent's cost bases, both with and without adequate records, the complicated mathematical adjustments and the burdensome decisions placed on the executor, warrant repeal of these provisions.

Appendix A

Examples of Carryover Basis Problems Under the 1976 Tax Reform Act

1. A was given 120 shares of XYZ Corporation by her father at various times from 1938 through 1954. A was given an additional 65 shares of stock in this same company by her mother at various times from 1944 through 1947. XYZ Corporation was a small business that had been started by A's father in 1906 and the shares she received from him consisted of a portion of the shares originally

issued upon formation of the company. The shares which A received from her mother had been purchased by her mother in 1938. A had no records which would indicate what her father's or mother's costs of acquisition were, what the value of the stock was when the gifts were made or the amount of any gift taxes that may have been paid. Company records prior to 1921 had been destroyed by fire and consequently the only source documents were the minute books, certificate books and cancelled certificates of the corporation from 1921 through 1976. Examination of these records and determination of book values required 104 hours of professional and other staff time, costing approximately $2,850. These shares were determined to have a fair market value of $28,750 and a cost basis relating back to 1906 and 1938 of approximately $11,650, for a total gain of approximately $17,100. (Source: The Northern Trust Company)

2. Decedent's estate consists of 45 issues of stock. Decedent's cleaning lady was very efficient and discarded all of his records that were older than three years. Consequently, the Executor has been unable to locate any information regarding the cost basis for these securities. All but a few of the stock certificates were dated in April, 1970. The decedent had no immediate surviving family and relatives from whom he might have inherited property predeceased him by many years. Since it is unlikely that the decedent acquired all of these assets at the same time, the Executor was required to write the transfer agent for each company involved. It is estimated that two to three hours per issue will be needed to finally establish the decedent's bases. (Source: The Northern Trust Company)

3. Decedent owned a home at the time of his death which he purchased in 1970. Decedent's federal income tax return for 1970 shows that the gain from sale of a previous residence was deferred when his last residence was acquired. According to statements by distant relatives, the decedent lived in at least two other residences during his lifetime. Decedent had no records which would indicate when these former residences were purchased, where they were located, the prices paid for them or whether any improvements were ever made. The Executor will be forced to search through title documents and other documents on file in the County Recorder's office. It is not possible to estimate the time that will be required to search back to obtain the required information. (Source: The Northern Trust Company)

4. Decedent's estate consists of 56 issues of stock. His records were quite voluminous and filled three cartons. Information regarding the basis of these securities was available for about 50 percent of the issues. The balance of the cost basis information was obtained by searching Probate Court records to determine which assets were acquired by decedent from his mother's and father's estates. Approximately 80 hours or 1⅓ hours per issue were required to establish cost bases for these securities. (Source: The Northern Trust Company)

5. A decedent has died since January 1, 1977 with approximately $1 million in personalty, consisting of numerous items of furniture, pictures, jewelry, silverware, china, etc. maintained in four separate homes and acquired from innumerable sources, including substantial gifts and inheritances from a long line of family members during the lifetime of the decedent who died at age 94. Cost records for these items are incomplete, and since some were acquired by gift, they may well trace back more than 100 years. Any attempt to list and define anything approaching an accurate cost for these items could well lead to the expenditure of 100 or more man-hours of the Executor's time. (Source: Cleveland Trust Company)

6. A sampling of trust accounts at Bank X in which the Grantor has died after January 1, 1977 indicates that even when cost figures are available, there will be extensive adjustments to basis required which will be time consuming and complicated. For example, in one trust, there are 84 different securities represented by 98 different blocks. In another trust, there are 62 securities represented by 97 different blocks. Under current law, the executor is therefore required to make 196 and 194 adjustments for death taxes on the appreciation element in each block. If a separate fraction is developed under the Technical Amendments Act for state death taxes, these figures may be increased respectively to 392 and 388 adjustments. These are representative normal trust accounts in which Grantors have died, and it is apparent that TRA 76 has injected enormous complexity into what used to be routine accounts. (Source: Cleveland Trust Company)

7. In a very large estate, there is a Florida residence valued at approximately $3,500,000 and a Cleveland residence valued at approximately $1,250,000. The land for the Florida residence was acquired in 1894. The original structure was put

up in 1920. There have been major additions to the property from 1920 to the present. The original architect is deceased. The original and subsequent building plans are available, but incomplete. Preliminary drawings are difficult to distinguish from the final plans used. The cost records are incomplete and they are difficult to document because the family archives contain numerous records for five substantial residence properties owned by the decedent over a period of seventy years. Consequently, both the cost of the original property and construction and the history of the improvements and additions are virtually impossible to document. Yet the executor has substantial monetary consequences at stake with respect to the cost of the original structure and improvements. (Source: First National Bank of Chicago)

8. An asset in an estate of a recently deceased widow is an 8 unit apartment building. Ownership of the apartment building passed to the decedent as surviving joint tenant on the death of her husband in 1962. Neither a federal nor a state death tax return had to be filed at the death of the husband; no appraisal was made of the property at that time nor was the depreciation basis altered. In order to apply the "fresh start" provisions of Section 1023(h)(2), the executor is now confronted with the task of securing an appraisal of the real estate as of the death of the husband in 1962. (Source: First National Bank of Chicago)

9. Securities owned by the decedent were held in street name by broker A. Broker A acquired decedent's account when Broker B was merged into the successor firm. The records of broker A are sketchy for many of the securities as to both date of acquisition and cost. Since the securities are in street name, it is not possible to secure any of this information from the transfer agents. (Source: First National Bank of Chicago)

10. Decedent owned certain stocks and bonds which were acquired through his broker during the period of 1955–1965 and were held by his broker. On the decedent's death, it was discovered that the broker was not able to produce any information respecting actual acquisition dates and cost. It appears that the rules of the SEC only require brokers to maintain copies of statements for 6 years and copies of confirmations for 3 years. (Source: First National Bank of Chicago)

APPENDIX B

SAMPLE OF TIME REQUIRED TO ESTABLISH COST BASIS FOR DECEDENT'S DYING IN 1977

	Number of issues	Hours spent do date	Hours per issue	Status
Approximate value of securities:				
$377,500	16	13	0.81	Complete.
$123,700	21	13	.62	Incomplete.
$183,000	15	10	.67	Do.
$262,000	13	5½	.42	Do.
$439,000	28	36	1.29	Complete.
$354,000	24	8	.33	Do.
$60,000	9	26½	2.94	Do.
$224,000	13	2	.15	Do.
$144,000	23	4½	.20	Incomplete.
$381,000	66	92	1.39	Complete.
$260,000	75	58	.77	Do.
$264,400	272	47	.17	Incomplete.
$498,400	35	36	1.03	Complete.
$594,000	28	30	1.07	Do.
$342,700	38	16	.42	Incomplete.

Source: Harris Trust & Savings Bank and the Northern Trust Co.

APPENDIX C

ESTATES OVER $100,000 PROBATED IN GREATER CHICAGO AREA IN 1976

	Cook County			Du Page County			Lake County			Combined		
	Number	Percent	Average size	Number	Percent	Average size	Number	Percent	Average size	Number	Percent	Average size
Estates where a corporate executor was appointed	355	26.43	$325,980	29	21.97	$407,793	20	23.53	$444,250	404	25.90	$337,708
Estates where an individual executor was appointed	988	73.57	247,657	103	78.03	257,195	65	76.47	290,692	1,156	74.10	250,927
Total	1,343	100.00		132	100.00		85	100.00		1,560	100.00	

Source: The Northern Trust Co.

PPG INDUSTRIES, INC.,
Pittsburgh, Pa., October 25, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Russell Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: The Senate Subcommittee on Taxation and Debt Management will hold hearings this week on H.R. 6715, the Technical Corrections Act of 1977.

Section 2(t)(7)(B) of this legislation deals with the foreign loss recapture rules in a manner beneficial to certain companies incurring losses in U.S. possessions. PPG Industries, Inc. would be one of the beneficiaries. This provision was singled out for criticism in the "Dissenting Views To The Report On H.R. 6715" of the House Ways and Means Committee and again during debate on the House floor. Although the appropriateness of this provision was ably explained to the House by both the Chairman of the Ways and Means Committee and its ranking Republican member, I would like to take this opportunity to respond on behalf of our Company.

The gist of the criticism is that section 2(t)(7)(B) provides private tax relief rather than a technical correction; also, that the subject was considered and rejected by the House last year. It is our sincere belief that these charges reflect a misunderstanding of the background behind this section. We consider it to be a technical correction to reflect appropriately the clear intent of the Conference Committee Report on the Tax Reform Act of 1976.

Contrary to published statements, the House of Representatives did not reject this provison last year, but in fact voted a more liberal transition rule. The House version of the 1976 Act, as it related to loss recapture rules, contained a five-year delay in their effective date with respect to losses incurred in Puerto Rico and other United States to encourage investments in Puerto Rico, and that U.S. companies which had made such investments in reliance on the tax treatment of Puerto Rican income and loss, deserved a relatively brief period to adjust to the new rules, especially since precipitous decisions could be very unsettling to the already-troubled Puerto Rican economy.

The Senate version of the recapture rules did not contain a comparable delay in effective date, but the Conference Committee ultimately agreed upon a three-year delay. Unfortunately, the text of the Tax Reform Act did not reflect the Conference Committee's decision—an inadvertence which was pointed out in floor colloquies in both the House and the Senate prior to the passage of the Tax Reform Act, in the Report on H.R. 6715, and in the statements of Chairman Ullman and Representative Conable of the Ways and Means Committee during last week's debate.

Section 2(t)(7)(B) merely carries out the original intention of the Conference Committee to have a three-year postponement for possessions' losses. Actually, section 2(t)(7)(B) is less generous than the intent of the Conference Committee in that it incorporates a restrictive modification recently proposed by the Treasury Department, to which we have reluctantly agreed.

In short, section 2(t)(7)(B) represents, not a new relief provision, but rather the correction of an inadvertent omission from the Tax Reform Act. As such, it has a proper place in the Technical Corrections Act of 1977.

Furthermore, the impact of section 2(t)(7)(B) will not be unreasonable. In 1968, aware of the existing tax laws, our company decided to invest almost $200 million in Puerto Rico. Through a series of unanticipated circumstances such as the lack of adequate electric power and the quadrupling of the prices of raw materials and oil, we have incurred heavy losses which are continuing. Section 2(t)(7)(B) will affect only a relatively small portion of these losses: (1) it will insure that a disposition of assets, which took place in early 1976 at a time when the House version of the recapture rules was the only available Congressional pronouncement, was not taxable by reason of losses incurred in 1976; and (2) it provides that the recapture rules apply to only a portion of the losses incurred in 1976, 1977 and 1978 and then only to income and dispositions after 1978.

It must also be pointed out that the estimates of the revenue loss from each of these consequences—$2 million associated with the 1976 disposition and possibly $10 million after 1980—are necessarily speculative. It is not completely clear that the 1976 disposition was taxable in any event; and the revenue loss after 1980 will occur only as and if our company is successful in turning around our Puerto Rican operations. Thus, although we welcome section 2(t)(7)(B) because it settles the issue regarding the 1976 disposition and because it gives the Company some breathing space, section 2(t)(7)(B) hardly constitutes the major give-away which its critics apparently perceive it to be.

I hope that this information will be a help during the Subcommittee's consideration of H.R. 6715.

Sincerely,

L. S. WILLIAMS.

SOUTHERN BANK & TRUST CO.,
Richmond, Va., November 1, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: I understand the Senate Finance Committee's Subcommittee on Taxation and Debt Management has had hearings recently in connection with the proposed repeal of the carryover basis law enacted as part of the Tax Reform Act of 1976. I am writing to ask for your support for repeal of this legislation which is bad law and which never received public debate at the time it was enacted by the Joint Committee of the House and Senate in 1976.

Frankly, I have been appalled by the complexity and problems created for fiduciaries under the carryover basis law in the relatively short period of time that we have had to live with the Tax Reform Act of 1976. Not only has this made life more difficult for us in the fiduciary business, but it has added an unbelievable burden to our citizens in the need for detailed record keeping, and in many cases we find people simply have no accurate records for assets acquired many years ago, particularly for assets where there was no original intent to sell for profit.

I could give a number of specific examples of how this law has proved burdensome, and will do so if you would find this additional information helpful.

Repeal of this complex carryover basis law would be a major step of progress, and would certainly be in furtherance of the present Administration's stated objective of simplifying tax administration for all citizens. I hope you share my concern in this regard and can add a voice to get some legislative relief.

With kindest personal regards, I am

Sincerely,

RIEMAN MCNAMARA, Jr.,
Vice Chairman.

UNITED VIRGINIA BANK/FIRST NATIONAL,
Lynchburg, Va., November 8, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: You currently have before you for consideration the repeal of a very complex and costly provision of the 1976 Tax Reform Act. This provision is the carryover basis law which will require an expensive, time-consuming effort for individuals, their families and ultimately the personal representatives of their estates and the Internal Revenue Service.

The carryover basis law requires a personal representative to determine the decedent's acquisition date and acquisition cost for each item of property included in an estate. In addition, the personal representative is required to adjust this basis to reflect the pre-December 31, 1976 appreciation, the tax add-on adjustment for estate and inheritance taxes paid, and a minimum basis adjustment. The personal representative is then required, under rather severe penalties, to furnish the cost basis to the Internal Revenue Service and the individual recipient of the property.

These additional duties become extremely difficult where tangible personal property is involved in a material amount. It is almost an impossibility to determine the source of acquisitions of the property let alone the cost or date of acquisition.

We strongly urge you to vote in favor of the repeal of the carryover basis law because of its complexity, its cost impact to personal representatives and individuals, and the sheer awesomeness of the task of compliance for each taxpayer in the country.

Very truly yours,

A. S. KEMPER III,
Executive Vice President.

THE CENTRAL NATIONAL BANK,
Richmond, Va., November 4, 1977.

Hon. HARRY F. BYRD, Jr.,
Russell Building,
Washington, D.C.

DEAR SENATOR BYRD: This letter is by way of a follow-up to a telephone call I made to your office on Wednesday, November 2, 1977. I write to you in order to urge you to support repeal of the carryover basis portion of the Tax Reform Act of 1976. This is a poorly designed piece of legislation which will greatly inhibit even the modest accumulation of capital. From what I have learned, it was not even separately considered by the United States Senate during either committee hearings or floor debate on the entire Tax Reform Act of 1976.

I am a native Virginian and resident of Richmond. After obtaining my undergraduate degree in 1974 from the University of Virginia, I attended T. C. Williams School of Law, from which I graduated in May, 1977. My present place of employment is the Trust Department of The Central National Bank of Richmond, Virginia. I belong to the Virginia State Bar, the Virginia Bar Association, and The Bar Association of the City of Richmond, Virginia. I am writing you in my capacity as a private individual and constituent. Your consideration of my request is greatly appreciated.

Yours truly,

O. STUART CHALIFOUX.

UNITED VIRGINIA BANK,
Richmond, Va., October 25, 1977.

Senator HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: As you can see from the letterhead, I work for United Virginia Bank in Richmond, Virginia as a Vice President and Trust Officer in the Trust Administrative Division. I have been working in this business for over 23 years and I must say that the provision of the 1976 tax reform act dealing with carry over basis is the biggest "can of worms" that I have encountered during my time with the bank. I am at the present administering several estates under this new act and am finding it almost impossible to determine any cost bases on tangible personal property that was owned by the decedent. In one particular case, the decedent was 96 years old at the time of her death and I am sure that she had held most of this property for 50 years or more and there are no records to substantiate what she paid for the tangible personal property, including jewelery and household furnishings.

I have been reading hopefully that there is a move to repeal this portion of the 1976 Tax Reform Act and I have also heard that you are interested in making some changes or possibly repealing this portion of the act which is the reason for my writing you this letter. I would like to add my voice to those who feel that the passage of this act was done without recognizing the problems that would be created by the carryover basis portion of the act.

If the idea was to raise additional revenue, I believe it can be accomplished by another means and I have taken the liberty of attaching to this letter a suggestion in lieu of the carryover portion of the tax reform act of 1976. At any rate, I hope that you will do everything possible to remedy the situation that now exists by virtue of the carryover basis portion of the act by assisting in the repeal of this portion of the act as soon as possible.

Yours very truly,

JOHN E. CAMPBELL.

Enclosure.

SUGGESTED PLAN IN LIEU OF CARRYOVER BASIS IN TAX REFORM ACT OF 1976

After deduction of debts (including mortgage loans) and funeral expenses from the gross taxable estate (including insurance proceeds, jointly held properties, includable gifts, etc.) and $200,000, apply a surtax on the remainder of the estate. This tax will be in addition to the Federal estate tax that will be determined later but the surtax will be a deduction in determining the Federal estate tax and the State Credit.

An example would be as follows:

Assume gross taxable estate	$750,000
Debts and funeral expenses	10,000
Mortgage loan on home	20,000
Allowed deduction for surtax purposes	200,000
Subtotal	230,000
Total	520,000
1 percent surtax	.01
Total	5,200

Federal estate tax computation assuming fee simple to other than spouse or charity:

Gross estate	$750,000
Debts and funeral expenses	10,000
Mortgage	20,000
Administrative expenses and exor. commission	30,000
Surtax	5,200
Subtotal	65,200
Taxable estate	684,800
Federal tax:	
Taxable amount:	
$500,000	$115,800
$184,000	60,720
Total	[1] 176,520
State tax:	
Taxable amount:	
$500,000	$10,000
$184,000	7,360
Total	[1] 17,360

[1] The above computations take into consideration the $30,000 unified credit.

The surtax would be in lieu of taxes that are presumed to be lost by the stepped up cost basis that prevailed in estates prior to 1977. However, I do not believe the carry over basis will be the "bonanza" that Congress envisioned when adding this provision to the Tax Reform Act. One reason is the fresh start date on listed securities will be tantamount to a stepped up basis for quite awhile. Secondly, sales will be made in such a way to minimize capital gains by sales for losses from other securities. The portion of the act dealing with assets other than listed securities such as real estate, a closely held business and tangible personal property create an even greater burden in trying to determine the original cost basis. How many people could go through their home and tell you the cost of each item of furniture? Possibly the Antique Collector might have a record, but very few others would. It does not take too many items of nice furnishings to exceed the $10,000 allowance for tangible personal property.

I believe that the U.S. Government would receive greater revenue by going to a surtax plus the Federal estate tax than by hoping to receive revenue from greater capital gains by sale of inherited securities by beneficiaries with a carry over basis.

Therefore, I believe it would be better to repeal the carry over basis provision and go back to the stepped up basis as it stood before January 1, 1977. The substitution of the additional surtax as illustrated above will create (I believe) as much revenue as capital gains taxes would bring from the carry over basis provision as it now stands.

One other advantage to the stepped up basis is the removal of the stigma of not wanting to sell because of gain. The carry over basis will tend to further the stagnation of sales in the securities market due to the resulting capital gains and its attendant taxes.

The example using a 1 percent surtax was used only for illustrative purposes. I believe this could be a graduated tax beginning at 1 percent on smaller estates and increasing by brackets of taxable estates at the rate of 1 percent each bracket but not to exceed 5 percent on the top bracket. This would favor the smaller estates but would not be too great a burden on the larger estate since the surtax is a deductable item in determining the estate for Federal estate tax purposes. For example if the estate is taxed at a top bracket of 50 percent and the surtax would be a deduction from the taxable estate at its highest tax bracket (i.e., assume $60,000 surtax in an estate with a top bracket of 50 percent). It would actually cost the estate $30,000 net as to the surtax. While the larger estate pays a higher rate it is offset partially by the surtax being a deductable item in determining the net taxable estate.

Whether the surtax would be deducted before determining the marital deduction could be worked out and the amount of surtax rates could be determined by Congressional Economists to reach the dollar result desired and at the same time get rid of the "biggest monster" created during my time in this business (23 years) by scrapping the carry over basis provision and returning to pre 1977 date of death value for cost basis (or optional value) in estates.

Listed below are some advantages to the government using a surtax system in lieu of the carry over basis provision.

(1) Immediate receipt of revenue as opposed to possible revenue depending on sale of carry over basis stock by distributee.

(2) Greater activity in securities market if carry over basis is abandoned and revert to stepped basis.

(3) The greatest benefit would be that there would be no need for additional personnel to follow the surtax[1] as there will be in the carry over basis provision both from the standpoint of new record keeping and enforcement of the provisions of the carry over basis portion of the Tax Reform Act.

Also listed below are some benefits to the American public by repeating the carry over basis provision of the Tax Reform Act.

(1) New cost basis that is easy to determine.

(2) Less expense in the settlement of estates. The carry over basis creates such a great amount of additional work, banks, attorneys, accountants, etc. will certainly have to raise their Executor's fees to cover this additional work.

(3) Remove one hindrance from sale of securities, i.e., low carry over basis, which would be a plus for the economy to have turnover in securities market.

(4) Terminate future record keeping of individuals of cost basis for household furnishings, etc.

I am sure there are other benefits both to the public and the government, however, I believe the above are sufficient to illustrate the proposal set forth.

Suggested breakdown of surtax rates—

After deductions: first 750,000, 1 percent; next 750,000, 2 percent; next 1,500,000, 3 percent; next 2,000,000, 4 percent; and all over 5,000,000, 5 percent.

THE FIRST AND MERCHANTS NATIONAL BANK OF RADFORD,
Radford, Va., November 1, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate,
Washington, D.C.

Hon. WILLIAM L. SCOTT,
U.S. Senate,
Washington, D.C.

DEAR SENATORS BYRD AND SCOTT: The Tax Reform Act of 1976 contained a provision for the carry over of a decedent's cost basis of property inherited by

[1] The surtax could be incorporated in the present estate tax form.

his heirs. I have been in the trust business for eighteen years and to my recollection, this was the worst piece of legislation I have seen affecting the settlement of estates and administration of trusts. It is unworkable. For this reason I strongly urge you to support the repeal of the carry-over basis law and replace it with the law which was effective prior to January 1, 1977—that is where the heirs' cost basis of inherited assets was determined as of the decedent's death or six months thereafter.

At this time, we have a Federal Estate Tax return due for a decedent who died January 10th. The return was due September 10th. We have requested an extension of time to file the return for two reasons. The first reason is that the NRS does not yet have the necessary forms to file the return on. The second reason is that we have not been able to come up with the decedent's cost basis of certain assets. Unfortunately, we never will be able to come up with this cost basis because the information is nonexistent. However, under the law, we face penalties if we do not come up with this nonexistent information.

We are named executor in the will of another individual who has a large coin collection. This lady has collected coins all her life. Several months ago, I told her that in the event of her death we would need the cost basis of her coins and explained to her what "cost basis" meant as she did not know. The lady looked at me with a bewildered expression. She explained that some of the coins had been given to her, that some she had traded for, that others she had purchased, and still others that she took out of change. She has no idea of her cost basis. I believe that this is the case of most people. Do you know the cost basis of each of your assets?

Again, I believe that this pass through of cost basis is unworkable and the law should be repealed. Frankly, I don't think the people of this country realize yet the full meaning of the 1976 Tax Act but when they finally realize the full implications of this Act, I believe you will be hearing from them in mass.

Gentlemen, again, I strongly urge you to support the repeal of the pass through of cost basis provisions of the 1976 Tax Act.

Very truly yours,

PERRY G. GORHAM,
Vice President, and Trust Officer.

ALEXANDRIA NATIONAL BANK OF NORTHERN VIRGINIA,
Alexandria, Va., October 31, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate,
Russell Office Building,
Washington, D.C.

DEAR SENATOR BYRD: The carryover basis provisions of the Tax Reform Act of 1976 are a nightmare because:

(1) *Chattels.*— Stamp collections, coin collections, or for that matter chattel collections of any kind, now create a virtually impossible situation. The cost of each separate item must be ascertained, and each item must be separately appraised so that the "fresh start" basis can be determined by the time-apportionment formula provided in the Code. The Technical Corrections Act of 1977 would provide a minimum basis which does not require the ascertainment of the original cost by only for pre-1977 chattels.

(2) *Securities.*—The impossibility of proving for listed securities because of stock splits, stock dividend, tax-free exchanges, and securities received by gift can be cited in some cases.

(3) *Repeated acquisitions.*—Dividend reinvestment plans, mutual fund holdings, and common trust funds in which numerous Section 1023 (c) and (e) adjustments are required because of the constant small additions to the original holding demonstrate the incredible record keeping that can be required.

(4) *The closely-held stock.*—Many closely-held businesses built up by the owner during his lifetime have little or no cost records to aid the Executor of his estate. He never intended to sell.

(5) *Real estate.*—Although the recorded deed will give the acquisition date of real estate, it does not help us as to additions or improvements. And each addition or improvement is, of course, an acquisition for cost basis purposes. Each "substantial" improvement will be regarded as a separate improvement for purposes of the time-apportionment determination of the "fresh start" value. However, an appraiser may find it impossible to appraise an improvement separately.

(6) *The incredibly complex estate.*—An estate with numerous holdings of routine assets may require pages of carryover basis adjustments. Some persons have already written to Members of Congress, describing an estate generally, and then simply attaching page after page of computations making the required adjustments.

(7) *Duty to provide cost basis information.*—The Executor is required to provide cost basis data to the IRS and to beneficiaries of all items in the gross estate. In some cases, the Executor may have a nominal probate estate but be subject to onerous duties, subject to penalties for failure to comply, to give donees such data as to nonprobate assets, such as joint and survivorship assets.

I strongly urge your support in repealing this bad law.

Very truly yours,

F. W. Tompkins,
Vice President and
Senior Trust Officer.

American Council of Life Insurance,
Washington, D.C., November 1, 1977.

Hon. Harry F. Byrd, Jr.,
U.S. Senate, Russell Senate Office Building, Washington, D.C.

Dear Senator Byrd: The Senate Finance Committee, in its mark-up of H.R. 6715 (The Technical Corrections Bill of 1977), is scheduled to consider several amendments to the carryover basis provisions which were added to the income tax laws by the Tax Reform Act of 1976. The amendments are embodied in S. 2228, introduced by Senator Dole and you. One of the amendments would increase, from $60,000 to $175,000, the minimum tax basis available with respect to assets included in a decedent's estate. When these assets are subsequently sold by the heirs, only the selling price in excess of this basis represents taxable income.

NATURE OF PROBLEM

In a marked departure from present law, the Treasury Department, in testimony on October 27, 1977, before your Subcommittee, proposd an offset against this "minimum basis" for life insurance, which offset would have the practical effect of imposing an indirect income tax on part or all of the proceeds of the life insurance where the decedent is otherwise entitled to use the "minimum basis" provision. This would occur despite the fact that such proceeds are clearly—and have historically been— exempt from income tax under section 101(a) of the Code. Therefore, we strongly urge that you reject the Treasury's proposed offset.

SPECIFIC EXAMPLE OF TREASURY OFFSET

Assume a taxpayer dies with securities valued at $175,000 which have a tax basis of $25,000. Under the Byrd-Dole amendment, the tax basis of those assets would be increased to $175,000 and the decedent's heirs would not owe any tax on a sale of the assets, except with respect to a subsequent increase in their value.

However, the minimum basis allowance for a decedent in the same situation, except that he also owns $75,000 of life insurance, would, under the Treasury proposal, be reduced by the $75,000 of life insurance. Thus, the tax basis of the securities in the hands of his heirs would be only $100,000 and they would owe income tax on a $75,000 gain when the assets are subsequently sold.

In other words, the $75,000 of life insurance would produce an additional $75,000 of potential taxable gain for their heirs—despite the long-standing Congressional policy specifically reflected in the tax laws of excluding the proceeds of life insurance from the income tax base.

Moreover, this indirect taxation of life insurance proceeds would fall unevenly on decedents and their heirs depending on the composition and size of the decedents' estates. It would fall most heavily on those with relatively small estates consisting at least in part of appreciated assets. Decedents with large estates will most likely have a tax basis in their assets above the minimum and, thus, would not be affected one way or the other by the ownership of life insurance.

In summary, therefore, if it is decided to amend the minimum basis rules, we urge that the Treasury modification be rejected and that the treatment of life insurance as presently reflected in the minimum basis rules be retained.

Sincerely,

William T. Gibb.

DOWNING, SMITH, JORGENSEN & UHL,
Decatur, Ill., October 26, 1977.

Re House Ways and Means Committee public hearing, October 6, 1977, on proposed substantive amendments to the Tax Reform Act of 1976.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee, Subcommittee on Taxation and Debt Management, Senate Office Building, Washington, D.C.

DEAR MR. BYRD: The notice of the public hearing on October 6, 1977, on the proposed substantive amendments to the Tax Reform Act of 1976, by the House Ways and Means Committee, arrived too late for me to make a timely response.

In my opinion the carryover basis, generation-skipping, special farm valuation provisions and many of the other provisions of the Tax Reform Act of 1976 are incomprehensible and in fact unworkable.

I cannot believe that elected and publicly paid representatives of the people and their staffs could present and pass such abominable legislation.

Because of the complexity of the carryover basis provisions, I have heard it suggested, in a public meeting, that it would be better to pay the penalty and fine, even to the maximum of $7,500.00, rather than attempt the computation of a basis that could be inaccurate and in error, if in fact the basis could be computed. This should not be and it is an unnecessary and an extreme choice to the taxpayer when it involves an illconceived, unstudied and inexpertly prepared federal law.

The Congressional Committees have had the advice of outside expert witnesses who have explained these problems. However, Congress and its staff and the Department of Treasury have failed to heed the advice.

As with many others who are involved in the area of taxation I have attended many meetings and seminars concerning this Act. It is enlightening and surprising that the experts do not have the answers and that the representatives of the Department of Treasury and the staff of the Congressional Committees attending these meetings, only add to the confusion and uncertainty.

But, in the meantime the Act is effective, and complying with it is the intent of all concerned, if it can be understood. This Act has placed a severe burden on the taxpayer, their legal representatives and advisors and counselors.

If Congress and the Department of Treasury intend any further tax reform I trust it will not result in such a complicated law or regulations. They should remember these laws involve the ordinary taxpaying public, not generally accustomed to the unintelligible laws and regulations promulgated from Washington.

If you and the Committee and the Department of Treasury do not believe so, I ask you and each member of the Committee to carefully examine the 1976 Federal Income Tax Form Booklet, of 32 pages and forms, mailed to each taxpayer by the Commissioner of Internal Revenue, and particularly page 31 (which I enclose) which identifies the numerous schedules, forms and a few of the many publications available. Upon receipt of most of these (a packet in plain plastic cover over one inch thick) the taxpayer has enough material to astound and confuse him for most of the next year.

Even a conscientious, sincere and law abiding citizen, which most of us try to be, would have difficulty in assimilating the Tax Reform Act of 1976 and other Federal tax laws.

It is sad to report, in my opinion, that this legislation is no credit to the legislative ability or talent of the Executive Department, Congress or their staffs.

It is my hope that the House Ways and Means Committee, the Joint Committee on Taxation and the House of Representatives and the U.S. Senate will pass amended tax laws which we can all understand and which will contain provisions which will work and not be so extremely complicated and difficult.

Very truly yours,

R. R. UHL.

HINDRY & MEYER,
Denver, Colo., October 31, 1977.

Hon. HARRY S. BYRD,
Chairman, Senate Subcommittee on Taxation and Debt Management, Washington, D.C.

DEAR SENATOR BYRD: The Chairman of the Taxation Section of the Colorado Bar Association has asked me to be sure that you, as Chairman of the Senate Subcommittee on Taxation and Debt Management, are advised that the Board of Governors of the Colorado Bar Association has previously gone on record as advocating repeal of Section 2005 of the Tax Reform Act of 1976 (provisions relating to carry-over basis). The position of the Colorado Bar on this subject has been previously communicated to all Colorado legislators and to the Ways and Means Committee of the House of Representatives, but there was some question whether your committee was in possession of this information in connection with recent hearings on the carry-over basis provisions.

Kindest personal regards.

Sincerely yours,

MILTON E. MEYER, Jr.,
Chairman, Committee for Repeal of Carry-Over Basis, Taxation Section, Colorado Bar Association.

Enclosure: Letter from Daniel S. Hoffman, president of Colorado Bar Association to the Honorable Floyd Haskell, U.S. Senator re repeal of carryover basis provision of the Tax Reform Act of 1976.

THE COLORADO BAR ASSOCIATION,
Denver, Colo., May 6, 1977.

Re Repeal of carryover basis provisions of the Tax Reform Act of 1976.

Hon. FLOYD HASKELL,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR HASKELL: The Colorado Bar Association is writing to each member of the Colorado Congressional Delegation. The Association supports the passage of H.R. 1563, H.R. 2674, H.R. 5278, and H.R. 6128 to the extent that each Bill repeals the carryover basis provisions (Section 2005) of the Tax Reform Act of 1976. The Association's position is based exclusively on its opinion that the provisions as enacted create unacceptable administrative burdens in connection with the administration of decedents' estates.

The carryover basis provisions require the personal representative of most decedents' estates to develop extensive and detailed information about the income tax basis of each asset owned by a decedent, and then to compute as many as four different adjustments to each income tax basis, each involving numerous computations. For example, bases of assets must be adjusted for Federal and State death taxes paid by the estate attributable to the appreciation of each asset, and bases of appreciated assets may be increased pro rata by a total amount up to $60,000. Basis may be increased by any succession tax paid by a transferee and further basis adjustments must be made to take into consideration the December 31, 1976 value of each asset. Collection of the information necessary to fulfill these duties and actual computation of the adjustments represent new and additional administrative burdens created solely by this law. In contrast with Colorado's new modern, simplified and unsupervised Uniform Probate system, these administrative burdens will substantially increase the time and effort spent on the administration of a decedent's estate. This will serve to substantially increase the cost of administration that must be borne by the government and by the beneficiaries of the estate. The Colorado Bar Association suggests that the generalized imposition of these burdens on decedents' estates is undesirable.

The Association takes no position with respect to the substantive tax policies behind the concept of carryover basis, nor what substantive law policies, if any, should be substituted subsequent to repeal. However, we do request that the statute as enacted be repealed until such time as Congress can resolve the substantive tax issues in a manner which avoids the severe administrative burdens placed on decedents' estates by the present law.

Sincerely yours,

DANIEL S. HOFFMAN, *President.*

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., November 2, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: The American Bankers Association strongly opposes the carryover basis provisions that were enacted as a part of the Tax Reform Act of 1976. We understand that the Senate Finance Committee may consider the carryover issue during its further consideration of H.R. 6715, Technical Corrections Act of 1977, probably tomorrow morning, Thursday, November 3.

We urge the Committee to repeal carryover. We further strongly urge the Committee to reject any halfway proposals to clean up carryover because they will not solve the real problems of proving basis or the complexities of determining "fresh start".

Sincerely,

ROBERT L. BEVAN.

MURDOCH & WALSH,
Wilmington, Del., November 2, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Taxation and Debt Management Subcommittee, Finance Committee, U.S. Senate, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I urge the repeal of the carryover basis provision added to the Internal Revenue Code by the Tax Reform Act of 1976.

As you know, prior to enactment of the carryover basis rule, the income tax basis of assets in a decedent's estate was "stepped up" to the value at the date of death. The carryover basis rule attempts to carry the decedent's pre-death income tax basis over to those individuals who acquire the property from the decedent through his estate.

The rule is so complex that it requires the adjustments shown on the attached form for virtually every single asset in an estate. The form is completed to show the adjustments necessary to just one assets in a decedent's estate. A separate form would have to be filled out for virtually every asset acquired before 1977, no matter how small the asset's value, unless the asset qualifies as a "personal and household effect." The rule does not tell what to do when basis and date of acquisition are unknown. Few individuals keep the detailed records needed to compute the carryover basis adjustment for every assets. For these reasons, the rule is unworkable.

The single largest effect of the rule will be to increase dramatically the cost of estate administration. The revenue to be derived from carryover basis just cannot justify the cost.

Your subcommittee recently heard testimony regarding several bills (S 1954, S 2238, S 2227 and S 2228) which have been introduced and would either repeal the rule, mitigate its damaging effects or at least postpone the effective date. I urge your support of repeal of carryover basis, or, alternatively, delay of implementation until the rule can be made workable.

Sincerely,

JOANNA R. FULMER.

Enclosure.

CARRYOVER BASIS FOR PROPERTY ACQUIRED FROM A DECEDENT

Name of Decedent ______________________

Date of Death May 30, 1977

Description of Property ______________________

	FRESH START ADJUSTMENT				
	Assets Other Than Traded Securities				
1.	Decedent's adjusted basis				27,800.00
2.	Date of death value (Note A)		62,500.00		
3.	Line 1	27,800.00			
4.	Depreciation claimed by decedent	+6,000.00			
5.		33,800.00	-33,800.00		
6.			28,700.00		
7.	Days held prior to 1/1/77	4,787			
8.	Total days held	÷4,937			
9.		.96	x .96		
10.			27,552.00	27,552.00	
11.	Depreciation prior to 1/1/77			+5,760.00	
12.				33,312.00	
	Traded Securities				
13.	Value on 12/31/76			N/A	
14.	Line 1		N/A		
15.	Line 11		+ N/A		
16.			N/A	- N/A	
17.				N/A	
18.	Fresh start adjustment (Line 12 or Line 17, whichever is applicable)				+33,312.00
19.					61,112.00
	DEATH TAX ADJUSTMENT (Note B)				
20.	Federal estate tax	18,400.00			
21.	Federal state death tax credit	- 880.00			
22.	State estate tax	+ - 0 -			
23.	State inheritance tax paid by estate	+ - 0 -			
24.		17,520.00		17,520.00	
25.	Estate tax value (Note C)	62,500.00			
26.	Line 19	61,112.00			
27.		1,388.00	1,388.00		
28.	Value of gross estate	450,000.00			
29.	Marital deduction	250,000.00			
30.	Charitable deduction	---------			
31.	Non-recourse mortgages	---------			
32.		200,000.00	÷200,000.00		
33.			.007	x .007	
34.	Death tax adjustment			122.64	+ 122.64
35.					61,234.64
	MINIMUM BASIS ADJUSTMENT (Note D)				
36.		60,000.00			
37.	Total of Line 35, all carryover basis property	139,000.00			
38.					
39.	Estate tax value (Note C)				
40.	Line 35	-			
41.					
42.	Estate tax value (Note C) all appreciated carryover basis property				
43.	Line 35, all appreciated carryover basis property	-			
44.			÷		
45.				x	
46.	Minimum basis adjustment				+ - 0 -
47.					61,234.64

INHERITANCE TAX ADJUSTMENT

48. Inheritance tax paid by heir			1,500.00	
49. Estate tax value (Note C)	62,500.00			
50. Line 47	-61,234.64			
51.	1,265.36	1,265.36		
52. Value of heir's total inheritance for inheritance tax purposes		÷130,000.00		
53.		.0097	x .0097	
54. Inheritance tax adjustment			14.55	+ 14.55
55.				61,249.22

BASIS FOR COMPUTING GAIN

56. If Line 55 exceeds Line 2, enter the greater of Line 2 or Line 19. If Line 55 does not exceed Line 2, enter Line 55				61,249.22

BASIS FOR COMPUTING LOSS

57. Line 55			61,249.22	
58. Line 18			-33,312.00	
59.			27,937.22	
60. If Line 59 exceeds Line 2, enter Line 2. If Line 59 does not exceed Line 2, enter Line 59.				27,937.22

IF THE SALE PRICE IS LESS THAN THE BASIS FOR COMPUTING GAIN BUT MORE THAN THE BASIS FOR COMPUTING LOSS NO GAIN OR LOSS IS RECOGNIZED.

Preparer's signature ____________________

Preparer's Social Security Number ____________________

Date prepared ____________________

NOTES

A. The alternate valuation date may not be used on Line 2 even if the alternate valuation date was elected.

B. The death tax adjustment is made only if federal estate tax was due with respect to the property. If no federal estate tax was due, the fact that state death taxes were paid by the estate with respect to the property is not relevant. The adjustment is not made to property used to fund a marital or charitable deduction. When the entire estate passes to the surviving spouse so that the surviving spouse incurs tax to some extent, it would appear that the executor may elect which property will be considered to have funded the marital deduction portion of the gift.

C. This value may be the date of death value or the alternate valuation date value. If the property is subject to non-recourse liabilities, the value to be entered is the value from the preceding sentence less the amount of such liability.

D. If Line 35 plus the sum total of all carryover basis property which are cash items exceeds $60,000.00, omit this adjustment. Skip to Line 46 and enter zero. Enter Line 35 on Line 47.

WEBSTER & CHAMBERLAIN,
Washington, D.C., November 1, 1977.

Re Technical Corrections Act of 1977

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Under the provisions of Section 3(q) of the bill (amendment of governing instruments to meet requirements for gifts of split interest to charity), two amendments have been provided.

As you know, the Shriners Hospitals For Crippled Children was instrumental in bringing the problem of unqualified split interest trusts to the attention of the Congress. The remedy provided was Section 2055(e)(3). At the present time, Shriners Hospitals is suing the Internal Revenue Service in various Federal courts seeking refunds of taxes erroneously withheld because of the Government's interpretation of Section 2055(e)(3) as presently drafted.

We bring this to your attention so that the Committee Report on the bill, or the bill itself, shows that enactment of these amendments contained in H.R. 6715 is not meant in any manner to affirm or otherwise legitimize the Government's Temporary Regulations presently construing Section 2055(e)(3).

It would be a most inappropriate result if any Court construed these amendments as affirmation of the position of the Internal Revenue Service on matters not pending before the Congress today. In other words, I would not want a Court to think that because the Congress chose not to address the issues being litigated, it was satisfied with the Government's construction and, by inference, then, bootstrap the Government's otherwise shaky case.

Very truly yours,

WILLIAM J. LEHRFELD.

AMERICAN STOCK EXCHANGE, INC.,
New York, N.Y., November 7, 1977.

Re H.R. 6715 "Technical Corrections Act of 1977."

Senator HARRY F. BYRD, Jr.,
Chairman Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing on behalf of Amex Commidities Exchange, Inc. ("ACE"), regarding section 2(u) of H.R. 6715, which would create a distinction between the tax treatment of different kinds of commodity futures contracts: agricultural commodities would be subject to a six-month capital gains holding period, while non-agricultural commodities would be subject to a nine-month holding period. We believe that creating such a distinction is not in the public interest and that all commodities should continue to be subject to the six-month holding period.

ACE is a corporation recently organized under the sponsorship of the American Stock Exchange, Inc. pursuant to the New York Not-for-Profit Corporation Law, for the purpose of establishing a market in spot commodities, commodity options, and commodity futures. It is expected that, at least initially, non-agricultural commodities will underlie all contracts traded on ACE. Our concern—as reflected below—is that the proposed tax distinction may cause a movement of capital away from the non-agricultural commodity markets, with the result that liquidity may be reduced and their quality may deteriorate.

The commodity futures markets serve a valuable economic purpose in that they permit commercial users of a commodity to "hedge" the risk of future price changes in that commodity, thereby reducing business costs and the cost of the commodity or its by-products to the ultimate consumer. This is equally true for all commodities—whether agricultural or non-agricultural. If investors were to channel more of their futures market investments to agricultural commodities to obtain the benefit of the shorter holding period, non-agricultural commodity markets are likely to suffer a significant loss of volume. As a consequence, use of these markets by commercial interests is likely to decline, to the ultimate detriment of the consuming public. This will occur because commercial users of commodities are reluctant to use a thinly traded futures market for hedging purposes, for fear that they will be unable to liquidate their positions without affecting the market price.

Commodity futures contracts are, by their nature, shortlived; therefore, extending the capital gains holding period has an especially adverse effect on this type of investment. Congress recognized this when it exempted commodity futures transactions in the Tax Reform Act of 1976 from the extension of the holding period required for capital gains treatment. It appears, therefore, that Congress intended to insure that investment in commodity futures would remain a competitive alternative to investment in other financial instruments.

We do not believe that an amendment to the tax laws which could substantially affect trading in the futures markets and the commodities industry generally can be considered a "technical" amendment. It is of considerable substance, and as such requires more careful and detailed study than can be received in this technical amendments bill.

We respectfully urge therefore that section 2(u) of H.R. 6715 not be adopted.

Very truly yours,

NORMAN S. POSER.

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING,
Washington, D.C., November 1, 1977.

Hon. HARRY F. BYRD, Jr.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I am enclosing a brief memorandum setting forth our opposition to current efforts by the Treasury Department to impose an indirect income tax on life insurance policy proceeds. These efforts are being made by the Treasury Department in connection with the Finance Committee's consideration of carryover basis proposals, particularly S. 2228, which was cosponsored by you.

Although we fully support the attempts, including S. 2228, to limit carryover basis rules, we urge you to reject this Treasury recommendation which would seem contrary to those attempts.

AALU is a nationwide association of approximately 1,000 life insurance agents who are engaged mainly in advanced underwriting techniques.

Sincerely,

GERALD H. SHERMAN.

Enclosure.

MEMORANDUM IN OPPOSITION TO TREASURY RECOMMENDATION TO ADJUST DATE OF DEATH BASIS RULE AS PROPOSED IN S. 2228 BY THE AMOUNT OF LIFE INSURANCE POLICY PROCEEDS IN THE DECEDENT'S ESTATE

In giving qualified support to certain aspects of S. 2228, a bill introduced by Senators Byrd and Dole, the Treasury Department would indirectly subject the proceeds of life insurance policies to income taxation. This result, which runs counter to the general thrust of long standing tax law, is inadvisable and should be resisted.

S. 2228 proposes, among other things, that the current $60,000 minimum date of death basis rule be amended to provide that the minimum basis for assets at death should be at a level of $175,000, i.e., a level pegged to the maximum $47,000 estate tax credit. Assistant Secretary of the Treasury Donald Lubick, in supporting this proposal in hearings before the Senate Finance Subcommittee on Taxation and Debt Management on October 27, 1977, recommended further that "the minimum basis should be reduced by life insurance proceeds included in the estate." The consequences of such a proposal, if enacted, would be the unwarranted retreat from Congressionally endorsed policies of recent as well as long standing vintage.

Section 101 of the Internal Revenue Code has, for many years, provided that, with certain transfer-for-value exceptions, the proceeds of a life insurance policy are not to be subjected to income tax at death. The Treasury's proposal would result in the reduction of the basis of other assets, thereby causing an increase in the taxable income generated on the sale of those assets at some future time. In effect, despite the Congressional mandate by which life insurance proceeds are, for obvious and justifiable social reasons, not to be subjected to income taxation, those proceeds will ultimately be taxed through the creation of greater income on the sale of other estate assets.

When the Tax Reform Act was passed in 1976, life insurance proceeds, in recognition of the desirability of keeping them free of income tax, were not encumbered with the newly enacted carryover basis limitations. The recent Treasury proposal, as stated by Mr. Lubick, constitutes an unwarranted and basically undebated [1] reversal from this approach.

In addition to running counter to prevailing Congressional policy respecting the income taxation of life insurance proceeds, the Treasury's approach would impose an indirect tax in a highly capricious manner since it is likely to impose burdens on smaller estates. Estates of some size will doubtless have carryover basis in excess of $175,000 and will not need the protection of a minimum date of death basis. It is only the smaller estates, which can ill afford the indirect imposition of income taxes on life insurance proceeds, that will be affected.

We urge the rejection of the Treasury's suggestion that minimum date of death basis rules should be adjusted to account for the proceeds of life insurance policies.

ASSOCIATION FOR ADVANCED LIFE UNDERWRITING,
By GERALD H. SHERMAN, *Counsel*

STATEMENT OF IRWIN KARP, COUNSEL, THE AUTHORS LEAGUE OF AMERICA

The Authors League of America, the national society of professional writers and dramatists, respectfully submits this statement for the Committee's consideration and requests that it be included in the printed record of the Hearings.

SUMMARY OF THE STATEMENT, AND ALTERNATIVE AMENDMENT REQUESTED BY THE AUTHORS LEAGUE

(i) The Authors League urges that the carry over provisions of Sec. 1023 be eliminated from the Internal Revenue Code. Authors' estates are taxed on the fair market value of their literary property,* under present and pre-1977 law. But under Sec. 1023, authors' heirs must now pay a much higher income tax when they sell inherited literary property because they are required to use the author's basis—rather than (as in the past) the fair market value on which the estate tax is levied. Since an author's basis for his or her literary property is nominal, limited to the inconsequential costs of materials, the income taxes of their widows, widowers, children and other heirs is increased enormously. The inequities of this 1976 shift from the estate tax valuation basis to the almost-zero value basis certainly will be discussed by other witnesses and we will not repeat the arguments against that change.

However, Sec. 1023 imposes a second inequity on families and other heirs of authors, composers and artists that is not inflicted on the heirs of other taxpayers. This statement is directed to that unique problem.

(ii) As noted, the carry over provisions of Sec. 1023 change the dollar basis of inherited property. Inadvertently, these provisions also drastically changed the "capital asset" status of literary works and copyrights acquired by an author's heirs on his death imposing on them the author's "ordinary income" (non-capital asset) status. This change places inequitably heavy tax burdens on heirs of authors who died after December 31, 1976:

(*a*) When these heirs sell such property, they must pay tax at ordinary income rates.

(*b*) When they donate such property to libraries or other tax-exempt institutions, they may deduct only the author's nominal cost, rather than (as before) the property's fair market value.

(iii) If Congress does not eliminate Sec. 1023 in its entirety, The Authors League requests that Congress amend the Code to provide that literary property inherited by an author's heirs have the same "basis"—i.e., asset status—

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[1] Special note should be taken of the fact that there has been no opportunity for public comment on this specific Treasury recommendation despite its far reaching consequences respecting the taxability of life insurance policy proceeds.

*"Literary property" includes literary, dramatic, musical and artistic works; rights and copyrights in them; and the author's manuscripts, drafts, letters and similar property. See: Secs. 1221(3) and 1231(b)(1)(C).

which such property had for heirs before Sec. 1023 was enacted. By restoring that status, authors' heirs would be entitled, as they were previously: (a) to capital gains treatment on the sale of such property, and (b) to deduct its fair market value when they contribute it to tax-exempt institutions.

REASONS FOR THE ALTERNATIVE AMENDMENT

The purpose of Sec. 1023 was to foreclose "stepping-up" the dollar basis of inherited property to its fair market value. (See: Joint Committee on Taxation's Summary of the 1976 Act, p. 88.) However, the broad language used for that purpose, "carrying over" the decedent's "basis", has a second effect when superimposed on Secs. 1221 and 1231. These sections have, since 1950, denied authors (but not their heirs) capital-gains statuts for their literary property. If Sec. 1023 is construed to carry over the deceased author's ordinary income/non-capital asset status for the literary property under these sections (in addition to his dollar basis), it would deprive his or her heirs of the capital asset status they previously had under the Code.

We believe Congress did not intend or foresee that Sec. 1023 would thus change the capital asset status of literary property in the hands of an author's heirs. But in any event, the Authors League believes Congress should amend Sec. 1023 to eliminate this harsh consequence because:

(a) Literary property in the hands of an author's heirs actually has a different nature, legally and economically, than it does in the author's hands. The special reasons which led to denying capital gains status and treatment to authors during their lifetime do not apply to their heirs.

(b) Imposition of the author's ordinary income/non-capital asset status on his or her heirs subjects them to unfair and damaging tax consequences.

(c) Depriving authors' heirs of capital asset status for inherited literary property is not necessary to accomplish Sec. 1023's purpose of foreclosing the stepping-up of the dollar basis of inherited property to its fair market value.

THE NATURE OF LITERARY PROPERTY ACQUIRED BY AN AUTHOR'S HEIRS

(i) Literary property is a capital asset. A taxpayer who purchases a literary work or rights from an author is entitled to capital gains treatment when he sells the property. In his hands the property is a capital asset, no matter how little he paid the author or how much he gained on the subsequent sale—and even though the author is denied capital gains treatment if he sells the same property to the same buyer on the same terms and conditions. Similarly, before Sec. 1023, inherited literary property was a capital asset, in the hands of the author's heirs. When the heirs sold such property, they were entitled to capital gain treatment. *Ira Gershwin, et. al.*, v. *U.S.*, 153 F. Supp. 477 (Ct. of Claims, 1957)

(ii) Authors were denied capital asset status and treatment for their works during their lifetime for very definite reasons. Sec. 1221(3) provides that a copyright, book, play or song is not a "capital asset" when "held by a taxpayer whose personal efforts created such property." (emphasis added). The reason for denying authors capital asset status in their works even though the same works would be capital assets in the hands of purchasers or heirs, was explained by the Ways and Means Committee's 1950 report on this section. The Committee said that when "a person writes a book or creates some other sort of artistic work . . . with the idea of realizing income on it he should be treated as, being in the trade or business of writing . . . ." and that the "income from his personal efforts" should be taxed as "ordinary that the "income from his personal efforts" should be taxed as "ordinary income." (House Report No. 2319, 81st Cong., 2d Sess; 1950 CB-2, p. 421)

(iii) This reason for denying authors capital asset status in their lifetime has no valid application to their heirs. When, for example, a deceased novelist's mother sells the motion picture rights in a book she has inherited—she is not in the trade or business of writing, she is not deriving income from that business, and she is not earning income "from (her) personal efforts." On the contrary, she is realizing gain from the sale of a capital asset she acquired from someone else—no less so than the taxpayer who purchased the rights from her son, resold them years later to a movie company, and is entitled (even after Sec. 1023) to capital gains treatment on the proceeds.

As the Court said in *Gershwin et al.* v. *U.S.*, the author's mother is entitled to capital gains treatment because "She inherited the (works) from her son, and never acquired or sold any others. Her only dealings in the (works) were with those she inherited, and these were less than a half a dozen in number. *She was not engaged in any business.*" (emphasis added) (153 F. Supp. at p. 480).

It should be noted that unlike an author's inter vivos gift, a transfer of literary property by reason of the author's death is hardly the result of a "voluntary" act Indeed, transfer by death is far less voluntary than a sale. Consequently, Secs. 1221 and 1231 did not carry over the author's non-capital asset status to heirs of his literary property, as they did to inter vivos donees.

THE CARRYOVER OF NON-CAPITAL ASSET STATUS TO AUTHORS' HEIRS IMPOSES UNFAIR AND DAMAGING TAX CONSEQUENCES

(i) Although Sec. 1023 would impose the author's non-capital asset status on his heirs, it would not give them the protection he had under Sec. 1348 against crippling high-bracket taxes on income from a sale of the work. Rather than the maximum 50 percent rate he would pay under Sec. 1348, they might be subject to U.S. tax ranging up to 70 percent, in addition to state and local income taxes.

The rationale of capital gains treatment is to avoid the inequitable consequences of taxing in one year, at ordinary-income rates, the increase in value of an asset that occurred over a number of years. (cf. *Holt* v. *Commissioner*, 35 T.C. 588, 598 (and cases cited)).

An author's heirs are particularly vulnerable to such inequitable consequences. The purchase price paid by a film company for rights in a novel reflects an increase in value that may have occurred over decades. Indeed, the sale of rights in one book or play by a distinguished author may reflect a value created by a whole lifetime of writing. It is commonplace that only two or three of an author's many works will be commercially successful or retain value after his death. It is only these few that provide an inheritance for his or her family, or other heirs. Consequently, it is all the more imperative that Congress restore to them the capital asset status of these inherited literary works, to protect them against the confiscatory effects of ordinary-income tax rates.

(ii) The second consequence of Sec. 1023 is to deprive authors' heirs of the right to deduct the fair market value of inherited literary property which they contribute to libraries or other tax-exempt institutions—a right they had under the Code prior to enactment of the section last year. There is no justification for this change.

Authors were deprived of the right to deduct the fair market value of manuscripts and similar papers they contribute to libraries and similar tax-exempt institutions by a 1969 amendment which revised Secs. 170(e) and 1221 (3). It is generally recognized that these changes were intended to foreclose public officials from taking such deductions.

Moreover, these 1969 changes did not deprive an author's heirs of the right to deduct the fair market value of his manuscripts, when they donated them to qualified tax-exempt institutions—since the Code recognized the capital asset status of manuscripts (and similar property) in the hands of an author's heirs. The heirs are not in the "trade or business" of creating such manuscripts or dealing in them. Rather, the author's manuscripts, in their hands, are "capital assets"—just as they are in the hands of a taxpayer who might purchase them from the author. And such a taxpayer is entitled to deduct the fair market value of the manuscripts when he contributes them to tax-exempt institutions, even though that value far exceeds the price he paid for the papers (as is the case with other capital assets contributed to such institutions).

If an author's heirs are denied capital asset status for his manuscripts and papers, they will be trapped in a Catch-22 situation. The papers will be evaluated and estate-taxed at their "fair market value," even though it may not be possible to sell them for years (if ever) at that price or one remotely approaching it. On the other hand, contributions of the manuscripts to a library or archives, the most logical and socially desirable recipient, would result only in a nominal deduction.

CONCLUSION

The Authors League respectfully urges that Congress eliminate the carry over provisions of Sec. 1023. But if that change is not made, The Authors League urges that Congress amend Sec. 1023, or Secs. 1221 and 1231, to provide that literary property inherited by an author's heirs have the same basis—i.e., asset status—which such property had for heirs before Sec. 1023 was enacted.

METROPOLITAN GOVERNMENT OF NASHVILLE AND DAVIDSON COUNTY,
METROPOLITAN HISTORICAL COMMISSION,
Nashville, Tenn., November 3, 1977.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Chairman of the Subcommittee on Taxation and Debt Management, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: This letter is to express to you the very serious concern of historic preservationists in Tennessee and Nashville in particular about provisions in the 1976 Tax Act. As you probably are aware, an amendment to the Technical Corrections Act of 1976 introduced in recent days by Senator Bennett Johnson of Louisiana would permit persons holding long-term leases (30 years or longer) on eligible historic properties to take accelerated depreciation on the improvements the same as would the owner. This is a crucial issue if this act is to help in preservation of our major landmarks as we feel it was intended to do.

In Nashville, for example, the city recently accepted title to the U.S. Customs House, a surplus property given away by GSA for historic preservation purposes. Under the plan submitted to GSA and the NPS, the city is seeking a developer who will spend some $3 million on the building and will sign a 99 year lease on the building. Developers making proposals are most concerned that they be permitted by the IRS to take accelerated depreciation. Another significant old hotel, the Hermitage, has a developer working on a proposal to spend over $2 million and this is also based on a 99 year lease with the owner. As you can see, this provision to permit long-term lease holders to realize some benefit from this Tax Act is important if it is to help in encouraging reuse of our man-made resources.

We will appreciate your efforts in explaining our concern to others and hope you will call us if we can offer any further assistance.

Most sincerely,

MAY DEAN EBERLING,
Executive Director.

PATTON, BOGGS & BLOW,
Washington, D.C., October 28, 1977.

Re Written testimony on H.R. 6715, the Technical Corrections Act of 1977

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

DEAR MR. STERN: Enclosed please find five copies each of the following written statements, which we ask be made a part of the record: five statements of Ernest S. Christian, Jr., respectively concerning the appropriate "fresh start" rule for preferred stock, the expansion of the scope of section 303 redemptions to include resulting income tax, the interaction of the minimum tax provisions with the investment credit ESOP rules, section 3(a) of the Technical Corrections Act, and section 3(q) of the Technical Corrections Act; the statement of Thomas H. Boggs, Jr., concerning the rules applicable to deductibility of foreign convention expenses; and the statement of James P. Low concerning trade shows sponsored by section 501(c)(3) organizations.

Very truly yours,

CHARLES B. TEMKIN.

Enclosures.

STATEMENT OF ERNEST E. CHRISTIAN, JR.

SECTION 3(Q)—CONFORMING GIFT TAX PROVISIONS TO ESTATE TAX PROVISIONS IN CASE OF TRANSFERS OF SPLIT INTERESTS

This statement is submitted in support of section 3(q) of the Technical Corrections Act of 1977 as passed by the House. This provision has already received the support of the Treasury Department, and it is urged that it likewise deserves the endorsement of the Subcommittee on Taxation and Debt Management. The purpose of this statement is to discuss the problem to which section 3(q) is addressed and its manner of solving this problem.

Both section 2055(e), relating to the estate tax, and section 2522(c), relating to the gift tax, provide that where property is divided into an income interest and a remainder interest, and one such interest is bequeathed or donated to charity and the other to a noncharity, or, in the case of a gift, the donor retains one such interest and donates the other to charity, no estate tax or gift tax deduction for the charitable bequest or gift will be allowed unless the charitable interest meets certain technical requirements. Essentially, the charitable interest must be in the form of an annuity trust, a unitrust, a pooled income fund, a guaranteed annuity or fixed percentage interest. These requirements are designed to assure greater certainty and precision in valuing the charitable interest for estate tax or gift tax purposes.

The Tax Reform Act of 1976 provided, however, that if a will or trust executed before December 31, 1977, contained such a split-interest bequest to charity, and if an estate tax deduction would be disallowed because of failure to meet the technical requirements of section 2055(e), an estate deduction nevertheless would be allowed if the will or trust were, pursuant to a judicial proceeding filed prior to December 31, 1977, reformed to meet the requirements of section 2055(e).

Inexplicably, however, no such transitional rule was provided with respect to reformation of an intervivos split-interest trust to meet the corresponding requirements of section 2522(c) for allowance of a gift tax deduction for a gift to charity. There is no less justification for permitting reformation for gift tax purposes than for estate tax purposes. If such split-interest trust gifts to charity are not permitted to be reformed, pursuant to judicial proceedings, to meet the technical requirements of section 2522(c), the result will be arbitrarily to impose a gift tax on an amount transferred to charity.

It must be pointed out that this is not a question of enabling a donor to obtain any positive tax advantage. There is no tax advantage to the donor, whether or not a reformation is permitted to occur. Nor is this a question of the charity losing a gift. This is solely a question of unnecessarily penalizing a donor for making a gift to charity which he is willing, and with the consent of a court able, to reform to meet the technical requirements of section 2522(c) for classification as a guaranteed annuity, fixed percentage interest, etc.

The Tax Reform Act of 1976 recognized the equity of permitting reformation in the case of the estate tax, where the transfer to charity was by request. Section 3(q) of the Technical Corrections Act makes a parallel amendment to section 2522(c), where the transfer to charity is by gift. This amendment permits a gift tax deduction if the trust is reformed, pursuant to a judicial proceeding filed prior to December 31, 1977, to meet the technical requirements of section 2522(c). This is a sensible result, and it should be approved by the Subcommittee.

SECTION 3(A)—INTERACTION OF SECTIONS 303 AND 306 OF CODE

This statement is submitted in support of section 3(a) of the Technical Corrections Act of 1977 as passed by the House, which deals with the operation of section 306 of the Code, both in general and in conjunction with section 303.

Section 3(a) has already received the enthusiastic support of the Treasury Department—it was prominently discussed before the Subcommittee in the statement of Donald C. Lubick, Deputy Assistant Secretary of the Treasury for Tax Policy, on October 26, 1977—and of private tax practitioners. Nevertheless, it is thought that it may be helpful for the Subcommittee to have for the record a brief description of the background of and the need for this legislation. Therefore, this statement notes the law in this area before passage of the Tax Reform Act of 1976, explains the impact of the Reform Act, and finally shows how section 3(a) is necessary to correct an unintended and inappropriate collateral consequence of the passage of the Reform Act.

I. Description of prior law

The objective of section 303, whose predecessor was adopted in 1950, is to permit an estate made up primarily of stock in one corporation to obtain funds to pay Federal and state death taxes, as well as certain funeral and administration expenses, without forcing a sale of the business. It does this by creating a special rule for qualifying redemptions.

Ordinarily, a redemption of stock is taxable to the stockholder as a dividend rather than as a sale of stock if section 306 applies or if the redemption fails to fit within one of various categories set out in section 302(b) of the Code, the common element of which is the substantial if not total reduction of the stockholder's interest in the corporation. Section 302 is the basic provision. Section 306 supplements section 302 with respect to certain stock, usually preferred, previously distributed. Commentators appropriately have questioned the need for section 306 as a supplement to section 302 in the case of redemptions as distinguished from sales of stock.

Typically, the redemption from an estate of part (or perhaps even of all) of its stock in a closely held corporation would not fall within any of the categories of section 302(b) because the redemption would not sufficiently reduce the estate's degree of ownership of the corporation, either direct or through attribution. The redemption would therefore be taxed as a dividend at ordinary income tax rates. However, section 303 changes this result: to the extent that the amount of the redemption does not exceed the death taxes and funeral and administration expenses, such a redemption is taxed as a sale of stock. In other words, rather than being taxed in its entirety as a dividend, a redemption under section 303 would be taxed only if it exceeded the stock's basis and, in such a case, this excess would be taxed as a capital gain. Prior to the Reform Act, the basis of such stock would have been its fair market value at the date of death.

The step-up in basis at death also had significance for section 306 purposes. The decedent might have owned preferred stock to which section 306 applied. However, section 306 by its own terms provides that it ceases to apply to stock which is transferred in a transaction where the transferee's basis is determined without reference to the transferor's. Because stock passing to an estate obtained a new basis, it could be redeemed without regard to section 306.

In addition, section 303(c) provides in effect that if stock held by an estate would qualify for section 303 treatment, then so would section 306 stock received by the estate subsequent to the decedent's death in a taxfree transaction in respect of the qualifying stock already held.

Thus, before the Reform Act, it was clear how sections 302, 303, and 306 worked in conjunction, and that section 303 overrode section 306 just as it overrode section 302.

II. Impact of reform act

In the Reform Act, Congress directly reaffirmed the policy underlying section 303 by making certain refinements in its application. In the General Explanation of the Tax Reform Act of 1976 ("General Explanation"), prepared by the staff of the Joint Committee on Taxation after the Act's passage, the goals of these refinements are described as follows:

"Thus, in general, the changes made by the Act are designed to make this special capital gains treatment available only where the closely held business interest constitutes a substantial part of the estate of the decedent and where the party whose shares are redeemed actually bears the burden of the estate taxes, state death taxes, or funeral and administration expenses, in an amount at least equal to the amount of the redemption."

General explanation at 551: see also id. at 546.

The Reform Act made no changes in section 306 itself. However, for reasons not germane to the application of sections 303 and 306, the Reform Act did eliminate, as of December 31, 1976, the rule providing an asset held in an estate with a new basis equal to its estate tax valuation. In its place, the Reform Act provided that the decedent's basis in such an asset would carry over to the estate, with upward adjustments (but not beyond the fair market value of the asset) to reflect Federal and state estate taxes attributable to post 1976 appreciation; a minimum aggregate basis of $60,000; certain state succession taxes; and pre-1977 appreciation. These new rules appear in new section 1023 of the Code, with the upward basis adjustments embodied respectively in subsections (c), (d), (e), and (h). See General Explanation at 551 and following.

While the language of section 306 was not directly amended, the new basis-at-death rules may be construed to change the operation of section 306 with regard to section 306 stock passing from a decedent to his estate. As was stated above, stock ceases to be section 306 stock if it is transferred and the new owner's basis in such stock is not determined by reference to the basis of the previous owner. Now, however, given the new carryover basis rules enacted by the Reform Act, this language may be said no longer to describe the basis of an estate in section 306 stock owned by the decedent.[1] Under this interpretation, stock which is section 306 stock in the hands of a stockholder would continue to be section 306 stock in the hands of the estate. Assuming it is, there arises the ultimate question of whether a redemption of such stock which meets the requirements of section 303 would be taxed as a sale under section 303 or would be taxed as ordinary income under section 306.

Consequently, a technical amendment is necessary to make clear that section 303 continues to override section 306 just as it has continued to override section 302.

III. Section 3(a) of the Technical Corrections Act

In reconciling the operation of sections 303, 306, and 1023, the dominant objective must be to continue to give effect to Congress' most recently expressed wishes: to avoid precipitating forced sales of closely held businesses in order to pay death taxes; and to prevent unrealized appreciation of assets permanently to escape income taxation, as happened under prior law because of the new basis given to assets held at death. This objective should be fulfilled in a manner that is simple and free from technical flaws.

Section 3(a) of the Technical Corrections Act would achieve this result. First, it provides that section 306 stock held on or before December 31, 1976, will for section 306 purposes be treated as having a "fresh start" basis. Second, it excludes distributions in redemption which qualify under section 303 from the purview of section 306.

This would be a natural continuation of prior law. Before the Reform Act, post-death appreciation was taxable in a section 303 redemption as capital gain; under section 3(a), the excess of the amount of the redemption over the stock's basis would also be taxed as a capital gain, the only difference being that, under the new carryover basis rules, pre-death appreciation would also be reached.

Furthermore, it must be emphasized that section 3(a) would not impinge unduly upon section 306. Section 306 is directed to the same type of situation to which section 302 is addressed—the removal of funds from a corporation without any relinquishment of ownership. Congress has obviously made the determination, repeated again in the Reform Act, that the desirability of using section 302 to prevent capital gain treatment upon such an occurrence is less important than the overriding need to avoid the forced sales of closely held businesses.[2] The same rationale applies with respect to section 306. Moreover, it must be kept in mind that this relief from section 306 would be limited to the amount of Federal and state death taxes and funeral and administration expenses borne by the estate or heirs.

IV. Conclusion

As shown above, an unintended and collateral consequence of the enactment of the new carryover basis rules was the creation of uncertainty regarding the operation of sections 303 and 306. Section 3(a) of the Technical Corrections Act as passed by the House would resolve this uncertainty in a manner that is consistent with the policies inherent in both prior law and in the new carryover basis

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[1] In describing the operation of section 1023(h), which gives all assets a "fresh start" as of Dec. 31, 1976, the general explanation contains a somewhat obscure reference to section 306: "The Treasury Department is to issue regulations determining the application of the 'fresh start' rule where gain from the sale of the property is subject to special rules taxing all or a portion of the gain as ordinary income (section 306, 1245, 1250, etc.) . . ." General explanation at 556.

[2] Additional instances illustrating the importance Congress has attached to this goal are as follows: Section 303 takes precedence where gain from the sale of stock of a foreign corporation would otherwise be treated as ordinary income, see section 1248(g)(1); the use of appreciated property in a section 303 redemption is not taxed at the corporate level, see section 311(d)(2)(D); a section 303 redemption is one of the reasonable needs of a business for which earnings may be accumulated, without imposition of the tax on unreasonable accumulations, see section 537(a)(2); and a reduction in ownership caused by a section 303 redemption does not trigger the limitations on carrying over losses, see section 382(a)(1)(C)(v).

rules. It is strongly supported by the Treasury Department. It merits the support of this Subcommittee.

EXPANSION OF SCOPE OF SECTION 303 REDEMPTIONS TO INCLUDE RESULTING INCOME TAX

This written statement is submitted in support of section 7(a) of S. 2228, which has been introduced by Senator Harry F. Byrd, Jr., for himself and Senator Dole. This legislation is necessary to ensure the effectiveness of section 303 of the Code in averting the forced sales of closely held businesses.

Section 303, a provision of almost thirty years' standing which was also in essence reenacted in the Tax Reform Act of 1976, permits an estate consisting primarily of stock in one corporation to obtain funds from the corporation to pay Federal and state death taxes, as well as certain funeral and administration expenses. Under this section a redemption by the corporation of the necessary amount of its stock is treated as a sale and is taxed at capital gains rates. Prior to the 1976 Act, the capital gains tax was usually nominal in amount because the basis of the stock was stepped up to its fair market value on the date of the decedent's death.

However, because of the new rules in section 1023 of the Code for the carryover of basis at death, pre-death appreciation of the redeemed stock is now taxable. Thus, when stock is redeemed to pay death taxes, the estate also needs to raise the funds to pay this income tax and may face the serious liquidity problem which section 303 is designed to relieve.

Assume that the owner of a family business worth $2,500,000 dies and that the owner's basis in each of the 25,000 shares of the stock outstanding was $10 per share. The Federal estate tax on the estate will be about $1,000,000. Under the new carryover basis rules, the estate's basis in the stock will be about $50 per share. Section 303 permits the redemption of 10,000 shares for $1,000,000 to be taxed as a sale, which will produce a tax of about $200,000 on the $500,000 gain. Additional stock must then be redeemed to pay this tax. If the additional redemption is not covered by section 303, it will be taxed as a dividend at a 70 percent rate, and so $667,000 worth of stock must be redeemed. If the additional redemption were to qualify under section 303, only half that amount would have to be redeemed. The difference could be the straw that breaks the camel's back.

Accordingly, it is appropriate for the amount of stock redeemable under section 303 to correspond not only to the death taxes and funeral and administration expenses, but also to the income tax payable upon the redemption. As is shown by the considerable payment of income tax in the example, such a change would in no way undermine the impact of the new carryover basis rules.

Section 7(a) of S. 2228 would achieve approximately this result by increasing the amount qualifying for section 303 treatment by the amount of income tax payable on the basic qualifying amount, i.e., the qualifying amount before taking this increase into account. In terms of the above example, section 7(a) would permit the redemption of $200,000 worth of stock. While section 7(a) would not apply to the income tax payable by reason of the redemption of this $200,000 worth of stock itself, including this additional income tax payable would require the use of an algebraic formula which might be difficult to administer. Hence, section 7(a)'s approach represents a sensible compromise which deserves the support of the Subcommittee on Taxation and Debt Management.

APPROPRIATE "FRESH START" RULE FOR PREFERRED STOCK OF CLOSELY HELD BUSINESS

This statement is addressed to one particular shortcoming of the new carryover basis rules added by the Tax Reform Act of 1976—the treatment of preferred stock in closely held business held before 1977. The Technical Corrections Act of 1977 would be an appropriate vehicle for the rectification of this problem.

Prior to the Tax Reform Act of 1976, an estate's tax basis in assets received from the decedent was the value of the assets for estate tax purposes, which was their fair market value at the date of death. Now, under new section 1023 of the Code, the estate's basis is generally the decedent's basis, with a number of adjustments. The purpose of having the decedent's basis "carry over" to the estate, as opposed to having the assets receive a new basis, is to subject pre-death appreciation to income tax.

However, in enacting the new carryover basis rules, it was also Congress announced intention not to apply the new rules to the portion of appreciation in assets held on December 31, 1976, which occurred prior to that date. Section 1023

(h) provides two rules designed to achieve this result. In the case of marketable bonds and securities, the estate's basis will be their fair market value on December 31, 1976. For all other property, the estate's basis will be the decedent's basis plus a fraction of the difference between the fair market value at death and the decedent's basis. The fraction corresponds to the relative number of days the property was held before and after December 31, 1976.

The rationale for use of the holding-period formula is that it avoids the necessity of determining the actual December 31, 1976, value of property by providing a reasonable and easily computable estimation of value on that date. The reasonableness of this estimate is, of course, dependent on the assumption that the daily amount of appreciation was constant.

Although the holding-period approach may represent an adequate compromise between exactness and administrative convenience with respect to assets which routinely appreciate over time, it is a patently inappropriate method for attempting to approximate the December 31, 1976, value of nonconvertible preferred stock issued by closely held businesses. First, the underlying assumption of constant daily appreciation is clearly incorrect in the case of such stock. While the value of such stock may fluctuate because of interest rate changes and similar factors, there is a fixed upper bound on such value because of the fixed, nonparticipating nature of this type of stock; unlike common stock issued by closely held enterprises, preferred stock will not increase in value over time. Therefore, under the holding-period formula, the longer the owner of preferred stock lives past 1976, the lower will be the estate's basis in the stock.

Second, a much better method is available. The very stability of the value of nonconvertible preferred stock permits an approach which produces a much more accurate estimate of value without sacrificing administrative convenience: deeming the stock's valuation for estate tax purposes to be its December 31, 1976, value. This would obviously yield a much closer approximation of the December 31, 1976, value than does the holding-period approach. Furthermore, while the estate-tax-value approach is more favorable to taxpayers than holding-period approach, it is by no means pro-taxpayer, because the value of the preferred stock at the decedent's death may in fact be greater or less than the actual December 31, 1976, value.

Enactment of the approach here proposed could be accomplished with the following legislation:

SEC. . "Fresh start." Rule for certain preferred stock.

(a) *Amendment to Section 1023(h)(2).*—(1) Subsection 1023(h)(2)(B) is amended by substituting a comma for the period at the end thereof, and by adding the following at the end of said subsection: "except that in the case of nonconvertible fixed preferred stock the increase under this subparagraph shall be the excess referred to in subparagraph (A)(ii)." (2) Subsection 1023(h)(2)(E) is amended by adding at the end thereof the following new subparagraph: "(iii) The term 'nonconvertible fixed preferred stock' means stock which at December 31, 1976, and all times thereafter until the death of the decedent—

"(a) was fixed and preferred as to dividends and did not participate in corporate growth to any significant extent,

"(b) had redemption and liquidation rights which did not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par value), and

"(c) was not convertible into another class of stock."

(b) *Effective date.*—The foregoing amendment shall apply in respect of decedents dying after December 31, 1976.

It is urged that the Subcommittee give serious consideration to remedying in this manner the clearly inappropriate treatment which section 1023(h) now provides.

The Tax Reform Act of 1976 contains a serious technical anomaly which involves the interaction of the minimum tax in section 56 and those Employee Stock Ownership Plans which are funded through additional investment tax credit. The result is clearly inconsistent with the underlying rationale on the basis of which the Tax Reform Act of 1976 expanded and liberalized the investment credit ESOP program and in furtherance of which the Reform Act eliminated an analogous incongruity. This anomaly should similarly be corrected.

The Reform Act made two overall changes in the investment credit ESOP program. First, the Reform Act extended the additional 1 percent investment credit program (due to expire in 1976) to qualified investment made before January 1, 1981. Second, the Reform Act provided that if an employer supplements its contributions under the 1 percent credit program by matching employee contributions to the ESOP, beginning in 1977 there will be an extra investment credit (up to an extra ½ percentage point of qualified investments) for the employer's supplementary contributions which are matched by employee contributions.

These changes were premised on the belief that the basic framework of the 1½% ESOP investment credit is as follows: (i) that the credit is allowed as a benefit to the employees, not the employer; (ii) that although the benefit is based on the employer's investment, the employer is merely a conduit for the benefit to the employees; and (iii) that there should be no tax cost to the employer associated with providing this benefit.

In effect, the investment credit ESOP is merely a transfer of part of the employer's tax from the Treasury to the ESOP trust.

This view of the investment credit ESOP is illustrated by an additional action taken in the Reform Act. It involved the investment credit recapture provisions. Before the Reform Act, if an employer had to repay previously allowed investment tax credit—which can happen if the property acquired is prematurely disposed of, or if the amount of the credit is redetermined for other reasons—the employer could not recover from the ESOP any amounts already contributed to it. That is, the employer would risk having to pay the ESOP's share of excess credit. The Reform Act, however, removed this disincentive by providing the employer with a set of options: using the amount of the repayment as an offset to contributions due the ESOP for other years; or deducting it; or recovering it from the ESOP.

A similar situation, where for technical reasons an otherwise unrelated provision has an unintended impact on the investment credit ESOP program, exists with respect to the interaction of the ESOP credit with the minimum tax. Presently, even though the 1½ percent contribution by the employer is in effect a payment of a like amount of tax—which the Congress has asked be paid to the ESOP trust instead of to the Treasury—the employer is not permitted to offset that "tax" against preferences under the minimum tax. Thus, if its preferences equal or exceed regular tax prior to reduction by the ESOP credit, the employer must pay a 15 percent minimum tax on each dollar of contribution to the ESOP trust.

This additional impediment to the adoption of ESOPs should be corrected. The following language would do so:

SEC.   . Elimination of minimum tax on investment credit ESOPs.

(a) *Redefinition of Regular Tax Deduction.*—Section 56(c)(3), (relating to the definition of regular tax deduction) is amended to read as follows: "section 38 (relating to investment credit), reduced by the excess, if any, of the credit allowed pursuant to section 46(a)(2)(B) (relating to additional credit) over the credit which would have been allowable pursuant to section 46(a)(2)(A)."

(b) *Effective Date.*—The amendment made by this section shall apply to taxable years ending after December 31, 1974.

This amendment applies to taxable years ending after 1974 because the original 1 percent ESOP credit enacted in 1975 was allowed for investments after 1974.

Inasmuch as the technical annomaly discussed above thwarts the full effectiveness of the Reform Act's extension and liberalization of the investment credit ESOP program, the amendment should be adopted as quickly as possible.

STATEMENT OF JAMES P. LOW, PRESIDENT, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives urges that the Technical Corrections Act of 1977 include the correction of an anomaly in the Tax Reform Act of 1976 which adversely affects all section 501(c)(3) organizations that sponsor trade shows in furtherance of their exempt purposes.

Section 501(c)(3), 501(c)(5), and 501(c)(6) organizations may conduct trade shows in furtherance of their exempt purposes. The Reform Act added new section 513(d)(3) expressly to reaffirm the principle that the sponsorship of these shows is not an unrelated activity, and therefore amounts paid to the organization by exhibitors for display space at the show are not unrelated business taxable income under section 511. The anomaly is that while new section 513(d)(3) makes clear that sponsorship of trade shows by section 501(c)(5) and 501(c)(6) organizations does not result in tax, it may be read to imply that sponsorship of trade shows by a section 501(c)(3) organization does result in a tax on unrelated business income.

Such a result was never intended by Congress and is illogical. A colloquy on the Senate floor between Senator Talmadge and Senator Long clarifies that the exemption from the unrelated business income tax also applies to trade shows sponsored by section 501(c)(3) organizations. See 140 Cong. Rec. 16015 (1976).

The possible negative implication for section 501(c)(3) organizations arises from the fact that new section 513(d)(3) fails to make any express reference to section 501(c)(3) organizations. That omission, however, does not reflect any substantive differentiation with respect to section 501(c)(3) organizations; it merely reflects the context in which the legislation arose.

New section 513(d)(3) was enacted in response to rulings issued in 1975 which held that where sales by exhibitors occur, trade shows sponsored by business leagues and labor, etc., organizations do not contribute to their exempt purposes, and the amount paid by exhibitors for dispaly space is unrelated business taxable income. See TIR-1409. 1975-2 C.B. 220. Accordingly, new section 513(d)(3) expressly exempts from the unrelated business income tax income derived by section 501(c)(5) and (6) organizations from qualified[1] convention and trade show activities which stimulate interest in the industry products and educate the organizations' members regarding new developments and techniques which are available to the trade.

Although no express mention was made of section 501(c)(3) organizations, the legislative history shows that Congress intended to overrule the 1975 rulings in principle and to substitute its conclusion that fairs,[2] expositions, and and trade shows do relate to the exempt purposes of the organization conducting them. The rationale of this Congressional conclusion equally applies to the sponsorship of trade shows by section 501(c)(3), 501(c)(5) and 501(c)(6) organizations.

Section 501(c)(3) organizations do conduct trade shows. For example professional societies use trade shows to educate their members regarding developments, products and technology available to them and of interest to the industry in which they work. These shows, whether or not sales by exhibitors occur, are in furtherance of their exempt purposes. A good example is the Society of Manufacturing Engineers which is a 501(c)(3) organization of 40,000 professional engineers. It would be illogical to permit a labor organization of employees exempt under section 501(c)(5) to sponsor a trade show free of tax and to impose an unrelated business income tax on the Society of Manufacturing Engineers if it conducted the identical trade show.

One of the specific criteria for a qualified trade show under new section 513(d)(3) is that the show educates the organization's members regarding new developments and techniques which are available to them. Certainly, for example, a trade show sponsored by an organization of employees of a particular industry, or members of a profession, does precisely that whether it is a section 501(c)(3) educational organization or a 501(c)(5) labor organizations. Some employee organizations may be organized under section 501(c)(4) and the Committee should also consider including them in section 513(d)(3).

This technical anomaly should be corrected by amending section 513(d)(3) as follows:

SEC. Omission of certain activities of trade show, etc.

(a) *Omission of convention and trade show activity.*—Subparagraph (b) of section 513(d)(3) (defining qualified convention and trade show activity)

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[1] Convention and trade show activities are qualified within the meaning of new section 513(d)(3)(B) if (i) they are carried on in conjunction with an international, national, state, regional or local convention, annual meeting, or show; (ii) the purpose of the sponsoring organizations is the promotion of interest in the industry's products; and (iii) the show promotes the purpose through the character of the exhibits and the industry's products displayed.

[2] Section 513(d)(2) also exempts from the unrelated business income tax county fairs conducted by section 501(c)(3) organizations. It overrules Rev. Rul. 68-505, 1968-2 C.B. 248, in which the Internal Revenue Service ruled that a county fair association has unrelated business taxable income from the sponsoring of horse races.

is amended by inserting "or to educate persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry" after "and services of that industry in general."

(b) *Omission of qualifying organization.*—Subparagraph (c) of section 513(d)(3) (defining qualifying organizations) is amended by inserting "(3)," after "described in section 501(c)", and by striking out the period at the end thereof and adding in lieu thereof: ", or which educates persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry."

(c) *Effective date.*—The amendments made by this section shall apply to qualified convention and trade show activities in taxable years beginning after October 4, 1976.

The American Society of Association Executives urges that this amendment be adopted as soon as possible in order to eliminate a substantial impediment to the development, understanding, and use of important new technologies, products, practices and techniques in American business.

STATEMENT OF THOMAS H. BOGGS, JR. ON BEHALF OF AD HOC COMMITTEE ON SECTION 602 RULES APPLICABLE TO DEDUCTIBILITY OF FOREIGN CONVENTION EXPENSES

This statement is submitted on behalf of the Ad Hoc Committee on section 602, which consists of seven major United States hotel chains (Hilton International, Hyatt International, Loews Hotel Corporation, Marriott Hotels, Sheraton Hotel Corporation, Holiday Inns, Inc., and Western International Hotels) and the American Society of Association Executives. At issue are the new limitations on the deductibility of the expenses of attending foreign conventions. These were enacted in section 602 of the Tax Reform Act of 1976—hence the name of the Ad Hoc Committee—and appear as section 274(h) of the Internal Revenue Code. It is believed that the enactment of these limitations was quite misguided, and the most appropriate course of action to be taken at the present time would be their outright repeal. But before discussing how such a repeal might properly be accomplished, this statement addresses two topics: first, certain technical problems which involve the operation of the existing rules and which, if the present statutory scheme is retained, should be corrected in the Technical Corrections Act of 1977; and second, legislation which the Senate Finance Committee considered in 1976 and which appears to be headed for reconsideration at the present time as a possible alternative to section 274(h).

At the outset, it is helpful to review section 274(h) briefly. It must be kept in mind that its limitations apply whether the person claiming the deduction is the traveler or another person, such as the traveler's employer.

A "foreign convention" is defined as "any convention, seminar, or similar meeting held outside the United States, its possessions, and the Trust Territory of the Pacific". Transportation expenses to and from such a convention are deductible only to the extent they do not exceed coach or economy fare, and only if more than half the days of the trip are spent in activities related to business. If less than half the days are so spent, only the allocable fraction of the transportation expense is deductible. Subsistence expenses while attending such a convention, for meals, lodging, local transportation and the like, cannot exceed the appropriate Government per diem rate; and whether this amount can be deducted in full, in part, or not at all depends on adherence to certain prescribed rules of attendance at meetings. Attendance must be verified not only by the individual, but also by an officer of the group sponsoring the convention. In addition, if an individual attends more than two such conventions in a taxable year, only the expenses related to two of them may be deducted.

The first technical problem with this structure relates to the definition of convention. The legislative history of section 274(h) indicates that Congress had in mind vacation-like group gatherings which were short on business and long on sightseeing and recreation. However, the language of section 274(h) goes far beyond that concept. The phrase "convention, seminar, or similar meeting" could be interpreted to include all sorts of traditional, legitimate, non-recreational business activities: one or a group of salesmen meeting with several employees of an actual or prospective customer; one or a group of lawyers conferring with the officials of a foreign client; one or a group of the executives of a company holding discussions with the officers of the company's foreign subsidiary; or a group of the employees of a single multinational corporation being brought together by the company for instruction on various items of common interest. These activities, which may be characterized by their nonpublic nature, obviously do not represent conduct which Congress found fault with and intended to discourage, and the definition of convention should be redrafted so as clearly to exclude them.

Similarly, the definition of foreign convention ought not to include the meetings of international organizations with worldwide memberships. Such organizations schedule meetings outside the United States not to provide vacation opportunities, but rather in order to provide convenient locations for their memberships as a whole to gather. They therefore do not constitute the abuse situations at which section 274(h) is aimed.

Accordingly, we believe the following language should be inserted at the end of section 274(h) (6) (A), which defines convention:

"The term shall not include (i) any private meeting which relates to doing business directly or indirectly within a foreign country or with the government, a company, or a national of a foreign country; or (ii) any convention, seminar, or similar meeting sponsored by an organization at least 20 percent of whose members are not citizens or residents of the United States."

It should be noted that the Technical Corrections Act of 1977, as passed by the House, has taken care of a similar problem—the application of section 274(h) to trips awarded as compensation for services.

A second series of points about the existing rules relates to the use of Government per diem rates as a reference guide for the deductibility of subsistence expenses. Government per diem rates frequently are fixed on the basis that, at the location in question, meals and/or lodging are available to Government employees either at reduced rates from private commercial establishments or for free at Government installations. This would of course not be true for private individuals. Consequently, it is inappropriate to impose a Government per diem rate as a limit on subsistence expenses in any instance where the rate reflects benefits not available to private individuals. Section 274(h) should be amended to so provide.

Furthermore, many Government employees are not subject to the posted per diem rate with respect to many foreign areas; instead, they may be reimbursed for their actual expenses. It makes no sense to apply Government per diem rates to private individuals where the rates are in fact not applied to Government employees, and section 274(h) should be corrected to reflect this, too.

Finally, there is a question of how the limitation is computed. If the limitation is to be retained at all, the statute should be made clear, as it now is not, that subsistence expenses should be limited on an aggregate basis—that is, the number of days of the trip (or half days, whenever only half a day is spent on business), multiplied by the appropriate Government per diem rate. This would remove any implication that subsistence expenses should be compared with the per diem rate on a daily basis, a procedure which would be extremely cumbersome and without redeeming virtue.

These corrections could be made by amending section 274(h) (5) to read as follows:

"In the case of any foreign convention, no deduction for subsistence expenses while at the convention or traveling to or from such convention shall exceed an amount which equals the number of days or half days, as the case may be, with respect to which a deduction for subsistence expenses is allowable under (4) of this subsection, multiplied by the dollar per diem rate for the site of the convention which has been established under section 5702(a) of title 5 of the United States Code and which is in effect for the calendar month in which the convention begins. The preceding sentence shall not apply (i) if such per diem rate has been established by taking into account reduced rates of subsistence expenses which are not available to the general public or (ii) unless no employee of the United States who visits such site is eligible for reimbursement of actual expenses."

A third problem involves the existing substantiation requirements. Under section 274(h) (7), the taxpayer attending the convention must secure from the sponsoring organization a written statement, signed by an officer of the organization. This statement must among other things describe the schedule of the business activities and state the number of hours during which the taxpayer attended these scheduled activities. Larger organizations may have dozens of sessions conducted concurrently. For example, it is understood that the American Psychological Association is planning a convention at which they expect to have 17,000 persons in attendance and to conduct 70 simultaneous business sessions. Such organizations will find it extraordinarily difficult to keep track of the whereabouts of every participant at every point in time. It will be very expensive for them to hire enough additional officers to attempt to monitor all participants; and even then it will not be easy to prevent a dishonest participant from falsifying the records relating to attendance at any given session.

What is appropriate would be to require the individual attending a foreign convention to indicate on his tax return that he has done so and to maintain records describing the business activities conducted at the convention and his attendance at them. This is what is done now with respect to other expenses covered by section 274. The sponsoring organization should have to furnish only a schedule of the business activities at a foreign convention and a statement that the individual attended the convention as a whole.

To accomplish this, section 274(h)(7) should be amended by deleting the language "attaches to the return of tax on which the deduction is claimed"; inserting in lieu thereof the words "maintains in this records"; and amending section 274(h)(7)(B)(ii) to read "a statement that the individual attended such convention, and".

Fourthly, the definition of "foreign" should be confined to only those meetings held outside North America (including the Caribbean). The new provisions are having a very significant impact—and in some instances a disastrous impact—on the economies of our close neighbors. Further, segments of some U.S. industries are also being adversely affected. For example, more than 70 percent of the GNP of the Bahamas comes from tourism, and most of the food products and transportation services connected with this industry are purchased from the United States. Canada is a net exporter of tourist dollars to the U.S. and, although the new provisions were in effect only 10 days by January 10, 1977, cancellations at that time exceeded $12 million and virtually no new business was being booked. The longer-term impact will be a severe dislocation in the Canadian travel industry. A final example is Mexico where, although the new law was not yet effective, 31 conventions were cancelled by December 20, 1976.

Moreover, it should be noted that the use of the North American area as the geographical demarcation was adopted by the Committee on Ways and Means during its early consideration of the reform legislation which ultimately become the Tax Reform Act of 1976. The North American area was likewise utilized last year when the Senate passed its version of the foreign convention provision. It is understood that it was only by reason of an oversight on the part of the members of the House-Senate Conference Committee that the definition of "foreign" ultimately adopted was less inclusive.

Consequently, section 274(h)(6)(A) should be amended by adding at the end thereof the following language: "or the area lying west of the thirtieth meridian west of Greenwich, east of the international dateline, and north of the equator, but not including any country of South America."

Finally, it is submitted that the technical problems described above should be remedied as of January 1, 1977, when the new rules become operational. This would treat all taxpayers equally and would also avoid the considerable confusion which would result from correcting the errors in midstream.

The next general area addressed in this statement is the legislation which the Senate Finance Committee reported out in 1976. This proposal would apply only to conventions held outside the North American area. In the case of such a convention, the expenses would be deductible if the taxpayer establishes that his attendance had a direct relation to his trade or business and that, taking three factors into account, it was more reasonable for the convention to be held outside the North American area than within it. The three factors, which are considered jointly, are (1) the purpose of and activities taking place at the convention, (2) the purposes and activities of the sponsoring organization, and (3) the residences of the organization's members and the location of other sponsored conventions.

While we support the use of the North American area as the dividing line, the remainder of the proposal is a cause for serious concern. Under the legislation, it could be anticipated that the expenses of attending foreign conventions would not be deductible unless a taxpayer could show virtually that it was impossible to hold the convention within the North American area.

We believe that this approach would be considerably sounder if the listed factors were considered in the alternative and if the overall guideline were changed from "more reasonable" to "reasonable," the more commonly interpreted statutory test. In other words, the taxpayer would be required to establish that it was reasonable to hold the convention outside the North American area because of either (a) the relation between the purpose of and activities at the convention and the purposes and activities of the sponsoring organization or (b) the residences of the organization's members and the location of other sponsored conventions. Thus, for example, it would be sufficient for a taxpayer to demonstrate that an organization with a purely domestic membership has a legitimate international purpose and that this purpose was carried out at the convention. In the case of organizations with significant foreign membership—say, at least 20 percent—a taxpayer would have to identify this fact and also indicate where the organization has held and intends to hold conventions.

However, as was indicated at the beginning of this statement, the best course of action would be simply to repeal section 274(h). Even with the amendments here proposed, the rules of section 274(h) would remain a confusing and illconceived jumble. It would be far better for the whole deductibility question to be dealt with under the law which was developed under section 162, supplemented where necessary with new Treasury regulations. This would restore the focus of the inquiry onto the only appropriate question—whether the expenses of attending a foreign convention are ordinary and necessary business expenses.

TRUST DIVISION,
TEXAS BANKERS ASSOCIATION,
Austin, Tex., November 30, 1977.

Re Repeal of Carryover Basis—S. 2227.

Senator HARRY F. BYRD,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: I have just read your comments on the repeal of carryover basis in the November 22, 1977 Congressional Record. Your position has the complete support of the Trust Division of the Texas Bankers Association.

However, I noticed in the groups of those opposed to carryover basis that the Texas Bankers Association was omitted. I assure you that we have opposed this complex and essentially unworkable concept from the beginning.

Again, let me assure you of our support for the repeal of carryover basis and for a return to the prior law.

Sincerely yours,

ROBERT G. MCKENZIE,
Legislative Chairman.

TRUST DIVISION,
TEXAS BANKERS ASSOCIATION,
Austin, Tex., December 2, 1977.

Re Repeal of Carryover Basis—S. 2227.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: I have read with interest your comments on repeal of carryover basis in the November 22, 1977 issue of the "Congressional Record."

Since, as a matter of policy, the Trust Division of the Texas Bankers Association supports repeal of carryover basis there are a couple of minor points which I cannot find having ever been covered which I would like to call to your attention.

First of all, as I understand it, carryover basis is in the laws in order to make up the revenue loss when the Federal estate tax was removed on estates below a certain amount. The estimate of the amount of revenue to be recovered had to be based on an assumption that the assets will be ultimately sold. I cannot see where such an estimate could have any credible foundation. After all, who can really say for sure that a legatee or devisee will, in fact, dispose of an asset at a time when they are in a certain income tax bracket, let alone pinpoint the year this will actually happen.

The second point which needs to be made is that instead of carryover basis being a revenue producing measure it is actually achieving the opposite result. The increased administration costs which estates are incurring are a deduction on the Federal estate tax return. This, in turn, means less tax revenue for the government. Though simplistic, take for example an estate in the 50 percent bracket with increased administration costs directly attributable to carryover basis computations of $10,000. In this example the government loses $5,000 and the heirs lose $5,000.

Why not simply repeal the law, return to the prior law, and increase the Federal estate tax so your revenue is assured? To not do so is a guaranteed loss in revenue to the government justified by an estimate of future revenue gain via taxation of the appreciation which must be based upon a "guess" since I can think of no reliable way to make such a forecast. Guess it just depends on who reads the box car numbers.

Sincerely yours,

EDWARD A. YOPP,
Executive Director.

MCCUSH, KINGSBURY, O'CONNOR, LUDWIGSON, THOMPSON & HAYES,
Bellingham, Wash., November 15, 1977.

FINANCE COMMITTEE,
Subcommittee on Taxation and Debt Management,
U.S. Senate,
Washington, D.C.

GENTLEMEN: I am a member of the Section of Taxation of the American Bar Association, although a rather inactive one. My principal interest is in estate and gift taxes. As such, I received a copy of the Statement of the Section of Taxation and the Section of Real Property, Probate and Trust Law of the American Bar Association dated October 28, 1977, which to a considerable etent is addressed to the matter of change in or repeal of the carry-over basis portions of the Tax Reform Act of 1976.

I heartily endorse what has been said by the ABA Section.

I give you a concrete example now current in my practice.

My client died in March, 1977. He, with his wife of many years owned (free of all debt) a small but first-class dairy farm in this county. All of his property was tranferred to his wife upon his death by virtue of a Community Property Agreement, an instrument which is a creature of Washington statutory law and the effect of which is to provide for the transfer of Washington property at least without probate from the husband to the wife, or vice versa; but nothing more. Half of the community estate is subject to tax.

The entire community estate is valued at about $825,000. The principal asset is the farm, although there were substantial savings in cash and a trifle of investment in mutual funds.

This farm was acquired by this couple in five separate purchases, running from 1942 to 1956. They kept no record of the cost of the purchases and they have no records of the improvements which they built upon the properties they purchased, although the improvements were substantial, and they have no record of the depreciation taken or allowable on the properties until the last several years when their income tax returns are available and show such depreciation.

I could only guess at the cost of the original purchase of the five parcels, which together constitute the farm, by ascertaining the revenue stamps placed on the deeds at the respective time and revenue stamps often were not precise by any means.

The farm has been sold by the widow and she has the problem of computing her and the estate's capital gain, since, of course, she and the estate both conveyed their half interests in the sale.

It is absolutely impossible for anyone, no matter how learned or how well-equipped with calculators and computers, to compute capital gain under the current carry-over basis law—absolutely impossible, i.e., according to any system.

Repeal the current carry-over basis law and do it quickly.

Sincerely yours,

BURTON A. KINGSBURY.

BARNETT BANK,
Miami, Fla., November 29, 1977.

Re Repeal of carryover basis rules.
Hon. HARRY BYRD,
U.S. Senate,
Washington, D.C.

DEAR SIR: Speaking on behalf of the 115 member Trust Departments of the Florida Bankers Association, I can assure you that we fully support any proposal to repeal the hastily enacted carryover basis rules contained in the 1976 Tax Reform Act.

These rules are unduly complex, difficult to administer and, worst of all, they create an environment where amended income tax returns will become a "regular way of life" for our Nation's fiduciaries.

We urge, and fully support, any of the following remedies:

1. Total repeal of carryover basis rules and a return to prior law.
2. Defer implementation until 1979 or 1980.
3. Exempt all property acquired prior to 1977 from carryover basis rules.

Please let me know if there is anything further we can do to gather congressional support of this inordinately complex law.

Sincerely yours,

NORTON B. NICHOLS,
Chairman, Trust Division,
Florida Bankers Association.

ARLINGTON, VA., *December 2, 1977.*

Hon. HARRY BYRD,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: I am an attorney acquainted with the mechanics of commodity futures trading and actual practices in the commodity futures industry. I am also a constituent of yours.

I am writing to you to express my concern about what appear to be your views on H.R. 6715, regarding the correction of a typographical error in the Tax Reform Act of 1976. I would like to preface my remarks by saying that I greatly admire the futures industry as one of the last bastions of free enterprise and would not want to hinder its health by the imposition of unfair or discriminatory tax laws.

However I must take issue with those who oppose adding the word "agricultural" before the word "commodity" in sec. 1404(d) of P.L. 94-455 (26 U.S.C. 1222), relating to the holding period necessary for long-term capital gains treatment of futures transactions.

To explain why I feel the word "agricultural" should be added, it is necessary for me to engage in a short description of commodity futures markets, as well as the original purpose of sec. 1404(d).

Futures markets exist because they are risk-shifting mechanisms which provide for price stability for producers, middlemen and consumers of the commodities traded on them ("hedging"). At least in theory, a commodity futures contract which has no use as a hedging vehicle is illegal and will not be approved by the Commodity Futures Trading Commission ("CFTC").

Thus, makers of camera film (who need silver) might go long in the silver futures market so that binding commitments to deliver camera film in coming months will not be affected by price rises in silver; General Mills might go long in wheat, so that price rises in wheat won't force it to raise breakfast cereal prices; or an Iowa farmer might go short in corn each spring to guard against being hurt by price drops between planting and harvest. Speculation in the markets by persons with excess capital is encouraged, because without the liquidity which speculators bring to the marketplace, there could be no hedging.

All commodities trade on U.S. exchanges, whether silver, cotton, wheat, corn or even Mexican pesos, are traded in several different contracts, each contract expiring in a different month. Thus, on the Chicago Board of Trade, there are wheat contracts expiring in March, May, July, September and December of each year. The New York Commodity Exchange has silver contracts expiring in those same months each year.

The reason for exempting agricultural commodities from other capital gains in the Tax Reform Act of 1976 was not to help the futures markets, but to help keep food costs to the housewife down! The idea was that grain elevator, baking and cereal companies, and other middlemen and processors of foodstuffs who, in the normal course of their business, would hedge their future needs for agricultural commodities by going long in the market, would be able to get long-term capital gains treatment of their hedging transactions, keeping their costs of doing business lower and therefore the prices they charged for grocery store goods. (Note: since the farmer always hedges his growing crop by going short in the market, the farmer is never entitled to long-term capital gains treatment, which is accorded only to grains by those who are long in the market). However, the combination of a lack of any real risk in "spread" or "straddle" trading in certain non-agricultural commodities and the fact that the holding period for all other capital gains will be twelve months has turned this section into a haven for tax evaders.

Spread (straddle) trading consists of going long in a commodity in one contract month and simultaneously going short in the same commodity in another contract month, e.g., short December wheat and long May wheat. The chief economist of the CFTC, Dr. Mark Powers, in his book, "Getting Started in Commodity Futures Trading," explained how spread trading can be utilized to avoid paying taxes:

"For example, suppose on September 1 you have a $20,000 short-term capital gain for which you will have to pay taxes this year. You can utilize the futures market . . . to reduce this year's taxable income and defer the tax on that $20,000 short-term gain until next year—or perhaps even turn the short-term gain into a long-term gain, which would then be taxed at a lower rate.

"Here's how you might do it. On September 1 you buy two contracts of March Deutschemarks at $.35460, and immediately sell two contracts of June Deutschemarks at $.36000. When December 28 rolls around, the March Deutschemarks are at $.37460 and June's are at $.38000. Since you are long the March contracts and they've gone up, you have a gain of $20,000 (minus commissions of $100), on that side of the spread. But because the June contracts, which you sold, have increased equally in price, you have a $20,000 loss on that side of the spread. By offsetting the losing side of the spread—that is, by buying back the June contracts—you will obtain the $20,000 loss to deduct on this year's income tax. This nullifies the tax effect of the original short-term gain.

"(Of course, to the extent that the prices for the two contracts did not move up and down in unison, the gains and losses on the two sides of the spread would not exactly offset each other. It should be obvious, therefore, that in selecting a commodity for these "tax spreads" you should choose one in which there is a strong correlation between price movements in the various months.)

"By maintaining the position in the March contract until after January 1, you will carry that $20,000 gain over into the next tax year, and if you hold the contract until March 2 of that year, the profits will be long-term capital gains." Getting Started, pp. 143–144.

Which commodities are the ones with the strongest "correlation between price movements in the various months"? In the October, 1976 issue of Financial World, Dominic A. Tarantino, a partner in Price Waterhouse & Co., recommended silver as one example (see attached article). The peculiar "switch-trading" rules of Comex, which, being noncompetitive, allow tax traders to fit the correlation to their tax needs like a glove, have made silver the favorite tax spreading commodity (see attached excerpts from the CCH Commodity Futures Law Reporter, discussing a report of the CFTC's Division of Trading and Markets on Comex switch-trading and tax spreads, and a speech by CFTC Vice-Chairman John Rainbolt II). As Mr. Rainbolt noted, on December 30, 1976, "it appears that as few as 500 actual positions were taken from a volume in excess of 127000 contracts."

The typographical error in the Tax Reform Act made these tax spreads suddenly more attractive than most other shelters, and the upsurge in this activity forced the Internal Revenue Service into action. The IRS, realizing that silver futures of different months almost always move in tandem and that there was therefore no real chance of either making or losing money in a tax spread (which is really only one transaction, even though technically two market positions are taken), recently issued Rev. Ruling 77–185 (copy attached) denying favorable tax treatment to silver spreads. The futures industry has hired a former IRS

Commissioner, Sheldon Cohen, to fight this ruling in the courts. In determining whether the ruling should be upheld, the courts are sure to look at, and will probably be greatly influenced by, the progress of H.R. 6715 in working its way toward passage, for this bill is the best gauge of whether the Congress intended to create this huge loophole. The House of Representatives has already said no, and so should the Senate.

Along with Comex silver, the other widely-used commodities in tax spreads are the foreign currencies. See, e.g., Wall Street Journal, Sept. 20, 1977 (copy of front-page article attached) and In re Siegel Trading Co., Inc., CCH Comm. Fut. L. Rptr. Par. 20,452 (July 28, 1977).

Senator Byrd, I feel that the use of the tax laws to lower grocery prices is legitimate. I also think that if someone wants to take advantage of the way that Congress went about lowering food prices to reduce his own tax liability by spread trading in agricultural commodities, that is also fine. Since agricultural commodities do not always move in tandem, the way different months of Comex silver and foreign currency futures do, the agricultural spreader has a good chance of making or losing money on the spread—his losses, if any, are real, not phony.

But to allow this practice for non-agricultural commodities serves no purpose except to increase the commissions collected by the brokerage houses and to wipe out all the beneficial effects of the other sections of the Tax Reform Act of 1976. Therefore, I urge you and your committee to recommend passage of the bill by the Senate.

Sincerely,

DAVID J. KAUFMAN, *Esq.*

[From Financial World, October 1976]

TAX TOPICS

(By Dominic A. Tarantino [1])

YEAR-END TAX PLANNING WITH COMMODITY STRADDLES

Year-end review and tax planning for investments should start now. This year, because of the 1976 Tax Reform Act there are more considerations than usual.

This column deals with year-end planning using commodity straddles—a particularly effective technique where you may want to offset already recognized short-term capital gains. These are the gains which are taxed at the regular graduated rates—ranging up to 70 percent. The objective of this technique is to defer these profits to next year or, better yet, convert them to long-term capital gains.

Before going further, let's take a quick look at the Tax Reform Act. Changes have been made with regard to the holding period requirement for recognizing long-term rather than short-term capital gains. In general, the holding period for long-term gains, now more than six months, increases to more than nine months in 1977 and to more than one year in 1978. But omitted from these changes are commodity futures transactions. A long-term capital gain will still result if the futures contract is sold at a gain after a holding period of more than six months.

With that in mind we can come to commodity straddles—the simultaneous purchase and sale of two futures contracts, each in the same commodity but for delivery in different months. We can use silver futures as an example. (Don't forget the objective—to offset short-term gains already realized in 1976.) You arrange to buy July silver at $450 and sell May silver at $447. The spread between months on silver reflects the cost of carrying the commodity: interest expenses and charges for insurance and storage. This price differential usually remains fairly constant as it pertains to the contracts of two different months.

Subsequent price changes will result in a gain on one contract and a corresponding loss on the other. In December you review the straddle and find that the July contract is now $470 and the May contract is $467. Therefore, there is a profit of 20 points on the long side and a corresponding loss on the short side.

To accomplish the original objective, the short position should be closed out (covered) and the short-term capital loss recognized. Upon covering the short

[1] Mr. Tarantino is a partner in Price Waterhouse & Co. in charge of tax research and technical services in their national office. This month's column was written by John R. Walsh, Jr., a tax partner in the Seattle, Washington, office.

sale you should enter into another short sale. This is important because in a true hedging position you never want to be long in the commodity. Let's say that you sell September silver at $476; now you are still long July at $470 and short September at $476.

Moving on to 1977, at a time when the six-month holding period for the long contract is fulfilled, the contract is sold and the long-term gain realized. Let's assume that July silver is still priced at $470 and September is $476. For illustrative purposes, there has been no change in price since December—an unlikely event. Both contracts are now closed out so there's a 20-point long-term gain on the long contract and no gain or loss on the short contract.

Essentially, then, the short-term gain of 1976 which was offset by the loss on the May contract is converted to a long-term gain in 1977.

The foregoing procedure works in a rising market. In a falling market a loss occurs on the long contract and a gain is realized on the short side. Sounds OK at first, but there is a problem; you can't obtain long-term capital gain treatment on the gain realized on short sales—including short sales of futures contracts. Transactions in short contracts always result in short-term capital gains or losses. That's why when the straddle goes against you, it's best to close out both sides before the six-month holding period expires. This way the short-term gain is offset by the short-term loss.

Although it doesn't work in a declining market, a successful straddle can defer recognition of a gain to 1977 or convert this year's short-term gain into next year's long-term gain.

Competitiveness of Switch Trading on COMEX Questioned

The Division of Trading and Markets has been instructed by the Commodity Futures Trading Commission to discuss with the Commodity Exchange, Inc. the elimination of certain non-competitive practices during its special after hours switch trading sessions.

A "switch," also known as a straddle or spread, involves the simultaneous purchase of a futures contract for one delivery month and the sale of a contract of the same commodity in another delivery month.

While switch trading also takes place during regular trading hours when there are lulls in hectic trading, the Division of Trading and Markets concluded in a report to the Commission that the special switch session "does not appear to meet the standard of an open and competitive trading method."

Problems cited by the Division include one that all orders to be executed for a customer during the special session must be entered prior to the close of regular trading, while this requirement does not apply to floor brokers who may take advantage of favorable spreads that may arise during the session. Switches executed during the special session do not have to reflect the price range of switches executed during the regular trading period. The switch during the special session is often executed at a prearranged price differential. The lack of rules has led to the development of practices which readily lend themselves to unlawful activity according the Division.

Tax Straddles . . . The special session provides particular advantages to an individual seeking to establish a tax straddle or realize a tax loss, according to the report, since a trader can calculate the net result of his actions prior to entering the market.

Division Director Thomas A. Russo, stated that the report and the ensuing Commission instructive were prompted by earlier misgivings about the competitiveness of the sessions, and recent interest on the part of the Chicago Mercantile Exchange and New York Mercantile Exchange in establishing a similar trading session.

Rainbolt Discusses "Dual Trading" and "Switch Trading" With Silver Users Association

In a speech before the Silver Users Association in New York, CFTC Vice Chairman John V. Rainbolt, II said that "dual trading" and "switch trading" continue to be leading concerns of the Commission.

Mr. Rainbolt cited a lack of trust in the markets as the rationale for the recently adopted "dual trading" regulations, and noted that hearings will be held concerning the new requirements because of objetcions from the exchanges.

"Until an exchange and the CFTC can go to the trading records of a given day's trading and either confirm or refute an allegation that a broker traded ahead of his customer orders, the practices of the floor, even though it is made up of honorable people, will continue to be a problem to plague the industry and the Commission," he said.

"The Year of the Switch-Hitter" . . . Calling 1976 "the year of the switch-hitter," Mr. Rainbolt noted that after hours trading on the Comex, Inc., which a staff report recommended should be abolished as anti-competitive, was primarily used during the November-December period for straddle trading that permits the deferral of tax obligations.

"The tax implications of this activity are not the problem of the CFTC," Mr. Rainbolt noted. "However, no one could fail to look at the year-end switch-trading without asking themselves, 'Is this the way futures markets should be characterized, as a haven for the tax evader?' "

According to Mr. Rainbolt siwtch-trading averaged 30,000 to 60,000 contracts per month from January, 1975, through the summer of 1976, with the exception of the November–December period, when it averaged 140,000 transactions per month.

On December 30, 1976, some 33,000 straddles were executed during normal trading hours, an additional 30,000 contracts were executed at the special switch session after hours, and "it appears that as few as 500 actual positions were taken from a volume in excess of 127,000 contracts," Mr. Rainbolt said.

SECTION 165.—LOSSES

26 CFR 1.165–1: LOSSES

Artificial loss created to offset capital gain.—Neither a short-term captial loss created to minimize the tax consequences of an unrelated short-term capital gain through a series of transactions in silver futures contracts, which result in no real economic loss, nor the related out-of-pocket expenses incurred in connection with creating the loss are deductible under section 165(a) of the Code.

REVENUE RULE 77–185

Advice has been requested whether, under the circumstances described below, the loss from transactions in silver futures contracts is deductible under section 165(a) of the Internal Revene Code of 1954.

In order to minimize the tax consequences of a short-term capital gain of 150*x* dollars realized from the sale of real property in 1975, a taxpayer in 1975 and 1976 engaged in the following transactions involving the purchase and sale on margin of silver futures contracts:

1. On August 1, 1975, the taxpayer sold short 40 silver futures contracts for July 1976 delivery at a total contract price of 2,000*x* dollars, and simultaneously puchased 40 silver futures contracts for March 1976 delivery at a total contract price of 1,951*x* dollars.
2. On August 4, 1975 the taxpayer sold the 40 futures contracts purchased on August 1 for March 1976 delivery, at a total contract price of 1,825*x* dollars. On the same day the taxpayer purchased 40 silver futures contracts for May 1976 delivery at a total contract price of 1,851*x* dollars.
3. On February 18, 1976, the taxpayer sold the 40 futures contracts purchased on August 4, 1975 at a total contract price of 2,025*x* dollars and covered the short position established on August 1, 1975 by purchasing 40 futures contracts for July 1976 delivery at a total contract price of 2,051*x* dollars.

The commission on the closing of each transaction was 2*x* dollars. All of the transactions were entered into in accordance with the rules of the exchange and during normal trading hours.

For 1975 the taxpayer reported the following transactions:

	Dollars
Short-term gain from sale of real estate	150*x*
Less—short-term loss from sale of March 1976 silver futures (after commission)	128*x*
Net short-term gain	22*x*

For 1976 the taxpayer reported the following transactions:

Long-term gain from sale of May 1976 silver futures (after commission)	172*x*
Less—short-term loss from short sale of July 1976 silver futures (after commission)	53*x*
Net long-term gain	119*x*

The books of the taxpayer's brokerage firm showed the August 4 transaction as a debit to the taxpayer's account until it was cancelled out by the February 18, 1976 sale of the May 1976 futures contracts purchased on August 4, 1975. Because the taxpayer consistently maintained a "spread" position, the risk of the transaction was limited and therefore the margin requirement to finance the purchases and short sales of these silver futures contracts amounted to ¼th of 1 percent of the total futures contracts purchased during this series of transactions or approximately 10*x* dollars.

Issue 1. Section 165(a) of the Code provides the general rule that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c)(2) provides that individuals may deduct under section 165(a) losses incurred in any transaction entered into for profit, though not connected with a trade or business. However, section 1.165-1(b) of the Income Tax Regulations provides, in part, that for a loss to be allowable as a deduction under section 165(a), it must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable, and substance, not mere form, shall govern in determining a deductible loss.

In "Frederick R. Horne", 5 T.C. 250 (1945), a commodity broker-dealer was denied a loss on the sale of a membership in the New York Coffee and Sugar Exchange. The taxpayer had purchased Membership Number 133 in the Exchange on July 25, 1929. On November 24, 1941, he purchased Membership Number 171 in the Exchange. On December 2, 1941, the taxpayer sold Membership Number 133. The court noted that the taxpayer conceded that the purchase of the new membership and sale of the old membership were for the purpose of establishing a tax loss; that both of these transactions were component parts of a unified plan to carry out that purpose; and that the transactions enabled the taxpayer to remain a member of the Exchange without interruption. Citing *Gregory* v. *Helvering*, 293 U.S. 465 (1935), XIV-1 C.B. 193, for the proposition that an actual loss has not been sustained unless the taxpayer is poorer to the extent of the claimed loss upon conclusion of the entire transaction, the Tax Court of the United States disallowed the claimed loss on the ground that "he [Horne] stood in exactly the same position as before, except that he was out of pocket $100." The court viewed the taxpayer's temporary ownership of two membership certificates as producing no business advantage to the tapayer, as each seat on the Exchange was exactly like the other.

In *Gordon MacRae*, 34 T.C. 20 (1960), the taxpayer was denied an interest deduction on money borrowed to purchase $1,000,000 in United States Treasury Notes, because the tax Court of the United States found that the taxpayer did not purchase the notes, and did not borrow large sums of money, and did not pay any amount deductible as interest. In disallowing the deduction, the court viewed the substance of the transaction as nothing more than a series of steps taken by the taxpayer to create the deduction.

The court observed at page 27:

"The steps taken, each in itself a legitimate commercial operation, were here each mirror images, and add up to zero. The various purchases and sales, each real without the other, neutralize one another and fairly shout to the world the essential nullity of what was done. No purchase and no sale is essentially identical with what was done here, i.e., identical and virtually simultaneous purchases and sales. The choice of the more complicated and involved method of doing nothing had no purpose, save the erection of the facade upon which petitioners now seek to rely."

Under the rationale of section 1.165-1(b) of the regulations and of the *Horne* and *MacRae* decisions, the taxpayer in the instant case suffered no real economic loss in 1975. On August 1, 1975, the taxpayer had established a balanced position in silver futures contracts. After closing out the long position on August 4, 1975, the taxpayer continued a balanced position in silver contracts by immediately purchasing the 40 May 1976 contracts. After the sale and purchase of the silver futures contracts on August 4, the taxpayer was in exactly the same position as before these transactions, with the only difference being the months of delivery of the replacement contracts. Thus, the August 4 sale resulted in no real change of position in a true economic sense, and does not represent a closed and completed transaction.

Issue 2.—In 1976 when the taxpayer closed out all of the futures transactions the result was an economic loss of 9*x* dollars (128*x* dollar short-term loss from the sale of silver futures in 1975, less the 119x dollar net long-term gain on the sale of silver futures in 1976) resulting from the broker's commissions and small variations in the prices at which the futures contracts were entered into.

In the instant case, the taxpayer's dominant purpose for engaging in the above described silver futures transactions was to create an artificial short-term capital loss to offset a substantial short-term capital gain realized on the sale of real property, while insuring that no real economic effect resulted from such transactions. The taxpayer had no reasonable expectation of deriving an economic profit from the transactions.

Accordingly, neither the short-term loss of 128x dollars claimed in 1975, nor the out-of-pocket loss of 9x dollars arising in 1976 from the closing out of the silver futures contracts is deductible as a loss within the meaning of section 165(a) of the Code. See *Knetsch* v. *United States*, 348 F.2d 932 (Ct. Cl. 1965), and *Brown* v. *United States*, 396 F.2d 459 (Ct. Cl. 1968), where the Court of Claims disallowed deductions for out-of-pocket expenses incurred in transactions determined not to have economic substance.

[From the Wall Street Journal, Sept. 20, 1977]

World of the Futures Is Under Sharp Attack by Tax-Dodge Probers

COMMODITY TRADES STUDIED BY JURIES AND REGULATORS; $500 MILLION IN EVASIONS—THE SONG OF A BLIND CANARY

(By Jonathan R. Laing)

The U.S.'s commodity futures exchanges are relics of a free-wheeling, rapacious brand of capitalism that has all but vanished from the American scene. Discouraged by the complexity of their markets and the fierce individualism of their members, the government has pretty much left them alone.

That situation is changing, and drastically. Last June a federal grand jury in Chicago indicted five soybean traders on the Chicago Board of Trade, the nation's largest futures market; they were charged with a variety of criminal offenses, including tax evasion and defrauding customers through rigged trading. Other federal juries are said to be zeroing in on similar transactions in other futures markets.

"There are likely to be literally dozens and dozens of indictments of commodity traders and others growing out of these investigations over the next couple of years," predicts an official of the Commodity Futures Trading Commission (CFTC), the federal watchdog over futures trading, which has assisted in the investigations. "What we're talking about here is not just traders rigging the markets for their own profit and to the detriment of the public, but one of the biggest tax rip-offs of all time. Judging from what we've seen so far, more than $500 million in taxes have been evaded in recent years through illegal commodity trades."

A STUDY DRUMBEAT

Futures markets are also feeling heat directly from the CFTC. In its 2½ years of existence, the agency has brought a steady drumbeat of administrative actions against exchanges and traders. As a result of one such action, an administrative law judge last July levied a $100,000 fine against Siegel Trading Co., a Chicago commodity brokerage concern, and suspended it from certain kinds of commodity dealings for six months. The firm and 10 other defendants, whose cases are still pending, were accused of generating more than $2 million in phony tax losses for a customer through rigged trades in foreign-currency futures on the Chicago Merchantile Exchange.

The crackdown on futures trading is largely an outgrowth of the surge in food and commodity prices in the mid-1970s, much of which was blamed, rightly or wrongly, on futures speculation. In response to the consumer uproar, Congress created the CFTC to replace the ineffectual Commodity Exchange Authority and gave the new body more power and more money.

"It was a classic case of an industry trying to live by 1890 robber baron standards in an age of public accountability," says John Rainbolt, CFTC vice Chairman. "The exchanges are going to have to change, though, because a multibillion-dollar industry can't be allowed to continue as a private club."

THE INVISIBLE HAND

Futures are nothing more than contracts calling for delivery of a commodity at a specified future time and price. (At most, 5 percent of such contracts result in deliveries. The traders typically don't want to end up with soybeans, say, or silver; they are simply speculating on price movements.) According to futures-exchange brochures, the "invisible hand" of unfettered competition among market participants ensures that the public investor or any other trader will always obtain the best possible price for his contracts fairly reflecting the latest supply-and-demand information affecting the price of any commodity.

A somewhat different picture is emerging from the investigations. It is a picture of competition that is often severely fettered by the traders themselves. According to federal sources, the probes are turning up evidence of widespread fictitious, prearranged trading, although both federal law and the regulations of all futures markets require that all trading be done competitively and through open outcry on exchange floors.

"When you have a lot of rigged trading it can create serious price distortions that ill serve the public," says William Schief, director of the CFTC's enforcement division. "Also, fictitious trading often artificially pumps up trading volume, creating an illusion of liquidity and market breadth that can be misleading to act on."

BETTING AFTER THE RACE

Though the pattern varies, rigged-trading schemes generally work this way: One trader buys a futures contract from another and simultaneously sells it back to him at a different price. Most such deals arise from a trader's desire to creat a tax loss. Typically they occur out of earshot of other traders. The prices are preset; there is no market risk.

"It's somewhat like being able to bet with a bookie after you know the outcome of the race," one source explains. "All traders have to do is make sure that the prices they use are somewhere within the previous trading range for the commodity on that particular day."

The savings can be substantial for a high-tax-bracket trader who switches a trading profit in this fashion. The profit is switched to a taxpayer in a lower bracket, perhaps another floor traders having a bad year. Generally, the lower-bracket taxpayer kicks back part of the trading profit to his high-bracket confederate, who doesn't report the kickback as income for tax purposes.

One reason for the prevalence of rigged trades is the ease with which professional floor traders can pull them off. For one thing, commodity-exchange ticker tapes report only price changes, not individual trades. And trades for brokers' own accounts aren't time-stamped and immediately reported. Though some exchanges have begun requiring floor traders to identify the hour within which trades for their own account were made, this requirement is easy to circumvent.

The recent Board of Trade indictments illustrate some of the alleged techniques. One trader, Sam H. La Mantia, was charged with making a series of rigged trades with accounts he had set up in the names of his son, two granddaughters and mother-in-law without their knowledge, trades that were designed to generate losses in his account and profits in the relatives' accounts. Mr. La Mantia allegedly kept the profits and failed to report them on his income-tax returns.

Another trader was accused of conspiring with a customer to lose $20,000 to the latter's account. The customer, it is charged, then kicked back most of the money to the trader.

"We've also come across numerous instances of traders paying for various goods and services by setting up an account for the party owed, rigging a trade for exactly the amount of the debt, and then claiming a tax loss," says a CFTC official. "The money has gone for everything from jewelry and vacations to cars and snowmobiles. One trader even set up an account for his mistress."

SPREADS OR STRADDLES

The current investigations are being directed mainly at what appears to be an even bigger tax dodge—rigged commodity spreads, or tax straddles. These have long been a legal and widely used technique whereby professional traders defer taxes and spread their often volatile trading income over a period of years. And with the tightening of other tax shelters such as cattle feeding and real estate, more and more high-bracket taxpayers have been steered into commodity tax straddles by their lawyers and accountants.

Such spreading involves the simultaneous purchase and sale of futures in different delivery months. In other words, you buy, say, a 5,000-bushel February soybean future and sell a 5,000-bushel April soybean future. The idea behind the strategy is that whichever way the commodity ultimately moves in price, one side of the spread will end up showing a profit while the other side will show a loss, since the prices of different futures of the same commodity tend to move in tandem.

A futures deal can be closed out at any time before the delivery date. Thus, the spreader can defer taxes by taking a loss on the losing side of the spread near the end of the tax year and deducting the loss from current income. He carries over the winning side of the spread to the following year, transforming ordinary income or short-term capital gains into long-term gains, which are taxed at about half the rate. Some traders do even better than that: They boast that by engineering such tax spreads year after year, they never pay any income taxes.

To be recognized for tax purposes by the Internal Revenue Service, however, a tax spread must carry economic risk—that is, there must be potential for making or losing money apart from any tax considerations. Federal investigators claim that a number of professional traders and others have used prearranged trades to eliminate all risk from their tax spreads. They have done this, the investigators say, by rigging the closing transactions so that the gain on one side of the spread will exactly balance the loss on the other for each participant.

OIL AND SILVER

At the moment, the primary targets of the investigations into rigged tax spreading are the Chicago Mercantile Exchange's foreign-currency market, the New York Cotton Exchange's now defunct crude-oil futures market, and the silver-futures markets of the Chicago Board of Trade and of New York's Commodity Exchange Inc.

"These rigged tax straddles appear to have been going on for years, but the IRS has lacked the resources or knowledge of futures markets to ferret them out," says one CFTC enforcement official. "The amount of taxes being laundered through these trades is staggering. Interestingly, a lot of it ends up flowing to offshore Bahamian and Panamanian trusts beyond the reach of U.S. tax authorities."

The federal crackdown on futures trading had a curious beginning. It was sparked by a Chicago interior decorator who went to the CFTC in the summer of 1975 to complain that he had been swindled by two Board of Trade floor brokers. His story was tangled and kept changing, but one fact leaped out at the investigators. The traders had paid the decorator for some furniture and jewelry through a soybean trade apparently manufactured for just that purpose.

The resulting CFTC investigation proceeded in a desultory fashion until early in 1976. Then a veteran Board of Trade floor broker, Robert Meyer, who is blind, contacted the agency and, after some negotiation, agreed to cooperate. Over the next several months Mr. Meyer guided government investigators through a labyrinth of rigged trades and phony accounts in the soybean pit. His disclosures became the basis of the government's cases. In May 1976, the commission referred the cases to the Justice Department for criminal prosecution.

Why did Mr. Meyer decide to turn government witness? Sources close to him say that he was motivated by a mixture of compunction and fear of prosecution. Others think the answer is more complex. One trader who knows him well theorizes that the decision grew out of resentments arising from his blindness.

"Bob is a very proud, talented guy, and he was clearly galled by the condescension with which a lot of other traders he considered his intellectual inferiors treated him," the trader says. "He'd cover it up by laughing cynically when other brokers would throw him scraps of big orders. I think he turned canary to settle some deep psychological scores."

The most prominent of the indicted traders is Richard Groover. Virtually all the major brokerage houses funnel their public orders for distant-delivery soybean futures through Mr. Groover because he dominates the other brokers in these thinly traded futures and has a reputation for efficient execution of orders. he had a financial interest in, at prices unfavorable to the customers. Mr. Groover

The indictment charges that Mr. Groover steered customers' orders to accounts he had a financial interest, at prices unfavorable to the customers. Mr. Groover says that he has always acted "in the best interests of public investors" and that he expects to be "completely vindicated in court."

Mr. Groover's trial is expected to begin late this year. As for Mr. Meyer, a federal judge last month accepted his guilty plea to one count of violating the Commodity Exchange Act and fined him $10,000. The Board of Trade wasn't so understanding. It suspended him indefinitely.

[From the Wall Street Journal, Nov. 29, 1977]

"STRADDLERS" STILL ACTIVELY TRADING DESPITE MOVES TO CURB THE PRACTICE

(By Shirley A. Jackewicz)

The government is making it harder to "straddle" a commodity market usefully, but that doesn't seem to be deterring traders, especially in the lively silver futures market.

Straddling is a practice that can help reduce an investor's income-tax liability. It consists of simultaneously buying and selling futures contracts of a given commodity for different delivery months. If prices move significantly, one or the other transaction is likely to show a loss that can be used to offset previous capital gains. That loss can be made up through another futures contract maturing in another tax year.

Last May, the Internal Revenue Service ruled that taxpayers can't use straddle trades in commodity markets to create short-term losses solely for the purpose of offsetting capital gains made elsewhere. Apparently, the IRS also wants to be convinced that there is a degree of economic risk involved in a straddle, not just a near-guaranteed loss, but this issue still is unclear, specialists say.

The Commodity Futures Trading Commission also is concerned about straddle trading, but neither agency's activities appear to be affecting the level of such trading. "Traders apparently are expecting some successful court fights," says one New York analyst.

COMMODITY INDEXES

	Close	Net change	Year ago
Dow Jones futures	325.34	−3.03	351.56
Dow Jones spot	351.59	−4.32	351.41
Reuter United Kingdom	1,497.5	+7.1	1,550.2

Straddle traders are attracted especially to the silver market, because prices there often move sharply, without much change in the difference between the quotes for the two delivery dates involved in the operation. This, analysts note, helps the traders achieve their tax-saving ends more easily.

Recently, there has been a flurry of silver straddling. On the Monday before Thanksgiving, for example, silver futures prices on the Commodity Exchange Inc., or Comex, in New York fluctuated within a 13-cent-an-ounce range, giving plenty of scope for traders to post sizable losses.

Indeed, straddle trades accounted for more than 89 percent of the 39,832 contracts that changed hands that day, an unusually large number, the Comex reported. What's more, the volume of straddle trading was such that the exchange extended trading for several hours beyond its usual 2:15 p.m. EST official closing time, a step it rarely takes.

The comparatively wide price fluctuation that day "enabled traders to achieve the loss they needed in one day," says one New York trader.

The recent buildup in straddles trading is accelerating at about the same pace as in previous late-year months, when it generally has accounted for about three-quarters of daily silver-trading volume, analysts say.

What's remarkable, they add, is that the trading hasn't been affected by government moves to tighten up on some of the circumstances in which straddles can be used for tax purposes. Besides the IRS, the Commodity Futures Trading Commission is looking into the practice. It noted in a staff report earlier this year that after-hours straddle trading on Comex is "inconsistent with the concept of competitive trading."

According to a CFTC spokesman, the agency's division of trading and markets has drawn up a proposed set of regulations governing straddle trading. These are scheduled to be reviewed by the commission itself within the next few weeks, he adds.

Yet another body—a federal grand jury—is investigating silver straddle trades, but traders' attraction to the practice continues, analysts note.

ST. PETERSBURG, FLA., *November 21, 1977.*

Hon. HARRY FLOOD BYRD, Jr.,
Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: I was delighted to read in the Wall Street Journal of your interest in repealing the carry-over basis rule adopted in the Tax Reform Act of 1976.

While that Act has some constructive features, the so-called carry-over basis rule looks like a "war on widows". For example:

1. To comply with the law and produce dates and records of costs of purchases by a deceased person over many years imposes a great burden on elderly survivors. Few of them can locate such records. Trying to solve the problem creates excessive worry and unreasonable expenses.
2. If a husband acquired a home for $15,000.00 or $20,000.00 forty or fifty years ago and bequeaths it to his widow, and if the home is now priced at several times that in inflated money, when she sells it after his death, her income is taxed on a so-called "gain" above the $15,000.00 or $20,000.00. Thus she loses much of the sales proceeds at the time she needs it when moving into a retirement facility.

I hope that you and your realistic associates will be successful in repealing the carry-over basis rule.

I have engaged in work relating to estates of decedents and their families since 1926 and consider the carry-over basis rule as the worst piece of legislation that has ever come to my attention. It is impractical and totally unfair to many older surviving widows and widowers.

With best wishes, I am

Yours very truly,

THOMAS T. DUNN,
Attorney at Law.

CALMAR, IOWA, *November 12, 1977.*

CHAIRMAN,
U.S. Senate Finance Subcommittee on Tax and Debt Management, U.S. Senate, Washington, D.C.

DEAR SIR: I thoroughly agree with the Iowa State Bar Association and the American Farm Bureau in urging repeal of the carry-over basis provision of the Tax Reform Act of 1976.

It is unworkable. If it remains, as the years go by, virtually no estate or heirs will sell real estate because the resulting income tax will be prohibitive. Land values will consequently further skyrocket and it will be impossible for a young man to buy and start his own operation.

Very truly yours

CARL NYSTROM,
Attorney at Law.

ATLANTA, GA., *November 18, 1977.*

Hon. HARRY F. BYRD, Jr.,
U.S. Senator, Washington, D.C.

DEAR SENATOR BYRD: Stories in the press recently have reported that you and some of your associates are in favor of eliminating or modifying certain portions of the 1976 Tax Act adopted by our Congress. More specifically these reports indicate that you favor either eliminating or modifying the carry over basis provisions of the Act.

On June 7, I wrote to The Honorable Mr. Albert C. Ullman in regard to some phases of the 1976 Tax Act. I enclose a copy of that letter. I received a courteous but uninformative reply.

It is the opinion of the lawyers I have talked with that the carry over basis provisions of the 1976 Act result in imposing an income tax on any gain in the use of the so-called "flower bonds" in the payment of estate taxes. These bonds have been purchased by many people who are willing to accept a very low rate of interest in the belief that the difference between the price they paid and the value of the bonds for estate tax purposes would be free of income taxes and would make up for the substantial loss these purchasers have taken in accepting the low rate of interest. These bonds have been purchased from the Government of the United States through the Federal Reserve System.

It is my conviction that this provision of the 1976 Tax Act amounts to an outright repudiation by the Government of the United States of its promise to the buyers of these bonds. I hope you may be able to agree with my position on this matter. It is, I think, one of the outstanding reasons why the carry over basis provisions should be eliminated or modified.

I am also of the opinion that the provision in that Tax Act which permits the gift, tax free, of $100,000 by one spouse to another spouse is a trap into which unwary taxpayers may fall. In my letter to Mr. Ullman I explained the reasons for my thinking in this connection.

I shall appreciate it if you can take the time and trouble to examine into the points have raised.

Very truly yours,

POPE F. BROCK.

Enclosure.

ATLANTA, GA., *June 7, 1977.*

Mr. ALBERT C. ULLMAN,
Member of Congress,
Washington, D.C.

DEAR MR. ULLMAN: The Kiplinger Tax Letter of May 13 reports that your Committee is planning a large number of amendments to the Tax Act of 1976. There certainly is ample justification for such action.

I have been in the active practice of the law for 64 years and have had experience in a wide variety of legal problems, including taxation. The Tax Act of 1976 is the most confused, uncertain and ambiguous statute I have ever read. I would guess it would cost the American tax payers a billion dollars a year in legal and accounting fees to find out just how much tax they legally owe the government.

I wish to urge you to consider a change in two of the provisions of the 1976 Act. One of the provisions permits a spouse to give the other spouse $100,000 free of tax. Obviously, this was intended as a beneficial provision. In another part of the statute it is provided that if the donor dies within three years the gift is added back to the donor's estate and taxed as a part of it. Take the situation of a man who has an estate of a half million dollars, who plans to leave one-half of it to his wife as a marital deduction. If he does this by his will that one-half of his estate is not taxed to his estate. However, if he is imprudent enough to give his wife $100,000, relying on the Act, and is imprudent enough to die within three years, his estate is stuck for the tax on the $100,000 and he has clearly lost the advantage his estate would enjoy if he left the money to his wife by will.

I cannot believe that your Committee deliberately intended such a strange result. I urge you to amend the Act so that the $100,000 tax free gift will not be added back to the estate of the donor, or if you are unwilling to do this, then repeal the provision allowing the $100,000 gift tax free, thus protecting the tax payer from what could be a costly trap for him.

Another provision of the 1976 Act has left on me the worst sort of impression of my government. The United States Treasury has been selling what are known as "flower" bonds with the specific promise that they will be accepted at face amount for the payment of estate taxes. The 1976 Act has now imposed a capital gains tax on the difference between what was paid for the bonds and the amount they are received at in the payment of estate taxes. In addition, many, if not all, of the purchasers of these bonds will get stuck for a minimum tax.

As soon as the market realized what the 1976 Act does these bonds fell from around $83 or $84 to $72 or $73. This is a direct result of the tax take from these bonds. Take the 3½ percent bonds due February 15, 1990. They were selling from $83 to $84 a hundred and people were buying them mostly believing that their estate would have the margin between that price and $100 as additional income. The most witless man would not buy 3½ percent bonds that would give him a return of only a little more than 4 percent on the purchase price when he could buy at the same time long term treasury bonds paying at least 8 percent except for the promise to accept them at face value for estate taxes. These buyers were induced to buy because of the promise of the government that the difference between what they paid and what they could be used for in paying estate taxes would be available to them and would make up the loss of income which they accepted in buying these bonds.

I do not argue with you as to whether as a matter of principle the difference between the purchase price of these bonds and the price they are received for estate taxes should be taxed. What I am saying is that it is just plain crooked on the part of the government to induce people to buy these bonds with a promise which the Tax Act of 1976 deliberately repudiates.

If you would amend the 1976 Act so as to make it applicable to all who purchased these bonds after the enactment of the Act no one can quarrel with you on moral principles, but to make the Act applicable to purchases made prior to the adoption of the Act is simply to spring a trap for people who have relied on the good faith of our government. Everyone who has any of these bonds now has already suffered a loss equal to approximately 12 percent of his capital investment if he should find it necessary to use the bonds in his lifetime. If he leaves the bonds to pay estate taxes the government will not fulfill its promises to receive them at 100 percent on the dollar. As a matter of form it will, of course, but as a matter of substance it will receive the bonds for estate tax purposes at one hundred cents on the dollar only after a capital gains tax has been paid and in all likelihood a minimum tax as well.

Frankly, I do not think you intended the result which the 1976 Act produces in respect to the flower bonds. My impression is that Act is so extensive and so complicated that perhaps nobody in congress understood many of its provisions. On the other hand, if it was done deliberately and with knowledge of its effects then it is a shocking business. When the government of a country turns crooked that society is on the road to disaster.

Very truly yours,

POPE F. BROCK,

OLWINE, CONNELLY, CHASE, O'DONNELL & WEYHER,
New York, N.Y., November 16, 1977.

Re H.R. 6715, section 2(t) (2) (C).

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The 1976 Tax Reform Act made a number of changes to Section 904 of the Code intended to curtail the use of capital gains for increasing the limitation on the allowable foreign tax credit. One of these treated the gain on a corporation's sale of stock of a second corporation as U.S. income unless (1) the stock is sold in a country in which the second corporation derived more than 50 percent of its gross income for the immediately preceding three-year period or (2) the foreign country in which the sale occurred taxes the gain at a rate of 10 percent or more. Code Section 904(b) (3) (C) (ii). The Senate Finance Committee report stated:

"The purpose of this rule is to prevent taxpayers from selling their assets abroad primarily to utilize any excess foreign tax credits which they may have available from other activities."

Section 2(t) (2) (C) of H.R. 6715 evidences Congressional recognition that the 1976 change was overkill and would disqualify transactions motivated by sound business considerations rather than by United States tax avoidance. We think that the proposed relief provision should be expanded slightly.

The Philippines imposes a 35 percent withholding tax on capital gains. A U.S. owner's gain on sale of its Philippine subsidiary, therefore, would attract a heavy Philippine tax and no U.S. tax, while the sale of the same foreign subsidiary in another foreign country might attract no foreign tax but a substantial U.S. tax. (A treaty between the U.S. and the Philippines negating this result has been signed but is not yet in effect.) Yet the 1976 amendment would have the incongruous effect of forcing a taxpayer to incur excessive Philippine taxes, wiping out any U.S. tax obligation, in order to escape the penalty (reduction of otherwise-allowable foreign tax credits) imposed if the taxpayer prudently sells outside the Philippines, thereby incurring a substantial U.S. tax obligation.

The taxpayer is caught in the middle. He loses either way. He loses because the 1976 amendment didn't anticipate either (1) that the Philippine capital gains rate would be higher than ours or (2) that there aren't any lower-rate countries where it makes sense to sell a Philippine subsidiary to a Philippine purchaser. (We understand that the 10 percent minimum tax rate was picked out of the air.)

Equity can be done and the U.S. revenues fully protected by the other new limitations upon foreign capital gain if Section 2(t)(2)(C) of H.R. 6715 is amended to add the sale of a foreign subsidiary which does its business outside the United States. Our suggested modification of this provision is attached, and we hope that it will be given favorable consideration by the Finance Committee.

We look forward to discussing this with you.

With best wishes.

Sincerely yours,

DONALD C. ALEXANDER.

Enclosure.

(C) *Source rule for liquidations of certain foreign corporations and sales of stock of certain foreign subsidiaries.*—Paragraph (3) of section 904(b) (relating to source rules for gain from the sale of certain personal property) is amended by redesignating subparagraph (D) as subparagraph (E), and by inserting after subparagraph (C) the following new subparagraph:

"(D) *Gain from liquidation of certain foreign corporations and gain from sale of stock of certain foreign subsidiaries.*—Subparagraph (C) shall not apply with respect to a distribution in liquidation of a foreign corporation to which part II of subchapter C applies or the gain from the sale of at least 80 percent of all classes of stock of a foreign corporation, if such corporation derived less than 50 percent of its gross income from sources within the United States for the 3-year period ending with the close of such corporation's taxable year immediately preceding the year during which the distribution occurred."

(D) *Effective date.*—The amendments made by this paragraph shall apply to taxable years beginning after December 31, 1975.

THE UNIVERSITY OF NORTH CAROLINA,
Greensboro, N.C., November 16, 1977.

Hon. HARRY BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: As a college professor of taxation, a practicing attorney and, formerly, a practicing CPA, I have discovered the "carry-over basis" provisions of the recently enacted 1976 Tax Reform Act to be among the most exasperating and difficult-to-apply of all I have ever experienced. Talk around local courthouses easily confirms my own reactions. Attorneys meet, discuss, argue and walk away no more certain of the law than they were before seeking assistance. Many attorneys are now simply refusing to handle small and medium-sized estates because the statutes are totally beyond their desire to even attempt to cope with them. The result, of course, will be to produce new tax attorneys and accountants whose higher fees will correspondingly reflect their specialty.

There is no question in my mind that the new provisions will have several profound effects. First, the cost of handling estates will certainly rise, decreasing both the amounts eventually reaching the heirs of an estate and the tax revenues based upon those amounts. Secondly, the government's administrative cost in attempting to assure compliance will probably offset any additional taxes that may result (not to mention that estate tax rates were substantially increased). Thirdly, these new provisions will prove to be a constant source of disagreement and litigation in much the same way the "contemplation of death" issue was before the 1976 Act resolved that issue.

Perhaps the basic issue is whether complicated rules and procedures are necessary to produce or are, in fact, going to produce a better and more equitable system of taxation. I would submit that they will not, and I will also suggest that Congressional adherence to such a policy will only serve to alienate both the professional community and the public from their government.

Please give the various new curative proposed legislation your careful consideration.

Thank you for your public dedication and service.

Very truly yours,

DAVID B. POST,
Assistant Professor.

WILMINGTON TRUST,
Wilmington, Del., November 1, 1977.

Re S. 1954, S. 2227 and S. 2228.

Mr. MICHAEL STERN,
Staff Director, Commitee on Finance, Room 2227 Dirksen Office Building, Washington, D.C.

DEAR MR. STERN: Pursuant to the October 20, 1977 press release of Chairman Byrd of the Subcommittee on Taxation and Debt Management, Senate Finance Committee, regarding S. 1954, S. 2227 and S. 2228, the following are my comments regarding those Bills:

First, due to the very important technical corrections contained in the Technical Corrections Act (H.R. 6715) I feel very strongly that any changes in the carryover basis law should be handled in legislation separate from the Technical Corrections Act. Many, many errors were contained in the 1976 Tax Reform Act (P.L. 94-455) and, in numerous situations, taxpayers need the clarifications provided by the Technical Corrections Act as quickly as possible and, hopefully, by the end of this calendar year.

However, I also feel very strongly that the present carryover basis provisions of the Internal Revenue Code are too complex and costly for taxpayers to be able to adhere to. Consequently, I would strongly support S. 1954, but if repeal of carryover basis is not politically viable this year, I feel that S. 2227 must be enacted in order to provide time for Congress to further consider this very difficult area. I feel that S. 2228 does not provide sufficient relief for taxpayers.

Very truly yours,

HAROLD F. MEASLEY, Jr.,
Tax Counsel.

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